Guideline

Subject: Inter-Segment Notes for Life Insurance Companies

Category: Sound Business and Financial Practices

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Introduction

This guideline establishes OSFI's expectations for the operation of inter-segment note (Note) programs by federally regulated life insurance companies and fraternal benefit societies. OSFI believes it essential for any Note program to incorporate the elements outlined in this guideline.

The revised Guideline is effective for fiscal years beginning on or after January 1, 2011.

OSFI recognizes the potential benefits of Notes; however, their use may expose companies to increased levels of operational risk. Given that notes are internal to a company, they do not have the formal structure and market discipline of publicly traded bonds. The integrity of the valuation of policy liabilities under the Canadian Asset Liability Method (CALM) valuation methodology is highly dependent on the asset and liability cash flows, including those from any Notes. It is expected that if a Note program is used, it will be formally incorporated into a company's investment policy framework.

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Rationale for the Use of Inter-Segment Notes

Life Insurance companies generally segment their assets in order to match them with particular blocks of liabilities. This reflects the need for asset/liability management, risk measurement, internal management reporting, and the need to meet regulatory reporting requirements and regulatory and professional standards that require the use of the CALM.

However, there are circumstances under which combining some of the asset or liability cash flows of two distinct blocks of business could result in either:

(i) a better matching of cash flows in aggregate, resulting in a reduction in interest mismatch risk under the CALM valuation method that would be reflected in lower total policy liabilities, or

(ii) a source of immediate cash funding from one block of business to another, using future product cash flows to repay the borrowing.[1]

Notes are a means of reducing interest rate mismatch risk through the sale of future asset or product cash flows of currently in-force policies from one product segment to another product segment.[2] For example, some of this management of interest rate mismatching could be done using interest rate swaps with banks. However, this would result in additional transaction costs and would introduce a counterparty risk.

Definitions

A **segment** is created when a block of assets is separately earmarked and tracked, on a real or allocated basis, to back a particular block of liabilities and/or surplus.

An **asset or liability cash flow** is any future cash flow used in the valuation of policy liabilities under the CALM valuation methodology. Such future cash flows could originate from assets, loans, policy premiums, fees, expenses or payments to policyholders.

1 For example, a new product segment may have initial acquisition expenses that must be settled in cash, but its offsetting income is in the form of future premium or fee margins. The funding to pay the current cash expenses could be obtained selling a Note that will be repaid by some of the future margins.

2 For example, a life insurance business segment will pay benefits in the distant future. However, in the early years there are only small amounts of net cash flow that can be invested to match this long benefit duration. When interest rates fluctuate, the business line is subject to significant amounts of interest rate risk. The life insurance line may use Notes as a method to sell its future anticipated excess cash flows in years 3 through 5 to an annuity business segment. In isolation, the annuity product line would invest in short term assets. The annuity line can use the Notes to back deferred annuities maturing in those years and, thus, still be matched. The cash paid by the annuity line can be used by the life insurance business segment to purchase long-duration strip bonds to back benefits payable in 20+ years. In total, the interest rate risk has been mitigated through the use of Notes.

An **Inter-Segment Note** is created when one product segment of a life insurance company buys/sells asset or liability cash flows used in the valuation of policy liabilities under the CALM valuation method from/to another product segment in the form of a note promising specific future payments. Notes are internal equivalents to bonds or loans entered into with external parties.

The **selling product segment** is the one that sells a Note representing future cash flows to another product segment. In return, it receives cash or other assets immediately.

The **buying product segment** is the one that buys a Note and, in exchange, pays cash or other assets to the selling product segment.

The International Financial Reporting Standard (IFRS) for insurance contracts, IFRS 4, includes definitions and guidance for classifying contracts as **insurance or non insurance contracts (i.e. investment or service contracts)**. Companies should apply this Guideline consistent with the contract classification determinations made under IFRS 4.

Restrictions on Inter-Segment Loan Activities[3]

The CALM valuation methodology, which is the Canadian Institute of Actuaries' standard for the valuation of insurance contract liabilities, requires the use of asset and liability cash flows. If the valuation of a product segment uses any cash flows from another product segment that has a separate valuation, OSFI considers these cash flows to be Notes and, therefore, subject to this Guideline.

The integrity of the valuation of insurance contract liabilities under the CALM valuation methodology is highly dependent on the asset and liability cash flows, including those from any Notes. Given that notes are internal to a life insurance company, they do not have the formal structure and market discipline inherent to publicly traded bonds or loans. This can result in higher levels of operational risk.

