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# CANADA

## FINANCIAL SECTOR ASSESSMENT PROGRAM

December 20, 2019

# TECHNICAL NOTE

## INSURANCE SECTOR: REGULATION AND SUPERVISION


Prepared By

**Monetary and Capital Markets Department**


This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program that visited Canada in October 22–November 14, 2018. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at http://www.imf.org/external/np/fsap/fssa.aspx

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# Glossary

| | |
|---|---|
| AA | Appointed Actuary |
| AIRB | Alberta Automobile Insurance Rate Board |
| AMF | Autorité des marchés financiers |
| AMF Act | An Act Respecting the Autorité des Marches financiers |
| AcSB | Accounting Standards Board |
| BoC | Bank of Canada |
| CacSB | Canadian Accounting Standards Board |
| CAD | Canadian Dollar |
| CALM | Canadian Asset Liability Method |
| CARLI | Capital Adequacy Requirements for Life Insurers—Québec |
| CASB | Canadian Actuarial Standards Board |
| CCIR | Canadian Council of Insurance Regulators |
| CIA | Canadian Institute of Actuaries |
| CLHIA | Canadian Life and Health Insurance Association |
| CMHC | Canada Mortgage and Housing Corporation |
| CoB | Conduct of Business |
| CRMI | Capital Requirement for Federally Regulated Mortgage Insurers |
| CTE | Conditional Tail Expectation |
| DCAT | Dynamic Capital Adequacy Testing |
| DoF | Department of Finance |
| ERC | Emerging Risk Committee |
| FCAC | Financial Consumer Agency of Canada |
| FISC | Financial Institutions Supervisory Committee |
| FSCO | The Financial Services Commission of Ontario |
| FSRA | The Financial Services Regulatory Authority (Ontario) |
| IBC | Insurance Bureau of Canada |
| ICA | Insurance Companies Act |
| ICBC | Insurance Corporation of British Columbia |
| ICP | Insurance Core Principle |
| IFRS | International Financial Reporting Standards |
| IRB | Internal Ratings-Based |
| LICAT | Life Insurance Capital Adequacy Test |
| LTV | Loan-to-value |
| L&H | Life and Health |
| MCT | Minimum Capital Test |
| MICAT | Mortgage Insurer Capital Adequacy Test |

| | |
|---|---|
| MoU | Memorandum of Understanding |
| NHA | National Housing Act |
| PACICC | Property and Casualty Insurance Compensation Corporation |
| PfAD | Provision for Adverse Deviations |
| P&C | Property and Casualty |
| ORSA | Own Risk and Solvency Assessment |
| OSFI | The Office of the Superintendent of Financial Institutions |
| RIBO | Registered Insurance Brokers of Ontario |
| SAC | Senior Advisory Committee |
| SRO | Self Regulatory Organization |

# EXECUTIVE SUMMARY[1]

**Canada has a highly developed insurance market that is important to Canada's economy.** Insurance penetration and density are as expected for an advanced economy like Canada. Canada is home to three large life-and-health (L&H) insurance conglomerates that are globally active, with only approximately a third of their business within Canada. In contrast to the L&H insurance industry, the property-and-casaulty (P&C) insurance industry is less concentrated, and foreign-owned insurance subsidiaries and branches have a significant market share. There are three mortgage insurers operating in Canada. The largest mortgage insurer is the Canada Mortgage and Housing Corporation (CMHC), which is a federal government agency that operates on a commercial basis; CMHC also has a separate social housing mandate. All mortgage insurers benefit from an explicit government guarantee; however, a deductible of 10 percent of the original principal amount of the insured mortgage applies to a lender's claim in respect to an insurance contract written by either of the two private mortgage insurers.

**Regulation and supervision of the insurance sector in Canada is conducted by the federal and provincial authorities.** Insurers can be incorporated under the federal or provincial regime. At the federal level, the Office of the Superintendent of Financial Institutions (OSFI) is responsible for prudential regulation and supervision of federally regulated insurers. The provincial supervisors are in charge of prudential oversight of provincially regulated insurers and conduct oversight of all insurers operating in their jurisdictions. Federally regulated insurers are also subject to provincial prudential powers given the provincial authorities' responsibilities for licensing of insurance business in their provinces. IFRS accounting standards as adopted by the Canadian Accounting Standards Board (CAcSB), as well the Canadian Actuarial Standards Board (CASB)'s standards of practice, are also referenced in prudential guidelines.

**Federal insurance supervision at OSFI and Quebec provincial supervision at Autorité des marchés financiers (AMF) is high-quality.** AMF has the most extensive prudential supervision responsibilities among Canadian provinces and was the only provincial insurance supervisor where prudential supervision was assessed. Both OSFI and AMF employ a risk-based supervisory approach that is well-structured to escalate supervisory intensity commensurate with firms' risk profiles. The regulatory frameworks are strong. The risk-based solvency frameworks, which were implemented after the 2014 FSAP, are advanced.[2] A comprehensive set of guidelines covering sound business and financial practices were also issued to address governance and risk management issues. OSFI and AMF work closely with the industry and apply moral suasion to achieve outcomes. With no authority to issue its own legally enforceable regulations, OSFI has relied on the use of guidelines backed by

[1] This Technical Note was prepared by Peter Windsor (IMF) under guidance of Phakawa Jeasakul (FSAP deputy mission chief). The review was conducted as part of the 2019 Canada FSAP led by Ghiath Shabsigh (FSAP mission chief).

[2] For L&H insurers, these are the Life Insurance Capital Adequacy Test (LICAT) at the federal level and the Adequacy Requirments for Life and Health Insurance (CARLI) in Quebec. Both LICAT and CARLI are harmonized guidelines. In the remainder of this Technical Note, references to LICAT apply equally to CARLI, unless mentioned otherwise. For P&C insurers, this is the Minimum Capital Test (MCT) at the federal level. At the beginning of 2019, the Mortgage Insurance Capital Adequacy Test (MICAT) was implemented.

enforceable instruments, which are accepted by regulated entities as equivalent. This approach, though working on a business as usual basis, may not be effective in a less benign environment.

**Federal-provincial cooperation and coordination should be further improved.** Cooperation and coordination between OSFI and provincial supervisors only occur on an informal basis that relies on specific interpersonal relationships. The federal and provincial authorities should work together to address barriers that prevent close and meaningful cooperation, and ultimately to enter into memorandums of understandings (MoUs) to enhance information exchange and policy coordination. There appear to be different practices and supervisory intensity between OSFI and AMF with regard to the supervision of significant L&H insurers. A joint OSFI-AMF benchmarking exercise can help ensure the consistency of supervisory intensity between the two major supervisors in Canada.

**Group-wide supervision needs improvement in legal foundation and consistency of application.** With no legal powers over unregulated holding companies, both OSFI and AMF rely on voluntary agreements with the companies (i.e., undertakings) to be able to obtain information and apply prudential requirements for the insurance groups. For federally regulated life insurers, OSFI should discourage holding companies from issuing senior debt and passing such proceeds to operating entities to be used as available capital; this issue arises due to the lack of target capital ratios at the non-operating L&H insurers and differences in minimum core capital ratios at non-operating and operating L&H insurers.

**A greater emphasis on solo supervision would be beneficial.** OSFI and AMF focus on comprehensive consolidated supervision that accounts for significant activities both in Canada and abroad. For the three largest life insurers, OSFI has regularly engaged with relevant foreign supervisors and conducted on-site inspections of international businesses. Given the life insurance market structure, capital and disclosure requirements at the solo level could be useful.

**Canada-wide surveillance, currently missing, can help enhance risk monitoring and identification.** OSFI assesses each insurer through an in-dept analysis of the company, the insurance industry and the operating environment, and also identifies emerging issues observed across the industry. AMF similarly monitors emerging trends and systemic issues of insurers under its remit. However, there are no formal discussions between federal and provincial authorities, especially in light a significant presence of provincially regulated insurers. As a first step, there should be aggregation of statistics about the whole insurance sector. A federal-provincial forum should also be established to discuss risks to the insurance sector and market-wide trends.

**There are some noteworthy sector-specific issues related to insurance regulation and supervision.**

- **For the L&H insurance:** OSFI and AMF in preparation for the new accounting standards (IFRS 17) should carefully consider how risk margins interact wth the regulatory solvency framework for life insurers.

- **For P&C insurance:** risk of earthquake is a signficant natural catastrophe scenario in Canada, potentially creating a financial stability issue if significant losses to banks and other lenders are substantial due to uninsured earthquake risk. Federal and provincial authorities should work together to address potential systemic risk from earthquakes in Canada. Regarding the auto insurance industry, it is important to strike a balance among ensuring insurance affordability, providing sufficient compensation to accident victims and maintaining prudentially sound insurers.

- **Regarding reinsurance:** OSFI has undertaken a review of the reinsurance framework. In doing so, OSFI should take into account the supervision performed by reinsurers' supervisors.

- **For mortgage insurance:** it is not clear that the transfer of risk from deposit-taking institutions to mortgage insurers results in sufficient overall capital within the Canadian financial system, particularly for mortgages with high loan-to-value. OSFI should carry out a benchmarking exercise with respect to capital requirements between the deposit-taking and mortgage insurance industries.

**Implementation of Own Risk and Solvency Assessment (ORSA) is still developing.** A review of the key metrics reveals that large insurers' views of their capital requirements are consistently less than the regulatory requirements. In constrast, smaller insurers view that their capital requirements would be higher than the regulatory requirements. OSFI and AMF should work with the insurance industry to ensure that ORSA reflects appropriate considerations for risk diversification, risk sharing with life insurance policyholders, and risk appetite with respect to potential ratings downgrades.

**Conduct oversight has improved since the 2014 FSAP.** Coordination and cooperation among provincial supervisors with respect to conduct supervision has increased. In Ontario, the creation of the Financial Services Regulatory Authority (FSRA) appears to address many recommendations of the 2014 FSAP's Insurance Core Principles (ICP) assessment, especially regarding the powers and resources of Financial Services Commission of Ontario (FSCO). In Québec, the insurance legislation has been updated, giving AMF new powers and penalties. However, it is not clear that the reform will be effective particularly in light of a recent case where AMF's powers were not sufficient to deter inappropriate market conduct.

| Table 1. Canada: Recommendations on Regulation and Supervision of Insurers | | |
|---|---|---|
| **Recommendation** | **Priority** | **Timeframe** |
| ***Improve Cooperation Between Federal and Provincial Authorities*** | | |
| Enhance inter-agency cooperation, particularly between federal and provincial authorities, with additional MoUs. (OSFI, provincial supervisors) *¶41* | M | ST |
| Carry out jointly a benchmarking exercise with respect to supervisory intensity. (OSFI, AMF) *¶44* | M | MT |
| Create a forum to discuss risks to the insurance market and market-wide trends. (federal and provincial authorities) *¶48* | H | ST |
| Work together to address possible systemic risk from earthquakces in Canada, building on the SAC's Earthquack Working Group. (SAC, OSFI, provincial authorities) *¶72* | H | MT |
| ***Enhance Regulatory Frameworks*** | | |
| Consider how spread risk is taken into account in the overall solvency framework for life-and-health insurers when IFRS 17 is implemented. (OSFI, AMF) *¶55* | H | MT |
| Consider disclosure requirements at the solo level, once ICP 20 is revised in late 2019, and ensure that such disclosures are easily available to stakeholders of Canadian legal entities. (OSFI, AMF) *¶58* | L | MT |
| Strengthen legal foundation underpinning insurance group-wide supervision; apply the regulatory framework more consistently to group-wide supervision (OSFI, AMF; DOF, Québec government) *¶61, 62* | H | ST |
| Ensure that the reinsurance framework reforms take into account the supervision performed by reinsurers' supervisors. (OSFI) *¶69* | M | ST |
| Jointly review the possible effectiveness of the new penalty regime introduced in the Insurers Act. (AMF, Québec government) *¶91* | H | I |
| Carry out a benchmarking exercise with respect to capital requirements between the deposit-taking and mortgage insurance industries, particularly to understand the amount of deposit-taking institutions' capital with no mortgage insurance and to compare with the Basel standards. (OSFI) *¶79* | H | ST |
| ***Enhance Supervisory Practices*** | | |
| Consider how their flexible approach to supervision would work in an industry crisis situation. (OSFI, AMF) *¶39* | M | MT |
| Place more emphasis on solo supervision of life insurers particularly a focus on the level of capital at the solo entity, in addition to its already comprehensive consolidated supervision. (OSFI) *¶59* | H | ST |
| Cease the practice of applying different total capital ratios and core capital ratios at the non-operating and operating levels of life insuers, which allows the downstreaming of senior debt into the operating entities. (OSFI) *¶64* | H | ST |
| Work with the insurance industry to ensure that ORSA target capital calculations include appropriate considerations of (i) risk diversification, (ii) risk sharing with life insurance policyholders, and (ii) risk appetite with respect to potential ratings downgrades. (OSFI, AMF) *¶101* | M | MT |

| Table 1. Canada: Recommendations on Regulation and Supervision of Insurers (concluded) | | |
|---|---|---|
| **Recommendation** | **Priority** | **Timeframe** |
| ***Improve Insurance Industry Data*** | | |
| Develop a single set of market-wide insurance industry data. (OSFI, provincial supervisors, DOF) ¶*48* | H | ST |
| Note: Institutions in the parenthesis are the agencies with responsibilities. In terms of priories, H, M, and L stand for high, medium, and low. In terms of time frame, I, NT, and MT stand for immediate (within one year), near-term (within 2–3 years), and medium-term (within 3–5 years). | | |

# INTRODUCTION

## A. Scope and Approach

1. **The approach to the review of the regulation and supervision of insurers was to build on the assessment of the Insurance Core Principles (ICP) as part of the 2014 FSAP (the 2014 assessment).** This review focused on changes made since then and following up on selected recommendations from the 2014 assessment particularly where the assessments were "partially observed."

