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# Guideline impact analysis statement

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Title	Earthquake Exposure Sound Practices - Guideline impact analysis statement (2013)
Category	Prudential Limits and Restrictions
Date	February 28, 2013
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## I. Background

Catastrophic losses from exposure to earthquakes may pose a significant threat to the financial well-being of many Property & Casualty (P&C) insurers and reinsurers (insurers). As such, insurers must effectively measure, monitor and limit their exposures in accordance with a prudent risk appetite and risk tolerance.



In particular, the complexities associated with managing earthquake exposures, combined with the potential severity of losses, the difficulty of mitigating the risk post event, and the impact of a major earthquake on the public, require insurers to have comprehensive policies and procedures in place, along with an appropriate level of oversight, to ensure they are effective.

## II. Problem Identification

The existing version of Guideline B-9 was issued in May 1998, and needs to be brought up-to-date in the following areas:

1. The principle-based guidance may be overlooked or misunderstood by insurers because the current manner of presentation and content of the principles are presented as secondary to the capital calculation, and some of the wording is not as clear as that reflected in more recent guidelines (e.g. Guideline B-3);
2. The Default Loss Estimates (DLEs) in Appendix 2 are out of date, difficult to use because of changes in CRESTA zone (groupings of postal codes) definitions and may no longer be considered conservative due to changes in earthquake modelling and the underlying science that have occurred over the last 15 years;
3. Best practices developed in the last 15 years in the use of earthquake models and in mitigating the risks associated with using models, need to be reflected in the guideline;
4. As earthquake exposure measurement evolves, collection of appropriate earthquake-related data is hampered by the inclusion in the guideline of a specified format for collection of data; and
5. The capital component of the guideline could become misaligned with the Minimum Capital Test (MCT) guideline, which is a separate document.

## III. Objectives

The updated guideline is intended to:

1. Emphasize and strengthen the principles-based approach to managing earthquake exposure;
2. Remove references to outdated Default Loss Estimates;
3. Update the description of best practices in earthquake exposure management;
4. Increase OSFI's flexibility in the collection of relevant data; and
5. Remove the details of the capital formula from the guideline and insert the updated capital formula in the MCT guideline.

## IV Options and Assessment

### Option 1 - Status Quo

Although the current version of the Guideline has served the industry and OSFI well in the past 15 years, it is out of date in several respects and could provide greater clarity, as noted above under Problem Identification. OSFI would be uncomfortable allowing the gaps identified in the current guideline to remain, given the importance of risk management in supporting a safe and sound Canadian financial system.

### Option 2 – Repeal Current Guideline

Although repealing the guideline would provide insurers with operational flexibility and reduce regulatory burden, this would increase risks in the financial system and not be in the best interests of policyholders.

### Option 3 – Revise the Guideline

While this option would entail a small cost to OSFI to update the guideline, a revised guideline would:

- enhance insurers' management of earthquake exposure;
- reflect up-to-date modeling practices and the underlying science;
- improve earthquake-related data collection; and

- provide for alignment of this guideline's capital component with MCT guideline.

## V. Consultations

An OSFI-IBC Earthquake Working Group was formed in August 2010 and included representatives of the Autorité des marchés financiers (AMF) and Financial Institutions Commission (FICOM), as well as insurers, reinsurers and reinsurance brokers. Participants provided input to an initial revised draft, subsequently discussed with the working group at meetings held in February, March and June 2012. The Canadian Institute of Actuaries (CIA) and the Reinsurance Research Council (RRC) also provided input to the revised draft.

OSFI issued a draft revised version of Guideline B-9 for comment during August and September 2012. Comments provided were reviewed and incorporated into a final version, as appropriate. A summary of public comments received and an explanation of how they were dealt with in the final guideline are included in Appendix B to the cover letter.

## VI. Recommendations

Option 3 addresses all of the objectives outlined above and is the most effective means of ensuring that federally registered insurers in Canada are following up-to-date and robust risk management practices to limit their loss exposure to earthquakes.

## VII. Implementation & Evaluation

All insurers are asked to complete a self-assessment of their practices compared with this guideline by September 30, 2013. Each insurer's board (or chief agent, as applicable) should review and discuss the self-assessment, together with the earthquake exposure risk management policy, prior to January 1, 2014. When a self-assessment identifies potential gaps, a plan appropriate to the insurer to respond to the gaps should be developed and presented with the self-assessment.

Each insurer should keep their OSFI Relationship Manager up-to-date on their progress on the above items, and provide the self-assessment and implementation plan on request. Each insurer should also file an approved copy of its earthquake exposure risk management policy with its designated OSFI Relationship Manager prior to January 1, 2014.

OSFI will continue to assess institutions' Earthquake policies and procedures as part of the supervisory review process.