In order to address operational risk issues, a company is expected to formally adopt a policy on Notes before implementing a Note program. A Note policy would include the implementation of an appropriate infrastructure of procedures and controls to properly administer the Notes and to be compliant with the expectations outlined in this Guideline.

Where Notes are used, all future cash flows resulting from the Notes should be recognized in the valuation of the insurance contract liabilities by both the selling product segment and the buying product segment.

[3] OSFI's expectations regarding Notes, as outlined in this Guideline, do not apply in the case of:
- Short-term (90 days or less) non-renewable loans between segments that are made solely for short-term cash management purposes;
- Notional allocations of capital from a surplus segment to surplus within product segments; and
- Any internal or inter-company loans whose cash flows are not used in the valuation of policy liabilities.

OSFI expects that Notes will only be based on the future cash flows related to existing in-force policies. They should not include expected future cash flows related to future sales.

Notes are expected to be used only as an interest rate risk mitigation tool or as a cash funding arrangement, and **not** for speculative purposes. Further, Notes should **not** be used for short-term cash flow management.

OSFI will review Note activity as part of its supervisory responsibilities and through the Appointed Actuary's Report.

Structure, Documentation and Operational Requirements

Life insurance companies are expected to clearly document the structure of a Note program and to clearly document the protocols that will be used to manage the Notes. It is expected that a Note program will be formally incorporated into the company's investment policy framework. The Note program is expected to be subject to the same levels of controls as the company applies to external bond investments.

It is expected that the documentation will:

- describe the intended purpose of the Notes and how they fit into the company's overall asset/liability matching strategy;
- specify any limitations on the size, number, structure or term of the Notes;
- describe the protocol and procedures for creating a Note, who can initiate it, who must approve it, and who has oversight responsibilities. Such procedures should be consistent with the framework governing external bond assets; and,
- describe the rights and obligations of the buying and selling product segments with respect to each Note, including the process to follow should either the buying or selling segment need to unwind a Note.

It is expected that Notes will be subject to the same level of scrutiny by the company's internal and external auditors as is followed in auditing externally sourced bonds.

Limitations and Restrictions

OSFI expects that the following rules will apply to the use of Notes:

- Notes sold by a surplus segment to any product segment are prohibited. This is to prevent the possibility of not recognizing a mismatch risk with the surplus. However, Notes sold by a product segment to surplus for immediate cash in exchange for future cash flows is acceptable.
- Notes between general fund product segments and segregated funds are prohibited. However, it is allowable to have Notes involving the general fund insurance contract liabilities associated with segregated fund products.

- Notes to or from non-insurance contract (i.e. investment contract or service contract) segments are prohibited. The liabilities for these contract types are not valued using CALM, so there are no requirements to recognize mismatch risks within the liabilities.
- Notes between product segments and holding companies, parent companies, subsidiaries or affiliates of the insurer are prohibited, except where permitted by other OSFI Guidelines or Regulations. For example, refer to Guideline E-6 *Materiality Criteria for Related Party Transactions* and Part XI of the *Insurance Companies Act* for further details. Notes between foreign subsidiaries are permitted to the extent that such Notes do not cross national jurisdictions, that such subsidiaries are subject to the rules of the same local regulator and where the use of such Notes does not contravene local regulations.
- Notes between insurance segments that are domiciled in separate national jurisdictions are prohibited. For example, Notes are not permitted between a product segment backing Canadian liabilities and a product segment in a U.S. branch. Similarly, Notes are not permitted between two foreign branches of a Canadian company.
- If a product segment contains both assets backing the insurance contract liabilities and assets that represent surplus or are backing non-insurance contracts, all the cash flows, in their entirety, represented by the Notes must be cash flows that are used in the valuation of the insurance contract liabilities under the CALM valuation method. This should be the case in both the selling and the buying product segments.
- Notes are expected to be in the form of bonds; either periodic coupon payment or zero-coupon. Similar to bonds, the Notes must have a fixed maturity date. The maturity date may not be longer than what is commonly and readily available externally in the market place, but in any case, no longer than 30 years.
- The size of each Note is expected to be consistent with the company's investment policy on the size of external bonds purchased.
- The total value of the Notes bought by a product segment must not exceed 25% of the total assets in the segment. Notes are to represent a fine-tuning of the asset/liability matching, and not a predominant asset category in its own right.
- For Canadian life insurance companies and fraternal benefit societies, the aggregate of all Notes in effect at any time is limited to 100% of the company's consolidated total available capital, as defined for the purpose of calculating the Life Insurance Capital Adequacy Test (LICAT).
- For Canadian branches of foreign life insurance companies and foreign fraternal benefit societies, the aggregate of all Notes in effect at any time is limited to 20% of net assets available, as defined for the purposes of calculating the Life Insurance Margin Adequacy Test (LIMAT).