2. **The review is based on the laws, regulations, and other supervisory requirements and practices that were in place at the time of the mission in October–November 2018.** Ongoing regulatory initiatives are acknowledged by way of additional comments. The authorities have provided a full and well-written self-assessment against selected ICPs along with responses to a questionnaire. During the mission, the assessor was able to review documentation of actual supervisory practices.

3. **The issues covered in this Technical Note were selected based on their macrofinancial relevance and previously identified deficiencies in the Canadian regulatory and supervisory framework.** The review covered prudential regulation and supervision under the federal regime and in the Québec jurisdiction, as well as market conduct oversight in Québec and Ontario (only certain aspects for the latter). The regulation and supervision of insurers in the remaining eight provinces and three territories was not addressed directly. There was a discussion with the Canadian Council of Insurance Regulators (CCIR) and a review of some of its documents, which provided insights into the coordination among provinces with respect to market conduct supervision. There were also discussions with government bodies in Alberta and British Columbia with respect to the regulation and provision of auto insurance in those provinces.

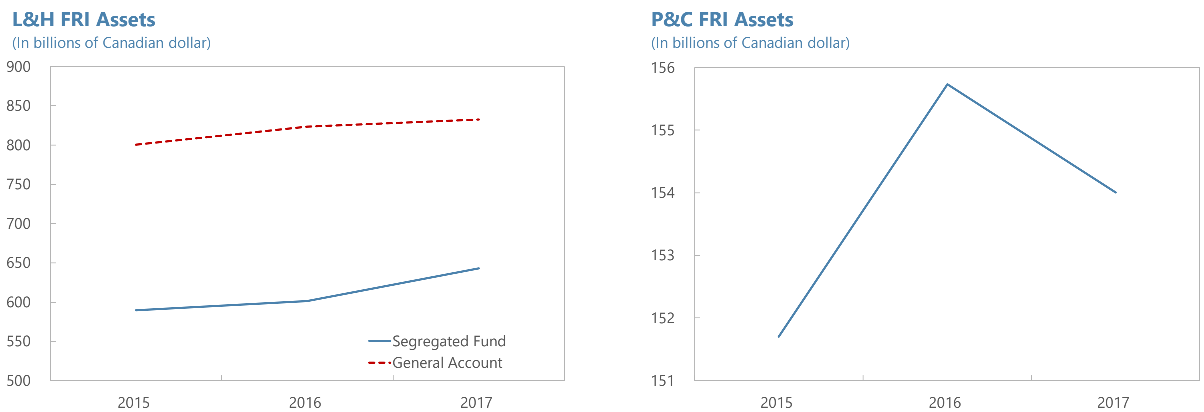
4. **The prudential regulation of insurers in Canada has been revamped since the 2014 assessment.** The same framework of regulation exists but the guidelines issued by the Office of the Superintendent of Financial Institutions (OSFI) and Autorité des marchés financiers (AMF) have been thoroughly overhauled and updated. Major changes have been made to the capital guidelines for life-and-health (L&H) insurers, property-and-casualty (P&C) insurers, and mortgage insurers. In addition, guidelines have been issued covering other aspects of regulation, including guidelines

implementing Own Risk and Solvency Assessment (ORSA). This FSAP included a review of these changes.

## B. Market Structure

**5. With about Can$1.7 trillion in assets, the insurance sector in Canada is a significant part of the Canadian economy and financial system.** The P&C insurance sector had Can$173 billion in assets at end-2017,[3] of which Can$154 billion was held in federally regulated insurers.[4] The assets of federally regulated P&C insurers have remained relatively stable over the last three years. Excluding segregated funds, the L&H insurance sector had Can$858 billion in assets at end-2017,[5] of which Can$833 billion was held in federally regulated insurers. Federally regulated L&H insurers have grown moderately over the last three years, with slightly higher growth in segregated funds business.

**Figure 1. Canada: Assets of Federally Regulated Life-and-Health and Property-and-Casualty Insurers**




Source: OSFI.

**6. The importance of the insurance industry to the Canadian economy is similar to other advanced economies.** Insurance density was US$3,260 per person, comprising US$1,407 of L&H premiums per person and US$1,853 of P&C premiums per person. This is significantly lower than the United States but similar to other advanced economies such as Australia, France and Japan. Insurance penetration is at 7.23 percent of GDP (3.12 and 4.11 percent for the L&H and P&C sectors, respectively), comparable to other advanced economies such as Australia, France, Japan, and the United States.[6] There is some evidence of variability in insurance penetration across the provinces,

[3] 2018 Facts, Insurance Bureau of Canada (IBC).

[4] Aggregate data provided by OSFI.

[5] Canadian Life and Health Insurance Facts, 2018 Edition, Canadian Life and Health Insurance Association (CLHIA).

[6] All insurance density and insurance penetration figures are for 2017, courtesy of Swiss Re Sigma—Sigma No 3/2018, Swiss Re Institute.

with penetration of 8.1 percent of GDP in Québec and 7.5 percent of GDP in Ontario. The number of domestic employees in the Canadian insurance sector is approximately 281,400 at end-2017.[7]

**7. There is some difficulty in obtaining a complete picture of the insurance industry in Canada.** OSFI maintains data related to federally regulated insurers, and each provincial supervisor maintains data related to insurers chartered in their jurisdictions. There is no single source of data to provide a picture of the entire Canadian insurance market. This matter is raised in the subsequent section on macroprudential oversight of the insurance sector.

**8. The number of federally regulated insurers continues to decline, showing evidence of steady consolidation of the insurance industry.** In a continuation of the trends reported in the 2014 assessment, the number of federally regulated insurers continues to decline across all categories (Table 2). In the 2014 assessment, the only category of federally regulated insurers for which the number was increasing was reinsurers; this trend has since reversed. A similar trend can be seen for insurers chartered in Québec (Table 3).

**Table 2. Canada: Number of Federally Regulated Insurers**

| | 2012 | 2018 |
|---|---|---|
| L&H insurers | 65 | 54[1/] |
| P&C insurers | 150 | 133[2/] |
| Reinsurance companies | 36 | 32 |
| Fraternal benefit societies | 13 | 12 |
| Total | 264 | 231 |

Source: OSFI

1/ Includes nine L&H insurers in run-off; the 2012 figure includes 34 in run-off or inactive.

2/ Includes eight P&C insurers in run-off. This does not include Canada Mortgage and Housing Corporation (CMHC), which is not a federally regulated insurer even though OSFI has an oversight role in relation to CMHC.

**Table 3. Canada: Number of Québec Chartered Insurers**

| | 2013 | 2017 |
|---|---|---|
| L&H insurers | 13 | 12 |
| P&C insurers | 49 | 36 |
| Multi-branch entities | 2 | 4 |
| Reinsurers | 2 | 2 |
| Others (Fonds and Fraternal) | 8 | 8 |
| Total | 74 | 62 |

Source: AMF.

[7] For the L&H sector, 155,200 employees according to Canadian Life and Health Insurance Facts 2018 Edition, Canadian Life and Health Insurance Association (CLHIA); for the P&C sector, 126,200 employees according to 2018 Facts, Insurance Bureau of Canada (IBC).

**9. The scale of the reinsurance industry in Canada is small and was therefore not a focus of this review.** The following market analysis of the L&H, P&C, and mortgage insurance sectors, excluding reinsurers.

***Life-and-Health Insurance***

**10. The L&H insurance industry in Canada is highly concentrated, dominated by three internationally focused, Canada-based companies.** Collectively, Manulife Financial Corporation, Sun Life Financial Inc. and the Great West Life Assurance Company held 90 percent of life insurers' total assets in 2017. Nevertheless, Canada is only approximately a third of their overall business. Domestically, these groups appear to enjoy competitive advantages against their smaller domestic and foreign-owned peers.

**11. The three large L&H insurers have focused on cost control and de-risking their balance sheets in recent years.** Despite their efforts, they all have legacy business in higher risk business lines such as variable annuities and long-term care products. The three large L&H insurers have diverse product offerings in Canada and in foreign markets, and are attempting to increase their return on equity by focusing on profitable but capital-efficient product offerings. For example, most of the segregated fund products are now offered at the minimum guarantee level allowed under taxation rules. The L&H sector has been experiencing reductions in return on equity in recent years, with downward pressures stemming from the combination of low interest rates and legacy businesses (some of the legacy business is also capital-intensive) (Figure 2).

**12. The investment portfolios of federally regulated L&H insurers are diversified and stable over time.** Within the general accounts, investment in government bonds and investmen-grade corporate bonds dominates, but there is a sizable allocation to mortgage loans (mainly, commercial mortgage loans). Within the segregated funds, which are subject to guarantees, the dominant asset class is mutual funds. Information about asset allocations within these mutual funds was not available. OSFI should improve the granularity of these data even though supervisors may have access to other sources of information other than the annual and quarterly regulatory reporting.

**13. Federally regulated L&H insurers have reduced the share of segregated funds that are subject to significant guarantees.** The amount of segregated funds with minimal guarantees has increased,[8] while the amount of segregated funds with more significant guarantees has been steady. Within general account business, non-participating business has also been increasing as a relative proportion of premiums. If this trend continues, the portion of the business where federally regulated L&H insurers can share potential gains and losses on investment portfolios with policyholder will decline. This may have some impact on capital requirements where the ability to share losses with policyholders is taken into account.

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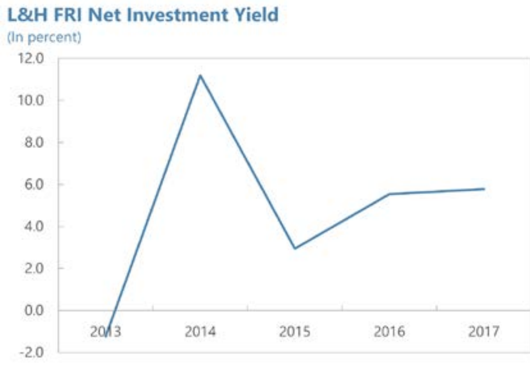
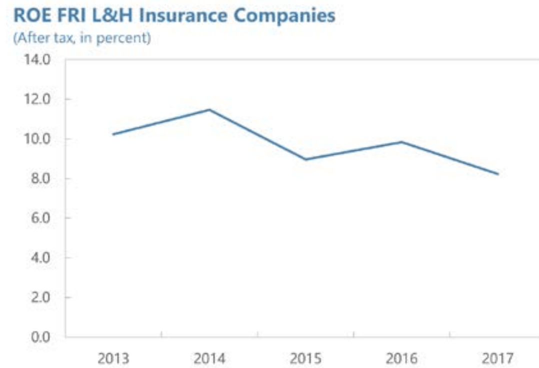
[8] The most minimal guarantees are a guarantee of capital on 75 percent of the portfolio for death benefits or investments held for a long period (e.g.,10 years or more). This can be increased to 100 percent of the portofolio and can be reset on a regular basis (but the qualifying period may be extended). The latter is an example of more significant guarantees.

