

**Solvency Modernization Initiative
Country Comparison Analysis
November 2009**

(Note: Portions excerpted directly from OSFI materials.)

Country: Canada

1. Background Description

Insurance is regulated at the provincial and federal level. Provincial regulators are primarily concerned with licensing of brokers, insurance rates and policy contents. In some cases, the provincial regulators also regulate insurers for solvency. However, most insurers are federally registered, and as such are regulated for solvency purposes by the Office of the Superintendent of Financial Institutions (OSFI). OSFI is an independent agency of the Government of Canada established in 1987; and it supervises and regulates federally registered banks, insurers, trust and loan companies; and private pension plans subject to federal oversight.

There are approximately 100 life and 200 property & casualty insurers in Canada at the present time.

In 2000, the Canadian Council of Insurance Regulators was formed. The purpose and role of this organization is similar to that of the NAIC. That is, this organization's mandate is to work with all financial service regulators to promote more efficiency and uniformity in Canada's regulatory framework.

2. Solvency Regulation Description

In 1999 OSFI adopted a new supervisory framework, and the objective of this framework is, "to provide an effective process to assess the safety and soundness of regulated financial institutions. This is achieved by evaluating an institution's risk profile, financial condition, risk management processes, and compliance with applicable laws and regulations" (OSFI, *Supervisory Framework: 1999 and Beyond*). Thus, OSFI considers corporate governance, risk management, financial analysis, internal audits, board oversight, and compliance as key components to ensure insurer solvency.

3. Minimum Capital Standards

Life Insurance – Minimum Total Minimum Continuing Capital and Surplus Requirements (MCCSR) Ratio of 120%

For purposes of meeting these tests, capital is divided into Tier 1 and Tier 2 capital. The sum of Tier 1 and Tier 2 capital is the amount of actual capital allowed to be used in the ratio test:

Total MCCR Ratio = [Total (Tier 1 + Tier 2) Available Capital]/ [Required Capital]

In addition, the ratio of Tier 1 Available Capital to Required Capital must be at least 60%.

Property & Casualty – Minimum Total Minimum Capital Test Requirement (MCT) Ratio of 120% (Tier 1 and Tier 2 capital only are used to calculate actual capital.)

4. Minimum Continuing Capital and Surplus Requirement (MCCR) Ratio and Minimum Capital Test Requirement (MCT) Ratio

The *life capital test* takes a consolidated view of a company's capital position. The Minimum Continuing Capital and Surplus Requirements (MCCR) stipulates formal minimum capital standards that reflect the inherent risk in the company.

Four types of approaches are used to find MCCR:

- a. A *factor* approach based on assets or on liabilities is used for credit, market (interest rate) and pricing risks).
- b. A *formula* approach (using current policies future cash flows and risk assumptions based on experimented values) is used for the mortality insurance risks.
- c. A *scenario* approach (one scenario) is used (based on current policies' future cash flows and risk assumptions from experimented values) for the insurance lapse risks
- d. A *mixed* approach (company model or factors based on industry model) is used for Segregated Funds guarantees.

If an insurer is licensed by a provincial authority rather than registered with the federal regulator, then the capital requirements are somewhat different, although the capital requirements in the provinces have been gradually changing to be consistent with OSFI.

The *property & casualty capital test*, the Minimum Capital Test or MCT, is a risk-based test that is focused on the credit and liability risk of property casualty insurers primarily. It indicates the general level of capital required to support these risks. Like MCCR it is a ratio based test in which actual capital (i.e., the sum of Tier 1 and Tier 2 capital) is compared to required capital. OSFI suggests that the ratio of actual capital to required capital should be at least 150%. A ladder of intervention exists if an insurer should fall below this level. As with life insurers, somewhat different requirements may exist for insurers registered at the provincial level.

In the future it is anticipated that internal models will gradually be allowed to be used. However, full-blown internal models will not come into use all at once. Instead, internal models may be added for one type of risk at a time, with more risks added sequentially. For example, to start, an internal model for market risks only is anticipated to be available for qualified insurers in the near future.

5. Peer Review

OSFI relies heavily on the actuarial and accounting profession in its regulatory framework. Legislation outlines various Appointed Actuary (AA) responsibilities and OSFI powers. Reliance on the AA takes place for actuarial valuation.¹ The AA may also act as a whistle blower. The AA cannot be the CEO nor the CFO (or other similar position) nor the chief agent.

OSFI also relies heavily on the External Auditor (EA). For example, OSFI relies on the audited year end financial statements and MCCSR determination. Legislation outlines various EA responsibilities and OSFI powers, including the power to revoke an EA appointment. New auditing standards consistent with International Standards of Auditing (ISAs) for year-end audits will apply after Dec. 15, 2010.² OSFI periodically meets with EAs (through EA Advisory Committees) to discuss general concerns and matters of mutual interest.

6. Reporting

Federally registered insurers are required to file quarterly and annual financial statements, and the accounting system is Canadian GAAP.

Canada is moving to IFRS in 2011.

Included in the AA duties are completion of the AA Report, Dynamic Capital Adequacy Testing (DCAT); and determination of capital requirements. Under DCAT, the AA performs a series of deterministic adverse scenario tests using the insurer's financial results and must certify that the financial position of the institution is satisfactory after these scenario tests. The DCAT considers the three most significant risks of the insurer and uses a confidence level of 99% over a one year time frame.

Insurers are required to report on their corporate governance, risk management, internal audits, and board oversight.

7. On-Site Examinations

¹ The Canadian Institute of Actuaries (CIA) develops appropriate standards for the AA; and the CIA standards of professional conduct apply.

² Canadian Institute of Chartered Auditors (CICA) standards of professional conduct apply.

Federally registered insurers are examined at least once every 3 to 5 years.

OSFI conducts regular meetings with senior management. The frequency of these meetings varies depending on the size, complexity, and risk profile of the financial institution.

8. Off-site Analysis

Each federally registered institution is rated by OSFI according to its **net risk**. Net risk is obtained by offsetting the aggregate quality of risk management against the aggregate level of inherent risk of the insurer. Inherent risks are classified into the following groups:

- Credit risk
- Market risk
- Insurance risk
- Operational risk
- Liquidity risk
- Legal and Regulatory risk
- Strategic risk

And an insurer is rated as low, moderate, or high for each of these categories. The quality of risk management is divided into groups also:

- Operational Management (i.e., day to day management)
- Financial Analysis
- Compliance
- Internal Audit
- Risk Management
- Senior Management
- Board Oversight

The quality of an insurer's risk management processes is assessed as strong, acceptable, or weak. The assessment of *aggregate* inherent risk and *aggregate* risk management quality are based on judgments of all of the inherent risk and risk management functions. In addition to the assessment of net risk, the direction of net risk is considered in rating an insurer. The level and frequency of supervisory scrutiny will depend on the risk assessment of the institution.

OSFI's actuarial department also undertakes verification of the technical provision.

10. Definition of Capital

Capital available to be used to meet solvency requirements is divided into Tier 1 and Tier 2 capital. Tier 1 (core capital) and Tier 2 (supplementary) capital are meant to be similar to the capital tiers under Solvency II.