Pricing of Inter-Segment Notes

Notes should be used to improve asset/liability matching by sharing cash flows between product segments or to provide a cash funding mechanism between product segments. Notes should not be used as a way for one segment to subsidize another through transfer pricing arrangements. Each product segment should be self-supporting and the Note should not put either segment at a disadvantage.

Notes should be fairly priced at currently prevailing market rates, with the price being fair to both the buying and selling segment to avoid any transfer pricing concerns.

The conditions and the pricing of the Notes should be consistent with the investment policy of the buying segment.[4]

Since Notes cannot default, the best estimate expected default assumption used in the actuarial valuation should be deducted to give a default-free pricing rate for a Note. Appropriate asset default assumptions are needed in the product segment that uses proceeds from selling a Note to invest in external assets.

The selling product segment is expected to invest the cash or other assets received from the sale of the Notes in accordance with its own investment policy.

It is expected that any Note program will include a requirement to inform the Appointed Actuary in advance of any new Note being initiated. This notice is expected to include the terms of the new Note. The Appointed Actuary, and at least one of the Chief Financial Officer or the Chief Risk Officer, are expected to give approval in writing before the Note is implemented.

Although no specific guidance is given here on how to determine the price, the Note program documentation is expected to detail the pricing methodology that will be consistently applied to all the company's Notes.

Unwinding of Inter-Segment Notes

Since circumstances change over time, it may be necessary, or advisable, to unwind an existing Note. The circumstances under which a Note can be unwound should be documented in the protocols that govern the Note program.

Any unwinding of Notes is expected to be done based on the then current market values of the notes.

[4] For instance, if the buying product segment has an investment policy to hold a 5-year AA corporate bond as a good match for its liabilities, the Note should be based on the current rate for a 5-year AA corporate bond in the market.

It is expected that any Note program will include a requirement to notify the Appointed Actuary, and at least one of the Chief Financial Officer or the Chief Risk Officer, in advance of any unwinding of an existing Note and that this notice must include the terms of the unwinding. The Appointed Actuary, and at least one of the Chief Financial Officer or the Chief Risk Officer, are expected to give approval in writing before the Note is terminated.

Oversight, Record Keeping and Reporting

It is expected that Notes will be tracked and reported separately in each asset segment.

The buying product segment should show them as positive assets and the selling product segment should show them as negative assets. The accounting function in the company should ensure that all Notes are netted and eliminated when preparing the financial statements of the company.

Ongoing management of Notes and their reporting to appropriate levels of management is expected to be at least as rigorous and frequent as the reporting for other asset classes.

The accounting of Notes should include the calculation and reporting of accrued interest to the same standards as is used for external marketable bonds.

A current inventory of all Notes should be maintained at all times and be available to the appropriate investment managers, external auditors, the Appointed Actuary, the Chief Financial Officer, the Chief Risk Officer and OSFI. This should include the segments involved, the structure of the notes, the maturity values, maturity dates, issue prices (and yield rates), issue dates, current values (and yield rates), and current date.

Actuarial Requirements

For actuarial valuation purposes, the Notes are assets of the buying product segment and negative assets of the selling product segment.

The appropriate cash flows from the Notes should be fully included in the CALM cash flow assumptions of both the buying product segment and the selling product segment.

The company is therefore expected to maintain a CALM valuation system that incorporates all the cash flows from all Notes. This system should be sensitive to the impact of interest-rate changes, death, and lapse on the cash flows.

Given that Notes are default-free to the buyer, this feature should be reflected in the CALM valuation of the insurance contract liabilities of the buying product segment.

Since the Notes are internal transactions of the company, there is no direct impact on LICAT or LIMAT.

Where Notes affect any participating accounts, the Appointed Actuary is expected to opine that the fair treatment of participating policyholders is maintained.

The stress testing and scenario testing performed during the Financial Condition Testing process should consider the impact of adverse experience on cash flows supporting the Notes in a manner consistent with the testing of the sensitivities of other cash flows.

As part of the data verification process, the Appointed Actuary should ensure that the cash flows of each Note are correct, that each is accounted for and included in the valuation, and that each is counted only once.

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