## Figure 2. Canada: Selected Statistics About the Federally Regulated Life-and-Health Insurers

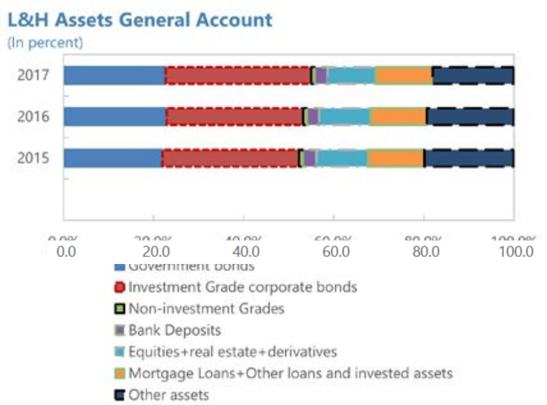
*Investment returns were quite volatile in 2013 and 2014, but have stabilized during 2015–17.*



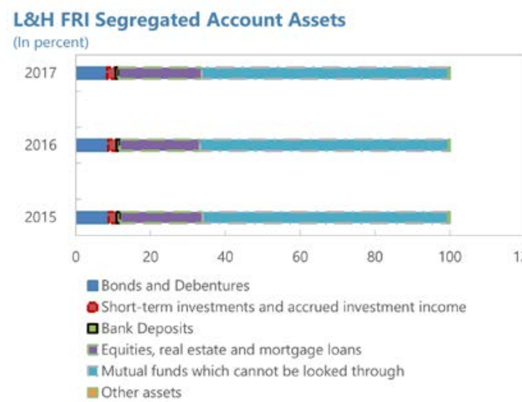

*Return on equity has been declining over time.*




*The asset allocation in the general account is well diversified across classes with government bonds and investment grade corporate bonds making up more than 50 percent of the portfolio.*

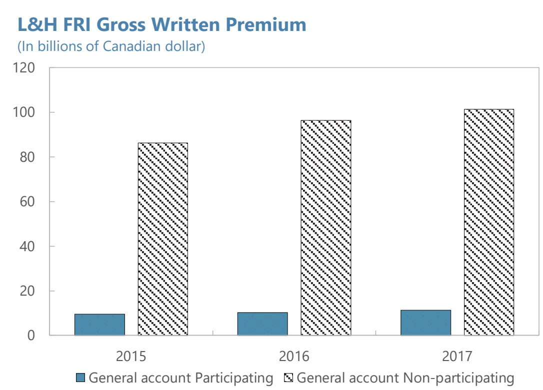



*Within segregated funds, investments in mutual funds that cannot be looked through dominate the asset allocation.*




*Segregated funds with guarantees have remained stable, while those with minimal guarantees have increased. General account actuarial insurance liabilities have also increased, …*


*… in line with increasing premiums. Non-participating business dominates the premium income.*




Source: OSFI and IMF staff calculations.

*Property-and-Casualty Insurance*

**14. In contrast to the L&H insurance industry, the P&C insurance industry is less concentrated, and foreign-owned insurers have a significant market share.** The P&C industry comprises Canada-based companies, which include subsidiaries of large Canadian banks and mutual/cooperative organizations, as well as local subsidiaries of the large global groups and licensed Canadian branches of foreign insurers. The top-ten federally regulated P&C insurers accounted for 73 percent of total premiums in 2017, up from 43 percent in 2012. The largest federally regulated P&C insurer is Intact, which accounted for 16 percent of total P&C premium in 2017. Intact also offers specialty lines of insurance in the United States. The second largest market share, with 11 percent of total premiums, belongs to Aviva, a group headquartered in the United Kingdom.

**15. The dominant product for P&C insurers is auto insurance.** Auto insurance accounts for over 42 percent of the P&C insurance sector (Table 4). Auto insurance markets in Canada are highly regulated, and the regulation varies significantly by provinces (Box 1).

**Table 4. Canada: Federally Regulated Property-and-Casualty Insurers' Premiums**
(In millions of Canadian dollar)

| Line of business | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|
| Auto | 19,049 | 19,530 | 19,935 | 20,061 |
| Property | 15,559 | 16,537 | 16,948 | 17,291 |
| Liability | 5,460 | 5,981 | 5,794 | 5,859 |
| Accident and health | 1,179 | 1,276 | 1,291 | 1,403 |
| Others | 2,406 | 2,547 | 2,601 | 2,741 |
| Total premiums | 43,654 | 45,871 | 46,569 | 47,356 |

Source: OSFI.

**16. There is some evidence of search for yield behavior among the federally regulated P&C insurers.** However, the investment profile of the P&C industry is conservative and still heavily weighted in fixed-income securities. There is a trend towards a reduction in bond investments and an increase in 'other loans'. This is likely related to reduced yield on investments in bonds as well as the difficulty in consistently making an underwriting profit. Combined ratios are close to 100 percent, although they exceeded 100 percent in two out of the last five years (Figure 3).

## Box 1. Auto Insurance—Market and Regulatory Landscape

Each province has its own approach to regulating the sale of auto insurance which may involve the restriction on premium rates charged by P&C insurers and the nature of claims that can be made particularly with respect to personal injury. P&C insurers selling automobile insurance in Canada are facing rising claims costs due to a number of pressures including increasing claims expenses for bodily injury and vehicle damages (the latter related to the costs of more modern car technology) and higher accident rates in some provinces.

This box explores the different approaches to auto insurance in four different provinces—Alberta, British Columbia, Ontario, and Québec.

**Alberta**

In Alberta, the Automobile Insurance Rate Board (AIRB) regulates rating programs of insurers selling automobile insurance in Alberta. This rate regulation applies to both basic coverage (third-party liability and accident benefits) as well as additional coverage (all perils, collision, comprehensive and specified perils). The AIRB was created in 2004 as part of reforms of the auto insurance market in Alberta, which included imposing a cap on minor injury claims. The regulations implementing this policy were refined and clarified in May 2018, classifying certain injuries where ambiguity about this had been.

Two ministerial orders have been issued, one on December 4, 2017 (November 1, 2017–November 30, 2018), and one on October 31, 2018 (December 1, 2018–August 31, 2019) requiring the AIRB to not approve filings from insurers where the cumulated rate increases were greater than 5 percent.[1] The Minister was concerned with the impact that significant automobile insurance rate increases might have on Albertans and their cost of living. Since the 2004 reforms, premium rates remained relatively flat with increases from 2012 to 2016 tracking slightly above inflation. Over that period, premium rate increases were not keeping pace with increasing claims costs since insurers did not file for higher premium rates that reflected their increasing claims costs. In 2017, insurers started filing for double-digit increases in premiums to reflect their claims experience and the AIRB decided in mid-2017 to cap rate increases to 10 percent. This cap remains in force as of today. That rate cap along with increasing claims costs has led to a situation where insurers are making loses of 10-14 percent of the premiums they can charge.

Alberta is undertaking a review of automobile insurance claims and costs,[2] which is due to be completed in December 2019. It is expected that the ministerial order will remain in place while this review is conducted.

In addition to the work of the AIRB, the Alberta Superintendent of Insurance supervises the conduct of business of all insurers licensed to sell products in Alberta, including those selling auto insurance.

**British Columbia**

The Insurance Corporation of British Columbia (ICBC) is a provincial crown corporation which provides mandatory basic auto insurance along with optional additional coverage. Coverage is provided to vehicles for personal use and commercial use. Basic auto insurance covers third-party legal liability, under-insured motorist protection, accident benefits, hit-and-run protection, and inverse liability for claims outside British Columbia. ICBC is the sole provider of basic auto insurance coverage in British Columbia. Optional coverage, including extended liability, collision and comprehensive plans, is provided in a competitive market by ICBC and with other private insurers.

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[1] Alberta Ministerial Order No. 25/2017.

[2] https://finance.alberta.ca/publications/insurance/bulletins-notices/2018/Superintendent-of-Insurance-2018-06-Notice.pdf

## Box 1. Auto Insurance—Market and Regulatory Landscape (continued)

ICBC experienced substantial losses on its basic auto insurance product in the last two years. While ICBC has faced increasing claims costs, Its premium increases have not kept pace with the costs to provide basic auto insurance. ICBC's premium rates must be approved by the British Columbia Utilities Commission (BCUC), and the regulatory framework set out by the British Columbia Government is designed to smooth out annual rate fluctuations.

ICBC, though not being federally regulated, is required to use OSFI's Minimum Capital Test (MCT) framework to set capital targets. There are separate targets for the basic MCT capital ratio (100 percent minimum with a management and rate-smoothing target of 145 percent) and for the optional MCT capital ratio (internal target of 250 percent). However, ICBC's MCT capital ratio was 31 percent at end-2018Q1,[3] which contrasts with the OSFI's minimum requirement for federally regulated P&C insurers at 150 percent. The British Columbia government decided on February 26, 2018, to temporarily suspend, until March 21, 2022, the requirement to maintain basic MCT capital ratio at 100 percent.

Based on a report by Ernst & Young,[4] the British Columbia auto insurance market is undergoing significant change, and the British Columbia Government has provided a revised framework which is to be implemented on April 1, 2019 aimed at controlling costs. The main change focused on care of claimants with bodily injury claims, with an aim at moving away from a litigation-based model for bodily injury claims in order to reduce legal fees for litigation.

**Ontario**

In Ontario, all forms of auto insurance including coverage for bodily injury claims are provided by private insurers. Ontario has a partial 'no-fault' regime for bodily injury so that all parties in an accident are entitled to payment from their own insurer for bodily injury due to an automobile accident. Drivers not at-fault in an accident, if they meet thresholds for permanent injury, can seek additional damages from the at-fault driver under tort law through suing the at-fault driver.

Auto insurance covers 'no-fault' bodily injury claims, third-party liability, direct compensation for damage (by an uninsured vehicle) to automobile of the insured who is not at fault. Additional (optional) coverage may be purchased, including to increase accident benefits and third-party liabilitiy (property damage and bodily injury) and to provide protection against damage to the insured's own automobile when the insured is at fault.

As there is a mandatory component to auto insurance, the Ontario government considers that it has an obligation to create a marketplace where insurance is available and affordable. Therefore, the premium rate regulation is in place. The Financial Services Commission of Ontario (FSCO) must approve rates based on a comprehensive filing, certified by an actuary, that details claims experiences and expenses. Insurers may use a simplified filing process for rate reductions only. The FSCO takes into account prudential supervision objectives when considering rate change proposals.

A review of the auto insurance system in Ontario was completed in April 2017, and this is known as the Marshall report.[5] This review found that the Ontario system was delivering high premiums and inappropriate care for victims of automobile accidents. The report includes a number of recommendations that seek to increase the proportion of claims payments and expenses that go towards caring for victims of automobile accidents rather than going towards legal fees and other expenses that do not address the injuries of victims.

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[3] ICBC Statement of Operations as at March 31, 2018.

[4] Affordable and effective auto insurance—A new road forward for British Columbia, Ernst & Young LLP, July 10, 2017.

[5] Fair Benefits, Fairly Delivered: A Review of the Auto Insurance System in Ontario, David Marshall, April 11, 2017.

## Box 1. Auto Insurance—Market and Regulatory Landscape (concluded)

**Québec**

In Québec, bodily injury claims are covered by a public automobile insurance plan administered by Société de l'assurance automobile du Québec (SAAQ). Private insurers provide additional coverage for property damage. There is a mandatory minimum amount of coverage for damage to third-party property required to be held by all drivers in Québec. There is also additional (optional) coverage for the driver's own car for accidents and other perils such as fire and theft.

Québec has a pure no-fault system for all road accidents involving bodily injuries, meaning that anyone injured in auto accidents in Québec cannot resort to tort law to sue for damages due to injury. For the mandatory third-party property and optional property damage coverage, rates are regulated by AMF on a 'file and use' basis. In other words, insurers can amend their premium rates for auto insurance without requiring a prior approval from AMF to implement the rate changes.[6]

**Government Intervention in Insurance Markets**

The varying approaches to automobile insurance in the Canadian provinces show there is no easy solution to ensure both affordable auto insurance and appropriate compensation to victims of automobile accidents. It appears that policy intervention to reduce claims costs can be effective in maintaining affordable insurance premiums for motorists; however, there are arguments from some stakeholders about whether this unfairly limits injury claims for victims of accidents.

The premium rate regulation that does not account for the necessity of insurers to earn a required return on capital can create an unsustainable loss-making situation for P&C insurers. The need for comprehensive reviews in Alberta, British Columbia and Ontario demonstrate that developing and maintaining the right policy settings is an ongoing, challenging task.

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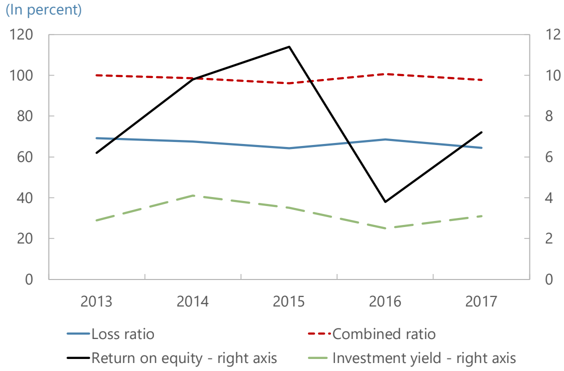
[6] AMF may require from insurer explanations about its rate changes or new criteria implemented in the rating process.

## Figure 3. Canada: Selected Statistics About the Federally Regulated Property-and-Castualty Insurers

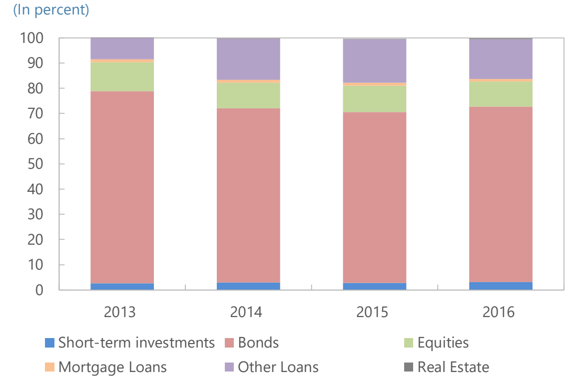
*Combined ratios are usually about 100 percent, exceeding 100 percent in 2013 and 2016. Return on equity is very sensitive to the combined ratio and to a lesser extent on return on investments.*

*However, there is evidence of search for yield behavior as the investment allocation shows a reduced allocation to bonds and an increased allocation to "other loans."*

**P&C FRIs Profitability**
(In percent)




**P&C FRIs Asset Allocation**
(In percent)




Source: OSFI and IMF staff calculations.

**17. In the two years in which federally regulated P&C insurers' combined ratios exceeded 100 percent, Canada experienced significant losses from natural catastrophe events.** Preliminary results in 2018 indicate another difficult year for P&C insurers. There have been a number of events which have been just below the threshold that triggers a claim through reinsurance. This means that the aggregate of these multiple smaller events will likely result in an underwriting loss in 2018.

***Mortgage Insurance (a Subset of Property-and-Casualty Insurance)***

**18. There are three mortgage insurers operating in Canada.** The largest mortgage insurer is the Canada Mortgage and Housing Corporation (CMHC). CMHC is a federal government agency which operates its mortgage insurance business on a commercial basis; in addition, it has a separate social housing mandate. CMHC benefits from an explicit government guarantee that provides 100 percent coverage of net claims by lenders in the event of CMHC's insolvency; in return, CMHC pays fees to the federal government in an amount of 3.25 percent of direct premiums written on all mortgage insurance contracts, and an additional 0.1 percent of portfolio insurance contracts written. As well, there are two private mortgage insurers operating in Canada, which are designated as approved mortgage insurers by the Minister of Finance on the advice of OSFI. They equally benefit from an explicit government guarantee; their coverage is, however, subject to a deductible of 10 percent. Simarly, the two private mortgage insurers pay fees to the federal government , but in an amount of 2.25 percent of direct premiums written.. Mortgage insurers are not allowed to cede risk into the reinsurance market according to requirements for the federal government guarantee.

**19. CMHC's role in the Canadian housing market is broader than providing mortgage insurance.** CMHC has a role in funding social housing and managing the National Housing Act (NHA) mortgage-backed securities program for which it provides a guarantee of timely payment to investors in the securities. CMHC also administers the Canada Housing Trust, which issues Canada Mortgage Bonds which are backed by NHA mortgage-backed securities.

**20. OSFI does not supervise CMHC under the Insurance Companies Act (ICA) but has a formal oversight role.**[9] OSFI's oversight responsibility only encompasses CMHC's commercial functions. Hence, OSFI does not oversee other functions of CMHC, such as its funding of social housing.

**21. CMHC is the dominant player in the mortgage insurance market.** The two private mortgage insurers follow the pricing of CMHC for the high loan-to-value (LTV) loans (i.e., loans with LTV above 80 percent). When OSFI's Capital Requirement for Federally Regulated Mortgage Insurers (CRMI) became effective, capital requirements for mortgage insurers substantially increased. As a result, CMHC revised its premium rates. When setting prices, CMHC considers a variety of metrics, including projected return on capital. In 2017Q1, premiums increased substantially for high-LTV loans in line with the need to hold substantially more capital. With the same pricing of the premium, a number of lenders have implemented random allocation of mortgage insurance across the three

[9] Section 21.2 of the National Housing Act.

mortgage insurers to ensure diversification. For low LTV-ratio portfolio insurance, there is a competitive market, with one or more of the mortgage insurers bidding to provide insurance on a mortgage portfolio.

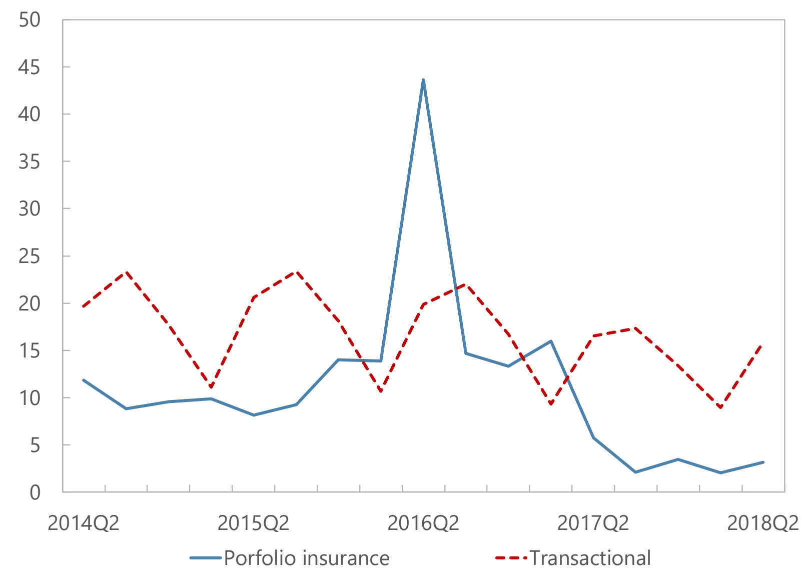
**22. Mortgage insurers are subject to a set of criteria for the types of mortgage loans they can insure while receiving the federal government guarantee.**[10] This set of criteria is known as the 'sandbox'. Only claims related to loans made according to the criteria set out in the 'sandbox' are eligible for the government guarantee. Key criteria include a borrowers' debt-servicing capacity (including stress tests), a maximum property value of Can$1 million, and a maximum amortization period of 25 years.

**23. All mortgage loans with LTV above 80 percent made by federally regulated financial institutions are required to be insured.** These loans are underwritten on a loan-by-loan basis (transactional). Nonbank mortgage lenders can also access mortgage insurance if they are an approved lender of one of the mortgage insurers. In order to qualify for the NHA mortgage-backed securities program, loans must be insured regardless of the LTV level. Therefore, federally regulated financial institutions and nonbank lenders may also purchase mortgage insurance on a book of loans on a portfolio basis where those loans have an LTV lower than or equal to 80 percent. This portfolio insurance business has collapsed since OSFI's revised capital guideline was implemented on January 1, 2017. Figure 5 below shows a significant increase in this portfolio business ahead of the anticipated repricing of portfolio insurance business particularly in the 65–80 percent LTV band. There was a pronounced spike in portfolio business in 2016Q2 ahead of the implementation of two regulatory changes (the other change was a Department of Finance (DOF)'s regulation that instituted a 'purpose test' for portfolio insurance, which came into effect in July 2016). Lenders rushed to meet this deadline, after which, any portfolio insurance obtained must be put into CMHC's securitization program within six months. In addition, this was before the implementation of the OSFI guideline that increased capital requirements (the CRMI) substantially, in particular for loans with LTV in the range of 65–80 percent.

**24. There is a declining level of high-LTV loans since the imposition of tighter requirements in the sandbox in 2016Q3.** The revision of the 'sandbox' introduced borrower stress testing, the cap of Can$1 million on the value of insured properties, and the maximum amortization of 25 years. There is clearly a seasonal business cycle, with most property transactions occurring in the second and third quarters of each year. Looking at the peaks in 2014–15 and comparing that with the peaks in 2016–17 clearly show a decline in transactional mortgage insurance for high-LTV loans (Figure 4).

[10] Eligible Mortgage Loan Regulations issued pursuant to subsection 42(1) of the Protection of Residential Mortgage or Hypothecary Insurance Act.

**Figure 4. Canada: Mortgage Insurance Premium by Quarter**
(In billions of Canadian dollar)




Source: OSFI.

# INSTITUTIONAL SETTING

## A. Supervisory Responsibilities, Objectives, and Powers

**25. Insurers are either incorporated under the federal or provincial regime.** Federally regulated insurers—insurers incorporated under the (federal) ICA as well as licensed Canadian branches of foreign insurers—are subject to OSFI's prudential regulation and supervision. Insurers, including federally regulated insurers, are subject to provincial prudential powers derived from provincial authorities' responsibilities for licensing of insurance business in their respective provinces. With respect to federally regulated insuers, such provincial prudential powers in most circumstances are not exercised independently, and cooperation occurs with OSFI. For instance, in Québec, all insurers, whether incorporated under the federal regime or in Québec or another province, are required to submit to the AMF's prudential framework. Hence, there is some overlap in prudential supervision of federally regulated insurers, but in practice most of the prudential supervision of federally regulated insurers is conducted by OSFI with some additional work conducted by provincial supervisors. Each province has an agency in charge of insurance supervision. With respect to insurance, OSFI's mandate is to protect the rights and interests of policyholders as well as creditors of insurers (as part of a mandate related to all financial institutions) and contribute to public confidence in a safe and sound financial system. Provincial supervisors largely follow OSFI's prudential guidelines, but AMF is actively engaged in policy development work with OSFI. AMF sometimes issues guidelines with some variations from OSFI's guidelines.

**26. OSFI exercises prudential regulation and supervision of federally regulated insurers.** Other federal agencies have a role regarding the insurance sector but do not have day-to-day involvement.[11] The Minister of Finance, supported by the DoF, has responsibility for overall stability of the financial system as well as legislation for the insurance sector at the federal level (as part of an overall mandate for financial sector legislation). OSFI is accountable to Parliament through the Minister of Finance. The Minister presides over and is responsible for OSFI, with the Superintendent in the role of the OSFI deputy head.

**27. The ICA requires approval of the Minister of Finance for changes in ownership, amalgamations, continuances and other types of transactions which have the potential to raise policy issues for the financial services industry as a whole.** For such approvals, the Minister receives a recommendation of the Superintendent. For such transactions, OSFI focuses on prudential issues and the Minister focuses on policy considerations.

**28. The provincial supervisors are responsible for supervising the conduct of business (CoB) of insurers (including federally regulated insurers) operating in their provinces.** The scope and approach adopted for CoB supervision of insurers and intermediaries in each province vary. In some provinces, insurance brokers and agents are regulated in the same manner and by the same supervisor, while in other provinces, self-regulatory organizations (SROs) may be given delegated powers to supervise certain categories of intermediaries.[12]

**29. Both OSFI and AMF refer to the Canadian Institute of Actuaries (CIA)'s Rules of Professional Conduct and the Canadian Actuarial Standards Board (CASB) standards of practice in their guidelines.** The ICA requires each insurer to have an appointed actuary,[13] who must be a fellow of the CIA. The appointed actuary's work must comply with Canadian Actuarial Standards of Practice produced by the CASB. The appointed actuary must also comply with the CIA's Rules of Professional Conduct. The CIA also issues Educational Notes to assist actuaries in applying standards of practice in respect of specific matters. Responsibility for the manner of application of standards in specific circumstances remains that of the practitioner. OSFI does not rely on the work of the appointed actuary without reviewing that work. Insurers provide their appointed actuary's key prescribed reports to OSFI—the Appointed Actuary's Report (AAR) and Dynamic Capital Adequacy Testing (DCAT) on an annual basis. OSFI issues annual memoranda setting out the information it needs to review in the annual evaluation. AMF has a similar process with regard to the appointed actuary; however, AMF provides guidance in addition to the CASB's standards of practice.[14]

**30. All insurers in Canada must apply IFRS to their public financial reporting which is also the basis for their regulatory reporting.** The Canadian Accounting Standards Board (CAcSB) has adopted International Financial Reporting Standards (IFRS) as the framework for accounting

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[11] For example, the Bank of Canada (BOC) provides liquidity to the Canadian financial system as needed, oversees payment, clearing and settlement systems, and assesses risks to financial system stability.

[12] For example, in Ontario, Registered Insurance Brokers of Ontario (RIBO), an SRO, supervises insurance brokers.

[13] Section 357.

[14] See for example, Actuary's Guide, September 2018 https://lautorite.qc.ca/fileadmin/lautorite/formulaires/professionnels/assureurs/guideactuaire-rapport-passif-polices-personnes_an.pdf

standards for publicly accountable enterprises. Each international accounting standard goes through an endorsement process at the CAcSB. The CAcSB is an independent, non-public body that establishes accounting standards for use by all Canadian entities outside the public sector. The CAcSB is funded by the Certified Professional Accountants of Canada. Publicly accountable enterprises include all insurers, as the definition of publicly accountable enterprises includes any entity "that holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses."[15] Therefore, the Canadian Generally Accepted Accounting Principles (GAAP) for insurers are IFRS. The ICA requires federally regulated insurers to apply Canadian GAAP.

**Box 2. On IFRS 17**

Since the adoption of IFRS in Canada in 2011, the previous Canadian GAAP accounting standards for insurance contracts have continued to apply, as IFRS 4 effectively grandfathered these pre-existing requirements. On May 18, 2017, the International Accounting Standards Board (IASB) issued IFRS 17 which at that time was due for implementation for all reporting periods beginning January 1, 2021. On 14 November 2018, the IASB proposed a deferral of one year to the implementation of IFRS 17.

As proposed by the IASB at the time of writing of this Technical Note, for the year beginning January 1, 2022 accounting for insurance contracts will undergo significant change in Canada. This will represent a complete overhaul of insurers' financial statements. Underlying this change will be fundamental changes that will affect the actuarial functions, finance functions and IT systems within insurers.

This will have ramifications for liabilities and therefore capital recorded on insurers' balance sheets as well as income recorded in statements of comprehensive income, as the way in which revenue and expenses will emerge will undergo fundamental changes.

All insurers and insurance industry associations consulted during the FSAP raised the issue of implementation challenges for IFRS 17. IFRS 17 will require significant systems development. The Canadian Life and Health Insurance Association (CLHIA) and the Insurance Bureau of Canada (IBC) were both among international insurance industry associations calling for a delay to implementation to allow more time to deal with these implementation challenges. This call by international insurance industry associations led the IASB's proposal to delay implementation by one year.

IFRS 17 implementation poses particular challenges for Canada because IFRS is applied to all insurers. In addition, prudential regulators in Canada tie prudential reporting and capital tests to the Canadian GAAP. This means that even small insurers in Canada must implement IFRS 17. Changes in the Canadian GAAP have a direct consequence on the life insurers' available capital in the Life Insurance Capital Adequacy Test (LICAT) and the provisions for adverse deviations (PfADs) that are taken into account for the surplus allowance, both of which are components of the numerator in LICAT capital ratios. There may also be an impact on how risks are measured for the base solvency buffer that is the denominator in LICAT capital ratios. For P&C insurers, the MCT capital ratio may be affected by changes to available capital, and there may be some impact on how capital required for various risks is determined.

OSFI and AMF have begun working with the industry about necessary changes to the LICAT and the MCT, as well as and the AMF equivalents. OSFI has provided guidance that federally regulated insurers should not adopt IFRS 17 early and that they should account for financial guarantee contracts in accordance with IFRS 17 and should not use the option to apply IFRS 9. In June 2010, AMF issued a statement that early adoption of standards is not permitted at the time of publication. After further analysis, AMF will notify institutions when early adoption is permitted. In September 2018, OSFI and AMF distributed draft LICAT and MCT guidelines to the industry for comment. In June 2019, they intend to distribute close to final guidelines, including changes to the LICAT and the MCT with respect to IFRS 17, and will conduct a quantitative impact study. In June 2020, a final package of guidelines and regulatory capital forms will be published. These dates

[15] Paragraph 3(a) of the Preface of CPA Canada Handbook.

**Box 2. On IFRS 17 (concluded)**

were set out in accordance with the original January 2021 effective date for IFRS 17 implementation. It is not yet clear whether this project plan will be adjusted in light of the proposed new effective date.

At the time of writing this Technical Note, neither prudential regulators nor insurers know the impact of implementing IFRS 17 in Canada because a number of material interpretations of IFRS 17 are required. IFRS 17 sets out principles for key inputs such as the discount rate and the techniques to be used in determining risk margins. There is a range of possible practices. The industry is not yet prepared to state where in the spectrum of possible practices or techniques they are likely to land. There appears to be 'first mover' reluctance. Behind the scenes, there are a number of groups formed to consider these issues in the accounting profession, actuarial profession and auditing profession. Ultimately, it is not in the interest of insurers, as well as their auditors and appointed actuaries, for there to be any outliers in the practical application of IFRS 17. There is a natural pull towards convergence within Canada and possibly internationally. However, the extent of that convergence is still unknown.

A smaller range of possible practices in each of the key judgements and interpretations needed for IFRS 17 implementation seems a likely outcome rather than a single answer for each judgement. Vigilance on the part of prudential regulators, appointed actuaries and auditors will be required to ensure that an accumulation of judgements in a particular direction does not lead to very different outcomes. Conservatism in all judgements may lead to very different outcomes compared to an accumulation of less prudent judgements.

One open question is the extent of international convergence in IFRS 17 implementation. This is an important matter for the three large Canadian life insurers that have significant operations abroad. Up until the advent of IFRS 17, accounting for insurance contracts was a matter of localized practice and therefore within a jurisdiction the accounting, actuarial and auditing professions could come to some consensus about practical implementation of accounting standards. This consensus building now needs to cross international boundaries for IFRS 17 implementation. Different jurisdictions are starting in different places, and this will complicate the process of achieving convergence in the necessary judgements to apply IFRS 17 in practice.

IFRS 17 implementation will be a journey within Canada and among all jurisdictions that apply IFRS. That journey began with the publication of the standard in May 2017. Its next major milestone looks to be the first financial reports after January 1, 2022. The journey is likely to continue thereafter as companies, stakeholders, the auditing profession and the actuarial profession look at IFRS 17 implementation across the insurance industry within Canada and then across the world. The natural pull towards convergence will continue.

## B. Inter-Agency Cooperation

**31. Formal coordination amongst the federal agencies is facilitated by three committees.** The Financial Institutions Supervisory Committee (FISC), which is chaired by the OSFI Superintendent, is the forum to exchange information related to supervision of federally regulated financial institutions and to deal with institution-specific issues. The Senior Advisory Committee (SAC), which is chaired by the Deputy Minister of Finance, focuses on financial sector policy issues and addresses systemic matters, including crisis preparedness. Both the SAC and the FISC have the same membership, including Bank of Canada (BOC), Canada Deposit Insurance Corporation (CDIC), DOF, Financial Consumer Agency of Canada (FCAC), and OSFI; however, other government agencies may be invited. The Heads of Agencies Committee, chaired by the BOC Governor, acts as a forum to exchange information and facilitate coordinated action on issues largely related to securities markets. Its membership includes DOF, OSFI and the four provincial securities regulators in Alberta, British Columbia, Ontario, and Québec.

32. **The CCIR facilitates coordination amongst provincial supervisors.** The CCIR is an inter-jurisdictional association of insurance regulators with the mandate to promote an efficient and effective insurance regulatory system in Canada. Membership of the CCIR includes all the provincial insurance regulators, and OSFI participates in the CCIR meetings as an observer.

33. **CCIR's activities have been significantly strengthened since the 2014 FSAP.** As per the 2014 FSAP recommendation, the CCIR has launched new initiatives to improve harmonization of CoB supervision across all provinces. In 2016, the CCIR began to implement cooperative supervisory activities, including on-site inspections and thematic reviews. All provincial supervisors share findings of their on-site reviews with other CCIR members. The CCIR Annual Statement on Market Conduct (ASMC) was introduced in April 2017 as a supervisory monitoring tool. This harmonized gathering of marketplace data is an important step forward in collecting Canada-wide insurance market data and supporting more effective supervision. This provides a single harmonized regulatory return covering information related to insurers' governance practices and policies with respect to the fair treatment of consumers. The information is collected once for all provincial supervisors. AMF administers the information collection on the basis of service agreements between AMF and each of the other nine provincial supervisors and three territories individually.

34. **This review does not cover the FCAC in view of its limited role in supervising the insurance sector.** The FCAC is an agency of the federal government. Its role with respect to insurance is limited and largely relates to consumer education.

# INSURANCE SUPERVISION

## A. Supervisory Approach

35. **OSFI conducts supervision on a consolidated basis, which involves an assessment of all of an insurance group's material entities both in Canada and internationally.** AMF also conducts supervision on a consolidated basis; however, the insurance groups it supervises substantively operate in Canada only.

36. **Both OSFI and AMF have an advanced approach to risk-based supervision and a very structured approach to escalating supervisory intensity as an insurer's risk profile increases.** OSFI and AMF have very similar approaches to supervision. An annual supervisory strategy is formulated for each insurer based on a risk assessment that is updated regularly after each supervisory activity. This sets out supervisory activities for the year. The aggregate risk assessment is based on the assessment of each significant activity of the insurance group in terms of inherent risk and quality of risk management to derive a view of net risk and importance for each significant activity. Consistency, quality and quantity of earnings, level of capital and liquidity risk, and liquidity risk management are then all assessed in light of the net risks from significant activities. These perspectives are pulled together in a risk matrix to derive a composite risk rating. This composite

risk rating then informs the level of intervention. Most insurers are deemed to have no significant problems and normal supervisory activities are undertaken. Beyond that, an insurer may be "staged," with four stages of enhanced intervention from "early warning" to "non-viability/insolvency imminent." When a federally regulated L&H insurer is 'staged', Assuris is informed and works cooperatively with OSFI. When a federally regulated P&C insurer is "staged," the Property and Casualty Insurance Compensation Corporation (PACICC) is informed and works cooperatively with OSFI. The process of staging works very similarly at AMF.

**37. Both OSFI and AMF have high-standard prudential guidelines that are highly compliant with the international standards.** Staff of both agencies also demonstrated excellent knowledge about the industry they supervise as well as a high level of expertise to undertake the task of supervision. Both OSFI and AMF appear to be adequately resourced. In AMF's case, it has the dual mandate of prudential and CoB oversight, both of which it appears adequately resourced to perform.

**38. The approach of OSFI and AMF to issue guidelines, work closely with the industry and apply moral suasion to achieve outcomes has worked well in a benign environment.** OSFI and AMF are highly respected by the insurance industry they supervise. There are acknowledged benefits from the flexibility of using guidelines rather than more legally binding regulatory instruments in terms of agility to respond to emerging risks.

**39. OSFI and AMF should seriously consider how this approach would work in an industry crisis situation.** The 2014 assessment made a recommendation to provide OSFI with delegated power to issue enforceable rules by administrative means. The Canadian authorities responded that their system works in their circumstances, a point that is agreed on for business as usual situations. For Québec, the Insurers Act (S.Q. 2018, c. 23, s. 3) introduced by Bill 141, which was enacted on June 13, 2018, will grant AMF with the powers to issue regulations once the Insurers Act comes into force in June 2019. It is not yet clear how AMF intends to use these powers.

## B. Cooperation and Coordination

**40. Cooperation and coordination between OSFI and provincial supervisors only occur on an informal basis that relies on specific interpersonal relationships**. The CCIR fosters cooperation and coordination among provincial supervisors, and OSFI has been an associate member of CCIR since its inception. OSFI, however, has not signed a memorandum of understanding (MoU) that allows it to formally share information with CCIR members or other provincial supervisors. Provincial supervisors which are CCIR members have signed a MoU to enable them to share information with one another. While OSFI does not have a MoU with any provincial supervisor in Canada, it has 18 bilateral MoUs with international counterparts and is a signatory of the International Association of Insurance Supervisors' Multilateral MoU (as is AMF). OSFI has a Cooperation Framework in place with AMF and exchanges information on an ongoing basis on matters of mutual interest, but this does not extend to formally sharing information on federally regulated insurers. Cooperation between AMF and OSFI is effective with respect to developing new regulatory initiatives for insurance supervision. OSFI also routinely informally liaises bilaterally with other provincial insurance supervisors such as British Columbia's Financial Institutions Commission and Ontario's Financial Services Commission (FSCO). Informal channels of information sharing depend on interpersonal relationships between OSFI staff and their provincial counterparts. Informal networks and verbal sharing of information appear to work to some extent, but this is not a robust platform for information sharing.

**41. OSFI and provincial supervisors should work together to address the concerns OSFI has regarding information sharing and to ultimately enter into MoUs to share information.** OSFI perceives risks to sharing information with provincial authorities given their mandates for CoB oversight and the more enforcement-oriented nature of that role. OSFI and provincial supervisors should work together to ensure adequate protection of any information that OSFI may share; OSFI should clearly communicate the level of protection of that information which would be satisfactory. The international Multilateral MoUs that OSFI has signed could be a benchmark.

**42. Both OSFI and provincial supervisors would benefit from better sharing of information.** OSFI's prudential supervision would benefit from input on market conduct issues, which can be indicative of endemic cultural or governance issues in a company. Provincial supervisors would benefit from greater input on prudential supervision and potentially less overlap on prudential supervision of federally regulated insurers licensed to sell insurance in their jurisdictions.[16] Provincial supervisors would benefit from the prudential perspective with regard to governance, culture and risk management within federally regulated insurers to help them assess the risk of market conduct issues.[17]

**43. There appear to be different practices and intensity of supervision between OSFI and AMF with regard to the supervision of significant L&H insurers.** Major federally regulated L&H insurers (under OSFI's supervision) are significant in the Canadian life insurance market and globally active so that a direct comparison with other entities is not meaningful. AMF has a dual mandate for prudential and market conduct oversight, thus combining some resources (e.g., on-site reviews) to cover both supervisory mandates. Besides the abovementioned factors, there are significant differences in the nature and intensity of how supervision is conducted by OSFI and AMF. OSFI has a more intense program of on-site inspections and more touch points with the major L&H insurers throughout the year than AMF. OSFI usually has more than one on-site review activity per year for a large L&H insurer. OSFI's on-site review activities are targeted to cover particular aspects of a L&H insurer's operations; for example, a specific investment portfolio or a significant activity outside of Canada. In comparison, AMF usually conducts an on-site inspection approximately once every two years with a broader coverage of topics including market conduct. The frequency can be higher if the risk profile increases; however, this was not observed during the review given no increased risk profiles. AMF meets periodically with executive staff of the control functions of major insurers. OSFI has significant monthly and quarterly interactions with the large L&H insurers it supervises; whereas, AMF can have months without interaction with a supervised life insurer. AMF receives biannual financial reports, while OSFI receives quarterly financial reports.

[16] For, example AMF undertakes financial analysis of federally regulated insurers licensed to sell insurance in Quebec.

[17] AMF receives all this information from federally regulated insurers through its prudential supervision.

**44. OSFI and AMF should work on a benchmarking exercise to ensure that the intensity of supervision of Canadian insurance companies is similar no matter who the supervisor is.** OSFI and AMF work closely in the development of insurance regulation resulting in a high degree of harmonization, which benefits the Canadian insurance market. This could be a template for close cooperation on the supervision side as well. It is notable that AMF supervises the fourth and fifth largest L&H insurers in Canada. AMF is the group-wide supervisor for one of the largest P&C insurers in Canada. It would be useful to assess the intensity of supervision, including supervisory activities taken, of the top-ten insurers in L&H and P&C sectors, taking into account the different risk profiles.

## C. Macroprudential Oversight of the Insurance Sector

**45. OSFI scans the external environment and insurance industry to identify emerging issues.** While primarily a microprudential supervisor, OSFI in undertaking this task assesses each insurer through an in-depth understanding of the company, the insurance industry and the operating environment. The Risks, Surveillance and Analytics Division conducts market surveillance and environmental scanning, and coordinates the Emerging Risk Committee (ERC) meetings. The ERC has representation from across OSFI and meets at least quarterly with the Superintendent. The ERC supports prioritization and encourages strategic responses to evolving and emerging risks. The ERC serves as a forum to facilitate a comprehensive understanding of the evolving and emerging risks, including identified gaps in OSFI's current approach to regulation and supervision of federally regulated financial institutions.

**46. AMF monitors emerging and systemic issues on an ongoing basis.** The Chief Economist Office, within the International Affairs and Strategic Oversight Department, monitors systemic risk across the financial system (including the insurance sector) and coordinates the Integrated Oversight Committee, which includes staff members from regulatory departments covering all financial institutions and markets regulated by AMF. This process enables AMF to obtain a comprehensive view of the financial system in Québec.

**47. There is no complete Canada-wide surveillance of the insurance sector.** No government body at the federal or provincial level has a complete statistical picture of the Canadian insurance sector. OSFI, as well as the Federal coordinating bodies (i.e., the FISC and the SAC), only consider federally regulated financial insurers, which do represent a large market share but still miss some material provincially regulated insurers. Provincial supervisors are not involved in formal discussions with the federal bodies about market-wide issues although there are informal lines of communication.

**48. Complete Canada-wide surveillance of the insurance sector should be conducted.** This requires aggregation of complete statistics about the Canadian insurance sector and a forum for federal and provincial authorities to discuss market-wide trends and risks to the insurance sector. This surveillance process will help take into account perspectives of the DOF, prudential supervisors and market conduct supervisors. Existing regulatory returns for microprudential supervision purposes should be enhanced to allow monitoring for macroprudential purposes (for example, see the issue of granularity raised in paragraph 12.

## D. Life-and-Health Insurance

***Solvency Requirements***

**49. The Canadian Asset Liability Method (CALM) is required to be used for the valuation of life insurance contract liabilities under IFRS 4, which continues to apply until the introduction of IFRS 17.** CALM produces liabilities that are valued in a manner consistent with the valuation of assets. This occurs because CALM involves a projection of cash flows from both the insurance policies and from the assets allocated to support them. The result is that as asset values change, the liability values move in tandem, unless there is a change in underlying experience or assumptions. If there is such a change in underlying experience or assumptions, the present value of that change based on projected future cash flows is taken into account.

**50. CALM is very different from other approaches to liability valuation in that it does not rely on an explicit discount curve.** However, for the comparison to international approaches, one can consider a notional discounting approach from an analysis of CALM. CALM allows insurers to take into account the full rate of return (i.e., all contractual cash flows) on all fixed-income assets as well as non-fixed income assets such as equities and real estate (there are some limiting assumptions on these types of assets). On the surface this looks much less prudent than other approaches to discounting insurance liabilities, which can be observed internationally. However, offsetting this apparently generous approach to notionally discounting liabilities, CALM requires the appointed actuary to determine provisions for adverse deviations (PfADs) for fixed-income asset defaults, non-fixed income assets' market risk, risk-free interest rate risk, credit spreads, mortality, mortality improvement, morbidity, morbidity improvement, lapse, and expenses. These PfADs are determined on application of a variety of scenarios with the worst outcome from application of scenarios taken as the PfAD. The aim is to have insurance contract liabilities valued within a corridor of 60-80 percent conditional tail expectation (CTE). It is impossible to directly compare CALM to other international approaches, but the impending IFRS 17 implementation will require implementation of an internationally comparable approach to valuing insurance contract liabilities.

**51. OSFI and AMF implemented the Life Insurance Capital Adequacy Test (LICAT) in 2018.** The LICAT replaced the Minimum Continuing Capital and Surplus Requirements (MCCSR), which was in place at the time of the 2014 assessment. The LICAT is a more advanced and risk-sensitive approach to capital and compares well with best practice solvency requirements internationally.

**52. The LICAT utilizes a mix of factor-based approaches and prescribes shock assumptions to measure a base solvency buffer.** The LICAT covers credit risk, market risk (interest rate risk, equity risk, index-linked products risk, currency risk), insurance risk (mortality risk, longevity risk, morbidity risk, lapse risk, expense risk, property and casualty risk), segregated funds guarantee risk and operational risk. All risk measures are targeted at a consistent level of confidence, namely

99 percent CTE over the one-year horizon. Diversification is taken into account within insurance risk and among all risks.

**53. Reflecting the nature of the three largest L&H insurers in Canada, the LICAT aggregates base solvency buffers across six geographies.** The six geographies are Canada, Japan, the United Kingdom, the United States, other Europe (outside the United Kingdom), and other locations. Liabilities are allocated to geographies based on the location where the business policy was written directly. Assets are allocated to the same geography as the liabilities that they back. The geography of the entity holding assets backing surplus determines the geography of those assets. The aggregation of up to six base solvency buffers across these geographies means that there is no allowance for diversification across these geographies.[18]

**54. There are two LICAT solvency ratios—total capital ratio and core capital ratio.** The base solvency buffer (the denominator) is compared to the sum of available capital, surplus allowance and eligible deposits (the numerator). The total capital ratio is:

$$\frac{Available\ capital + Surplus\ allowance + Eligible\ deposits}{Base\ solvency\ buffer}$$

The core ratio is:

$$\frac{Tier\ 1\ capital + 70\ percent\ of\ (Surplus\ allowance + Eligible\ deposits)}{Base\ solvency\ buffer}$$

Available capital consists of tier-1 and tier-2 capital subject to composition limits. There are deductions from tier-1 capital (e.g., goodwill and intangibles), some of which can be partially included as tier-2 capital (e.g., 50 percent of the deducted asset). Surplus allowance consists of certain PfADs calculated under CALM—risk-free interest rate risk PfADs and insurance risk PfADs. Eligible deposits are excess deposits placed by unregistered reinsurers and claims fluctuation reserves.

**55. When IFRS 17 is implemented, consideration should be given to how spread risk is taken into account in the overall solvency framework.** Spread risk refers to changes in the level or volatility of spreads between market asset returns/applicable discount rates on liabilities liabilities and the risk-free interest rate and how such spreads on asset returns and liability discount rates may vary. Currently, a PfAD for spread risk is calculated within the insurance contract liabilities, and this is not included in the surplus allowance. Therefore, within the Canadian life insurance solvency framework some allowance for spread risk is included, although it can be argued that it is not at the same level as other risks calculated at 99 percent CTE within the LICAT. The LICAT does not include a spread risk component. Given how insurance contract valuation is undertaken, this is somewhat understandable (a focus on cash flow matching and the inclusion of the PfAD). However, when IFRS 17 is implemented it is not clear if any component of the risk margin will relate to spread risk. Even

[18] An exception is a limited portfolio volume credit applicable to a component of the mortality and morbidity requirements.

when a 'top-down' approach to discounting is applied, it appears likely that there will be scope for asset and liability values to move to some degree independently if spreads over risk-free asset returns increase due to market repricing of risk. There may be a reasonable argument about trying to disaggregate the component of spread risk related to temporary market liquidity conditions and long-term changes in market pricing of credit risk so that any measure of spread risk focuses on the latter.

***Qualitative Requirements***

**56. OSFI and AMF have a comprehensive set of guidelines covering sound business and financial practices addressing governance and risk management issues.** Some of these guidelines are specific to life insurance and others are cross-sectoral, befitting the nature of OSFI and AMF as integrated prudential supervisors. An important guideline introduced since the 2014 assessment is E19: Own Risk and Solvency Assessment. This new requirement is addressed in more detail in the subsequent section on ORSA.

***Group Supervision***

**57. Consolidated group supervision is the focus of supervision for L&H insurers by both OSFI and AMF.** In OSFI's case, in relation to the three large L&H insurers, this means a focus on global group supervision. Both OSFI and AMF take an appropriately pragmatic view to supervision and apply their supervision in a way that is congruent with how life insurance groups are managed, focusing on significant activities of the group no matter where they are located in the group either legally or geographically. While OSFI expects insurers to hold capital within the consolidated group in a manner that is consistent with the level and location of risk, there is less focus on Canadian activities than is ideal.

**58. Disclosure requirements apply at the group level with little disclosure at the solo entity level.** OSFI and AMF should carefully consider the requirements of ICP 20 at the solo level, once ICP 20 is revised in late 2019, and ensure that such disclosures are easily available to the relevant stakeholders of the Canadian legal entities. Solo level disclosures should be required in a proportionate way.

**59. More emphasis on solo supervision would be desirable.** High emphasis is placed on consolidated, group-wide supervision. A greater focus on solo supervision, to complement group-wide supervision, would enhance the overall quality of supervision and provide a better basis for considering Canada-specific risks.

**60. Both OSFI and AMF rely on voluntary undertakings from holding companies to be able to apply prudential requirements and seek information on holding companies and group-wide activities that may create risks for the insurance subsidiaries.** In OSFI's case there are examples where no such undertakings exist in relation to group supervision. Also, there are contrasting approaches among life insurance groups.

**61. In both OSFI and AMF's case, they must wait for an approval of a change of ownership or similar transaction in order to have the opportunity to negotiate an undertaking to conduct group-wide supervision, including of holding companies.** There is uneven application of guidelines to group-wide activities as some groups have the full suite of guidelines applied, others have an information gathering requirement imposed, and some aspects of guidelines are applied based on an undertaking (e.g. capital ratio calculation). This was an important issue raised in the 2014 assessment that has not been addressed. It will require legislative changes at both the federal level and in Québec.

**62. Both OSFI and AMF should be given necessary powers to apply group-wide supervision in the same way no matter the legal structure of the insurance group.** This is particularly important given the emphasis on group-wide supervision. AMF should be able to impose its guidelines on holding companies of insurance groups irrespective of group structure or legal basis of incorporation.

***Downstreaming of Senior Debt***

**63. The absence of target capital ratios at the non-operating L&H insurers and differences in minimum core capital ratios at non-operating L&H and operating insurers allow the non-operating L&H insurers to raise senior debt and downstream that into the operating L&H insurers as qualifying available capital.** OSFI sets out target and minimum capital ratios for L&H insurers in Guideline A4: Regulatory Capital and Internal Capital Targets. For operating L&H insurers, the minimum and target total capital ratios are 90 and 100 percent, respectively, and the minimum and target core capital ratios are 55 and 70 percent, respectively. Non-operating L&H insurers are not subject to target capital ratios; their minimum total and core capital ratios are set at 90 and 50 percent, respectively. The absence of target capital ratios at the non-operating L&H insurers and differences in minimum core capital ratios at the non-operating (50 percent) and operating L&H insurers (55 percent) allows the non-operating entities to raise senior debt and downstream that into the operating entities as qualifying available capital without the possibility of breaching the target capital ratio at the non-operating company level.

**64. Issuance of senior debt by non-operating L&H insurers or holding companies is not a concern of itself; the concern is how it is treated in the capital framework.** For the purposes of funding an insurance group's operations there may be certain advantages for senior debt issuance, such as market liquidity and lower funding costs. Generally, senior debt is less expensive than subordinated debt that meets available capital requirements. However, downstreaming of senior debt and conversion of it into allowable capital instruments should be discouraged. For very good reasons, in accordance with international good practice and the approach to available capital in the banking sector, OSFI's LICAT definition of available capital does not include senior debt and this should not be undermined through different capital ratio requirements. OSFI does require that all regulated entities set internal targets and operating levels above the minimum and supervisory targets (as applicable), and disclose their total and core capital ratios on a quarterly basis.

## E. Property-and-Casualty Insurance

***Solvency Requirements*[19]**

**65. The valuation of policy liabilities covers expected losses plus expected deviations from the best estimate.** These are determined using provisions for uncertainty in the assumptions in the form of a PfAD. For P&C insurers, a PfAD is included in the determination of policy liabilities for the following risks: claims development, recovery from reinsurance ceded, and investment return rates. Capital requirements are determined as an excess amount above the PfAD.

**66. The Minimum Capital Test (MCT) ratio is calculated by dividing capital available by minimum capital required.** Capital available consists of Category A, B, and C capital with categories B and C subject to composition limits. Category A capital largely maps to tier-1 available capital in the LICAT. The minimum capital required consists of the sum of the capital requirements at the target level—99 percent CTE—for each risk component,[20] less the diversification credit. Risks covered are insurance risk (related to unpaid claims, premium liabilities, reserves for ceded reinsurance to unregistered reinsurers and catastrophe risk), market risk (interest rate risk, foreign exchange risk, equity risk, real estate risk and other market exposures), credit risk (counterparty default risk related to on-balance sheet and off-balance sheet exposures and collateral held for reinsurance exposures with unregistered reinsurers) and operational risk.

**67. OSFI and AMF made significant revisions to the MCT guideline in 2015 to make it more robust and risk-based.** Some of the more significant changes are to the definition of capital available, adjustments to insurance risk factors, adjustments to credit risk factors, recalibration of some market risk factors, introduction of foreign exchange rate risk, an explicit charge for operational risk, and recognition of diversification benefit between insurance risk and the sum of credit and market risk. The MCT has been further updated with minor revisions in 2017 and 2018, including to allow for accounting standard changes.

***Reinsurance Framework***

**68. OSFI has undertaken a broad review of the reinsurance framework applicable to federally regulated insurers.** This review applies to L&H and P&C insurers, but is more significant for the latter. OSFI has become concerned with insurers writing increasing amounts of business in Canada then ceding a significant portion of these risks outside of Canada. OSFI is concerned about the resulting small amount of capital or vested assets maintained in Canada to support the increased risk exposure, particularly through higher policy limits. In commercial P&C insuance, OSFI has observed a significant increase in policy limits but net retentions remain at similar levels; this is what OSFI refers to as a "leveraged business model." When losses occur a large reinsurance recoverable will be created, which becomes an on-balance sheet credit risk. This credit risk can be

[19] The comments apply equally to OSFI and AMF.

[20] Catastrophe risk in relation to earthquake must be calculated at a 1 in 500 occurrence level, a requirement subject to transition until 2022.

concentrated at a single counterparty. This represents a potential solvency issue in the event the unregistered reinsurer does not promptly settle its claim in line with the federally regulated insurer's obligation to settle its claim liability. OSFI is consulting with the industry regarding key proposals aimed to address risks associated with large exposures and concentration risk. Adjustments to the capital framework for P&C insurers are also being considered along with maximum policy limits linked to capital or assets held in Canada.

**69. One issue not covered by the OSFI discussion paper on reinsurance is any mention of supervisory recognition.**[21] While taking into account the supervision performed by the unregistered reinsurer's supervisor may not address all of OSFI's concerns, it may address some of those concerns. It is notable that ICP 13 requires supervisors to consider the supervision performed by reinsurers' supervisors.[22]

***Earthquake Risk and Financial Stability***

**70. Risk of earthquake is a significant natural catastrophe scenario in Canada with two key earthquake zones in British Columbia and Québec.** The take-up rate for earthquake insurance in the British Columbia earthquake zone is high, at around 40–70 percent of homeowners. Therefore, for P&C insurers in Canada the focus of their risk modelling and mitigation of earthquake risk through catastrophe reinsurance is on that region. In the Québec earthquake zone, which covers a corridor from Québec City to Ottawa, the take-up rate on earthquake insurance is much lower, at around 2–4 percent. Mortgage insurance coverage excludes losses due to damage from natural disasters, including earthquakes. A combination of low take-up rates on earthquake insurance and mortgage insurance exclusion means that a significant amount of earthquake risk would end up with banks and other lenders. For this to occur, borrowers would need to default on their mortgages and then the damaged property would need to be of a sufficiently low value not to cover the outstanding amount of the loan. Such a scenario is not improbable, as a significant earthquake is likely to cause business interruption leading to unemployment and thus mortgage defaults.

**71. Earthquake risk may create a financial stability issue if significant losses to banks and other lenders are sustained due to uninsured earthquake risk.** A report authored by former OSFI Superintendent, Nicholas Le Pan,[23] highlighted this financial stability risk. There are two key recommendations from this report. One is to set up a federal emergency backstop arrangement for P&C insurers to minimize the systemic financial impact resulting from a catastrophic earthquake that is likely uninsurable. Another is that the industry, as well as federal and provincial authorities, should undertake an education campaign to encourage disaster insurance coverage, particularly in the Québec City-Ottawa corridor. AMF has undertaken a special project to analyze and determine how to mitigate the major financial risks—to the public and to the industry—of a moderate or major earthquake in Québec.

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[21] Discussion Paper on OSFI's Reinsurance Framework, June 2018.

[22] See Standard ICP 13.4.

[23] Fault Lines: Earthquakes, Insurance, and Systemic Financial Risk, Nicholas Le Pan, C.D. Howe Institute, Commentary No. 454, August 2016

**72. Federal authorities are aware of this risk and have established an Earthquake Working Group within the SAC.** Provincial authorities from British Columbia, Ontario and Québec are not represented in the working group. OSFI and AMF are strengthening the resilience of the P&C insurance sector to earthquake risk by requiring capital at a 1 in 500 years occurrence level by 2022. These actions to address earthquake risk in Canada from a microprudential supervision and financial stability perspective are commendable. However, the problem is complex. In order to increase insurance coverage for earthquake risk, coverage must be available and affordable to consumers. In order for coverage to be available and affordable, insurers must be able to economically transfer the tail risk to reinsurance markets, through alternative risk transfer arrangements to capital markets (e.g. insurance-linked securities) or to a government backstop arrangement such as a reinsurance pool. Mandating earthquake coverage by homeowners or at least residential mortgage borrowers may be another tool, but there must be private insurers willing to sell such products affordably. There would be a moral hazard concern if the resources of private insurers are not sufficient to deal with an earthquake once it happens. In addition, in the absence of private coverage (or gaps in private coverage) there may be an expectation of government assistance in the event of such a significant disaster, which may give rise to an implicit government guarantee. This complex issue will only be addressed through a coordinated effort across federal and provincial authorities, together with input from the P&C insurance industry and other relevant players. Such coordination is encouraged, and the establishment of the SAC's working group is a good first step.

## F. Mortgage Insurance

***Solvency Requirements***

**73. The solvency requirements for mortgage insurers are based on the MCT for P&C insurers as mortgage insurers are P&C insurers.** Two key changes are applied to the MCT for mortgage insurers—the insurance risk calculation is entirely different and based on the risks borne by mortgage insurers and the diversification credit between the sum of credit and market risk requirements and insurance risk requirements does not apply. The key insurance liability for mortgage insurers on the balance sheet is unearned premium, subject to a test of adequacy (profit can be deferred but not losses). The balance sheet liability usually includes deferred expected profit in excess of the best estimate liability and PfAD. Capital requirements are in addition to the unearned premiums.

**74. The advisory CRMI, which came into effect on January 1, 2017, represented a significant change to how the insurance risk component is calculated in the MCT for mortgage insurers.** The CRMI defined a new approach for the regulatory capital requirements for mortgage insurance risk that is more risk sensitive and incorporates key characteristics such as borrower creditworthiness, outstanding loan balance, LTV ratio, and remaining amortization. It also introduces a greater level of prudence in the protection provided to policyholders and other creditors of the mortgage insurers. In particular, the new framework resulted in a 48 percent increase in sector-wide Pillar 1 capital required . Some of the increase in capital requirements represents a shift from Pillar 2 to Pillar 1 requirements.

**75. The CRMI is being updated in 2019, and a new separate guideline—Mortgage Insurer Capital Adequacy Test (MICAT)—has been issued.** Once the MICAT guideline is effective, on January 1, 2019, it replaces the MCT and the CRMI so that mortgage insurers have just one guideline for capital adequacy. The MICAT essentially combine the CRMI and relevant chapters of the MCT, along with some minor changes.[24] The formula for determining premium liabilities risk for residential mortgage loans refers to borrower credit scores at origination and removes references to credit score updating. The formula similarly accounts for property values at origination, but does take into account amortization of the loan balance so that LTVs are only updated with respect to outstanding loan balance. In this related change, capital requirements are increased by 5 percent to allow for deterioration in borrower credit scores after origination.

**76. Most capital for mortgages with LTV above 80 percent are held in the three mortgage insurers.** Banks hold capital to varying degrees for this risk depending on their use of the standardized approach, which provides for a zero risk-weight for such loans, or use of the Internal Ratings-Based approach (IRB), where different banks carry different amounts of capital for these loans.

**77. Comparing the capital required to be held by mortgage insurers and deposit-taking institutions for insured mortgage loans to international benchmarks for capital for such loans are not within the scope of this review.** This exercise would require access to sufficient data to calculate the amount of capital that deposit taking institutions (DTIs) are required to hold for insured mortgage loans and the capital that mortgage insurers are required to hold for the same insured mortgage loans (along with deferred profits related to those loans). These capital and deferred profit must be compared with what required capital would be for deposit-taking institutions in the absence of mortgage insurance.

**78. It is not clear that the transfer of risk from deposit-taking institutions to mortgage insurers results in sufficient capital overall within the Canadian financial system.** The capital requirements for mortgage insurers is calculated in a different way than for deposit-taking institutons. In addition, there is loss absorbing deferred profits in mortgage insurers' unearned premium provision. Feedback from the mortgage insurance industry indicates that at the time of writing this Technical Note, the amount of mortgage insurers' capital for loans with LTV in the range of 65–80 percent exceeds deposit-taking institutions' capital for these loans, making portfolio insurance uneconomic and therefore changing the profile of risks insured by mortgage insurers. There is evidence that the market for 'portfolio insurance' in that LTV bracket has reduced significantly due to the premium that needs to be charged to deliver a return on capital, providing more evidence that mortgage insurers' capital requirements are more stringent at this LTV bracket. This demonstrates that capital requirements can be quite different between the two industries.

**79. OSFI should carry out a benchmarking exercise between deposit-taking institutions' capital if there was no mortgage insurance and current capital requirements across the**

[24] The MICAT introduces credit risk capital charges for right-of-use assets resulting from the implementation of IFRS 16 and updates the credit risk factors for securitized assets with the factor table from Guideline B-5: Asset Securitization.

**deposit-taking and mortgage insurance industries.** This analysis should be more comprehensive than previous studies that have only involved a few banks using IRB. It should seek to answer the question of whether the use of mortgage insurance reduces the financial system's overall loss absorbing capacity. The loss absorbing deferred profits within the unearned premium provision of mortgage insurers would also need to be considered in the exercise. The exercise could also be extended to loans with LTV below 80 percent where mortgage insurers may offer 'portfolio insurance' to lenders.

## G. Market Conduct Supervision

**80. Market conduct supervision is undertaken by provincial supervisors in Canada.** Each province has established a supervisory agency for this purpose, and some of these supervisory agencies are also responsible for prudential oversight of insurers chartered in that province. This review assessed market conduct supervision by AMF in Québec and, to a more limited extent, market conduct supervision by FSCO in Ontario. The activities of the CCIR were also assessed to a limited degree.

### *Coordination of Market Conduct Supervision*

**81. Coordination and cooperation among provincial supervisors with respect to market conduct supervision has improved since the 2014 FSAP.** The following cooperative activities have been noted:

- Sharing of results of on-site reviews conducted individually by provincial supervisors;
- The initial joint on-site review conducted with respect to a large L&H insurer;
- Collection of common market conduct data to a central point, administered on behalf of other provinces by AMF.

**82. This increased cooperation appears to address a number of recommendations from the 2014 assessment.** The recommendations encouraged further work by the CCIR to increase consistency of market conduct oversight across Canada. The work of the CCIR has also assisted AMF and FSCO to address recommendations in the 2014 assessment.

### *Market Conduct Supervision in Ontario*

**83. Market conduct supervision of insurers and intermediaries in Ontario is performed by two supervisors—FSCO and the Registered Insurance Brokers of Ontario (RIBO).** RIBO is a SRO supervising insurance brokers in Ontario. As this Technical Note does not include intermediaries in scope, RIBO was not included in discussions or information requests.

**84. The main role of FSCO is market conduct supervision.** FSCO also has a prudential supervision mandate for a limited number of Ontario chartered insurance companies. FSCO has been actively following up on the recommendations of the 2014 assessment; however, several of those recommendations were only able to be addressed by the Ontario government.

**85. The Financial Services Regulatory Authority of Ontario (FSRA) was established by legislation in December 2016 as an independent regulatory agency.[25]** FSRA will assume the functions currently performed by FSCO and the prudential oversight function of cooperative deposit-taking institutions (credit unions) performed by the Deposit Insurance Corporation of Ontario. There is a transition plan in place with the aim of FSRA becoming fully operational by Spring 2019, pending requisite approvals and agreements.

**86. The creation and impending commencement of operations of FSRA appear to have addressed many of the recommendations of the 2014 assessment regarding the powers and resources of FSCO.** FSRA has been created as an independent, self-funded supervisory authority.[26] This will address the 2014 assessment's recommendation to consider exempting FSCO from the Ontario government's fiscal controls and administrative guidance as well as hiring controls set by the Ontario Public Service. In addition, FSRA will be overseen by a board of directors, with the chair and directors appointed by the Lieutenant Governor-in-Council on the advice of the Minister of Finance for a specific term. The board of directors appoints a Chief Executive Officer to be responsible for the day-to-day running of FSRA. This is in contrast to FSCO which was overseen by a Superintendent who performs the dual role of Chief Executive Officer of FSCO and assumes the statutory powers and duties of the Superintendent. The 2014 assessment included a recommendation to establish explicit provisions on public disclosure of the reasons for removal of the FSCO Superintendent. The FSRA Act does not appear to require such public disclosure for the appointment and removal of the chair and directors. Also, ministerial control remains strong through the requirement for the Minister to approve all by-laws made for the operation of FSRA, which means that ministerial control could be intrusive.

**87. FSCO and the CCIR have addressed recommendations of the 2014 assessment related to harmonization of regulatory regimes across provinces.** FSCO's Treating Financial Services Consumers Fairly Guideline (TCF) was issued in September 2018 and aligns with the work of a CCIR committee. The CCIR and the Canadian Insurance Services Regulatory Organizations issued guidance related to conduct of insurance business and fair treatment of customers on September 27, 2018.

***Market Conduct Supervision in Québec***

**88. AMF is the market conduct supervisor in Québec as well as the prudential supervisor for insurers chartered in Québec.** AMF derives its mandate from the Act Respecting Insurance, which will be replaced from June 13, 2019 by the Insurers Act.

[25] Established by the Financial Services Regulatory Authority of Ontario Act, 2016 (FSRA Act).

[26] The Ontario Legislature proclaimed FSRA's rule-making authority on September 28, 2018 including those governing fees and other charges required for FSRA to operate as an independent, self-funded agency that will operate on a cost recovery basis.

**89. Currently AMF can impose administrative penalties for any breach of the Act.**[27] This power has been used, among other things, to impose administrative penalties on insurers for breaches of the obligation to adhere to sound commercial practices as well as sound and prudent management practices. AMF imposes administrative monetary penalties on contravening insurers, in accordance with the Act Respecting Administrative Justice. The merits of the penalty imposed may be contested by the insurer before the Administrative Tribunal of Québec.

**90. AMF's ability to apply enforcement action has been changed by the Insurers Act, and this may make it more difficult for AMF to exercise its powers.** In particular, there would be fewer circumstances in which AMF can apply penalties and less effective penalties when it can apply them. The Insurers Act provides for a different approach in that only certain deficiencies identified by law, because of objectively observable facts, (e.g. failure to file documents) may be subject to administrative monetary penalties. The same issue exists for quasi-criminal offences because the current provision enabling prosecution for any contravention of the law or the regulations[28] has not been included in the new law, which limits the right to sue to a list of identified offences.[29] AMF may, under the Insurers Act, issue an order to the insurer to cease a misconduct or to take any action requested by AMF. Only in the case of failure to comply with such an order may AMF impose an administrative penalty in the amount of Can$10,000 per day. Thus, the initial breach that occurred prior to the issuance of such an order will not be subject to such an administrative penalty.

**91. The Québec government and AMF should jointly review the possible effectiveness of the new penalty regime based on the Insurers Act.** Substantial weakening of AMF's ability to take action should be addressed through amendments to the Insurers Act. This matter should be reviewed in conjunction with the case cited in the paragraphs below.

**92. Between 2009 and 2017, AMF took a number of steps to correct commercial practices related to the offering of insurance products by car dealers.** The products in question were policies that cover the difference between the value of a new replacement vehicle and an insurer's claim payment in the event of total loss of a vehicle.[30] Consumer dissatisfaction with sales practices included incomplete or inadequate explanations or disclosures and the sales tactics used to sell the products. Several notices were published by AMF to inform insurers and car dealers of their obligations and responsibilities. AMF reviewed the business practices of the main insurers in this market, and also imposed penalities on some entities. Despite AMF's actions and interventions, deficiencies in commercial practices persist at the time of writing this Technical Note. The inability to end commercial practices that put consumers at risk over such a long period indicates that AMF's penalty regime and moral suasion approach to supervision under the existing Act Respecting Insurance may not be sufficient to deter unsound business practices.

**93. Both the enforcement tools available to AMF and its own approach that relies on moral suasion over a long period of time have been ineffective in preventing harm to**

[27] Section 405.1 of the Act Respecting Insurance.

[28] Section 406 p) of the Insurance Act.

[29] Sections 513 to 516 of the Insurers Act.

[30] Called "Complementary Insurance for Damage Caused to Insured Vehicle."

**consumers in this case.** It appears AMF's enforcement action on some actors in this market have not been a deterrent to others. AMF could have escalated the matter more with the involved insurers (e.g. board discussions), but it is unclear whether this escalation of moral suasion would have been any more effective. The case has a number of lessons for AMF, the Québec government and other authorities across Canada:

- Moral suasion has not worked in this case;
- Penalties and enforcement actions taken (against car dealers and distribution firms) have not constituted an adequate deterrent;
- Over a long-time period AMF has not escalated its enforcement action.

## H. Own Risk and Solvency Assessment (ORSA)

**94. OSFI issued its ORSA guideline in 2015.** The ORSA guideline cross refers to OSFI's Stress Testing Guideline, which is a cross-sectoral standard. Furthermore, OSFI's guidelines for capital tests[31] require insurers to set their own internal capital target, which is effectively achieved through conducting ORSA. This implementation addressed a material recommendation from the 2014 assessment, when OSFI was found to be only partially observing ICP 16 due to the lack of an ORSA requirement.

**95. AMF's implementation of ORSA is more complicated.** As a starting point, the requirements for the implementation of ORSA are expressed in Principle 5 of the Capital Management Guideline. The next component is the Integrated Risk Management Guideline, which requires insurers to have complete, formal and integrated risk management strategies, policies and procedures that enable them to identify, assess, quantify, control, mitigate and monitor risks. Furthermore, they should make their risk management decisions considering, among other things, their risk appetite, financial resources, regulatory capital requirements and economic capital. The Stress Testing Guideline complements the ORSA regime in Québec. AMF also sees the fulfilment of DCAT by the appointed actuary of the insurer as part of its implementation of ORSA. However, ORSA is a requirement of the insurer and DCAT is the appointed actuary's responsibility.[32]

**96. DCAT performed by appointed actuaries are used to inform ORSA, which is the responsibility of insurers' management.** In some cases, ORSA stress testing refers to DCAT stress testing only; in other cases, mainly larger companies, there are also management-specified stress tests in addition to DCAT stress tests. The CIA is undertaking a project of integration of the DCAT and ORSA processes to allow for a better alignment with ORSA regulatory requirements.

**97. There has been limited experience with ORSA since its implementation in 2015.** OSFI and AMF do not receive ORSA reports as a matter of usual reporting in order to emphasize that this

[31] These include the LICAT, the MCT and the MICAT.

[32] AMF understands and accepts that for some smaller insurers, DCAT done by the appointed actuary of the insurer may be used by the insurer as an input to its ORSA.

is not intended to be a regulatory compliance requirement but a tool for insurers to manage their own capital. Both OSFI and AMF have requested ORSA documentation from companies to review the initial reports. OSFI and AMF receive ORSA key metrics. On-site inspections and regular discussions with management do incorporate review and discussions of ORSA.

98. **A review of the key metrics reveals that larger insurers' views of their own capital requirements are consistently less than the regulatory target capital.** For smaller insurers, their own views of the capital requirements tend to be much higher than the regulatory target capital. A review of a small sample of ORSA reports showed that large insurers tended to calculate each of the risks as a higher amount than under the relevant regulatory capital test for the industry, but their own view of the diversification credit is much more significant than the diversification credit under the regulatory requirement. For L&H insurers, the sharing of losses with policyholders through the ability to adjust policy holder benefits was also much more significant in their ORSA calculations than in the LICAT. It is understandable that a regulatory capital test has to be calibrated for the median company and may overestimate capital requirements for larger insurers compared to smaller insurers. However, there should be caution in considering diversification benefits at 99 percent CTE. Correlation of tail risks tends to be very different from correlation of risks in business as usual circumstances. The global financial crisis proved that assumptions about diversification of risk do not necessarily hold in a tail risk scenario.

99. **The trend of smaller insurers with internal target capital well above regulatory target capital and larger insurers with internal targets floored by the regulatory target capital can be clearly seen for both the P&C and L&H insurance sectors.** Figure 5 shows that for L&H insurers, the largest companies (70–100th percentile of asset size) have their own target capital ratios very close to their LICAT target ratios, and the distribution is very narrow. This suggests that for these companies, the target regulatory capital is binding and therefore their internal target capital is floored at the target regulatory capital. A similar outcome is seen for P&C insurers.

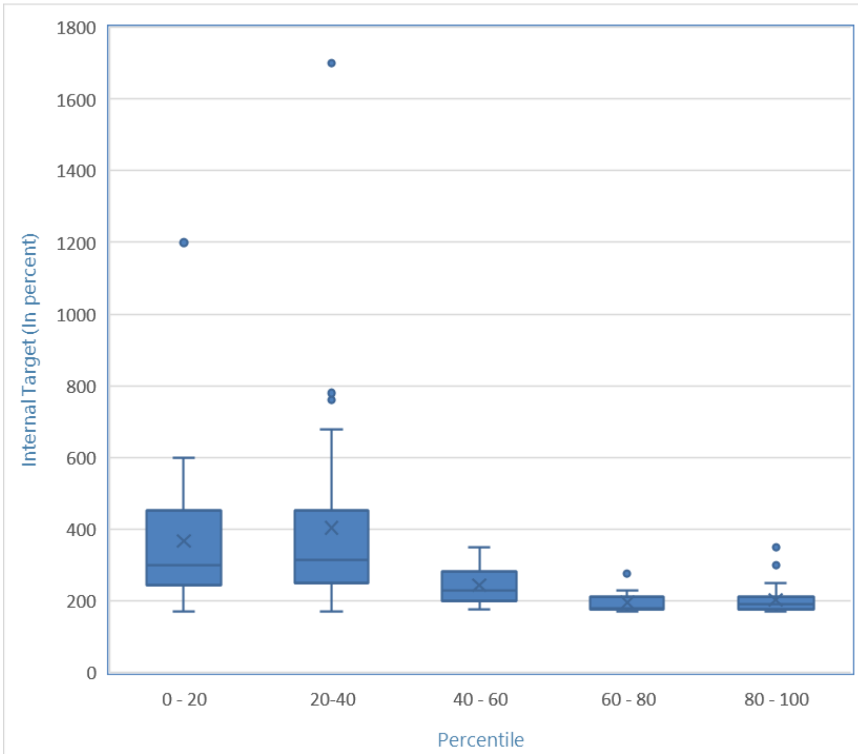
100. **Another observation is that the ORSA documents reviewed by the assessor did not include quantification of rating agency capital requirements.** Rating agency requirements were sometimes mentioned in discussion of target capital but rarely quantified. It is likely that rating agency requirements would be higher than target regulatory capital levels if insurers target a high-quality ratings well above minimum investment grade. Greater consideration of these requirements, which are likely to be above 99 percent CTE, should be clearly factored into internal target capital requirements.

101. **OSFI and AMF should work with the insurance industry to ensure that ORSA target capital calculations properly account for diversification of risk, sharing of risks with life insurance policyholders, and insurers' risk appetite for potential ratings downgrades.** This recommendation is in line with OSFI and AMF's expectations with respect to ORSA and is therefore a call to ensure compliance with guidelines. These require internal targets to take into account external or third-party capital expectations and includes an expectation that internal targets exceed supervisory targets. There are also requirements to validate and calibrate diversification benefits on a regular basis and consider whether such diversification benefits exist in a stress situation.

**Figure 5. Canada: Federally Regulated Insurers' Own Risk and Solvency Assessment**

Internal Target Compared to Regulatory Target Capital—A Comparison By Company Size

**Internal Target vs Percentile of Total Assets P&C Insurers**




**Internal Target vs Percentile of Current Excess Assets—Life Insurers**