Guideline Impact Analysis Statement

Guideline A-2

Capital Regime for Regulated Insurance Holding Companies and Non-Operating Life Companies

I. Background

Two large life insurers are controlled by non-operating life companies. These were established in the late 1990's to facilitate the transition from mutual to stock ownership. At that time there was no provision in the *Insurance Companies Act (ICA)* for regulated insurance holding companies. In 2001, the *ICA* was amended to permit the incorporation of insurance holding companies. Both life companies and holding companies are required by statute to maintain adequate capital in relation to their business.

II. Problem Identification

Unlike the banking sector, the insurance sector lacks an international standard for assessing solvency. The Minimum Continuing Capital and Surplus Requirement (MCCSR) used by Canadian life insurers is a risk-based framework designed primarily for the domestic marketplace. OSFI needs to establish a framework for assessing the capital adequacy of insurance holding companies recognizing that significant portions of their operations could be outside Canada.

III. Objectives

OSFI's objective is to develop a framework that provides an overall indication of the strength of the group and:

- measures adequately intercompany transactions that double gear or lever capital within the group;
- protects against intercompany transactions within the group done primarily for the purpose of arbitraging capital rules (e.g., moving business to the jurisdiction with the lowest relevant capital requirement);
- is risk sensitive; in particular addresses the significant risks;
- encourages the development of strong risk management systems and practices;
- enhances competitive equality within and between financial sectors, both domestically and internationally, subject to the adequate protection of policyholders and depositors;
- is easily understood and reflects, to some degree, how institutions are managed; and
- can be implemented cost effectively in the short term.

IV. Identification and Assessment of Options

OSFI considered a number of options, including:

Option 1: Use a consolidated MCCSR approach. This option represents the status quo, whereby the capital requirements that are applied to operating companies would also apply to non-operating life companies and insurance holding companies.

This option is the simplest for OSFI to apply and would result in a consistent and well-understood methodology being used for Canadian operating and non-operating holding companies. However, the MCCSR is designed primarily for the Canadian marketplace and may not measure all significant risks, or may not measure risks appropriately, for subsidiaries operating in foreign jurisdictions. It could be costly for companies that acquire subsidiaries in foreign jurisdictions to adapt their systems to measure risks using the MCCSR methodology. In addition, because it does not take into account the foreign regulators' solvency tests, it could prevent these subsidiaries from competing on a level playing field with locally-based companies.

Option 2: Use the capital adequacy requirements (CAR) for Canadian banks, including applying existing bank capital ratios. Under this option, the capital requirements developed for the banking sector, which have been adopted internationally, would be applied to non-operating life companies and insurance holding companies.

This option would result in the same capital regime being applied to conglomerate groups, regardless of whether they are predominately in the business of banking or insurance. However, the CAR regime does not measure insurance risk. Therefore it could underestimate the amount of capital needed under an insurance holding company structure, potentially putting policyholders at risk.

Also, it would be costly for insurance companies to develop the internal systems to report CAR, especially given that these systems will change again in 2007 with the implementation of the new Basel framework.

Option 3: Use internally developed models. Capital requirements would be determined using models non-operating life companies and insurance holding companies develop internally for managing their business and that meet supervisory standards.

This option, which would capture risks specific to the conglomerate group, is consistent with recommendations made by the International Actuarial Association for a risk-based total-balance-sheet approach. It also mirrors the internal ratings based approach in the new Basel framework.

Using internal models would be more expensive than options 1 and 2 because models are costly and time-consuming to develop and implement. In addition, the models approval process is costly for OSFI.

Option 4: Use an aggregation approach, whereby capital requirements in regulated subsidiaries and “proxy” capital requirements in unregulated subsidiaries are added together. Under this option, capital requirements would be calculated for each regulated subsidiary using the sectoral rules in that jurisdiction; proxy requirements would be determined for unregulated subsidiaries. The capital required would then be converted to Canadian dollars, summed and compared against the capital available in the consolidated non-operating life company or insurance holding company.

This option uses a technique proposed by the Joint Forum for assessing capital in conglomerate entities. It involves using and aggregating different capital tests, as well as different accounting and actuarial regimes. Because of the complexity, the framework would be time consuming to negotiate and implement. Therefore this option, like option 3, would be costly both for the companies and OSFI.

Option 5: Use a limited deduction approach - apply the MCCSR to Canadian and most operating subsidiaries and permit a limited carve-out for significant and well supervised foreign operations. This option combines aspects of Options 1 and 4. MCCSR would be applied to the consolidated non-operating life companies and insurance holding companies. In applying the MCCSR guideline, as with operating life insurers, investments in non-life solvency regulated financial corporations would be deducted from capital. In addition, with OSFI approval, in lieu of consolidating certain significant foreign life subsidiaries, the investment would be deducted from capital. Credit would be given for capital in excess of requirements or market expectations in those jurisdictions.

This option is generally consistent with the current MCCSR approach and the approach to unregulated holding companies. It addresses industry concern that applying the MCCSR at the holding company level impacts pricing decisions in foreign jurisdictions where Canadian requirements may not accurately reflect the risks undertaken. It will not involve the complex development efforts and negotiations that are inherent in Options 3 and 4.

Because this would be a new test (unlike Option 1) there would be costs for the companies and OSFI in setting up reporting systems; although, where there are significant new acquisitions, no additional costs should be incurred. In addition, some time will be needed for regulators, companies and others to become familiar with how the framework operates and how to interpret the results. Limiting the carve-out to significant foreign life subsidiaries reduces the cost of implementing this option.

V. Recommendation

Option 3, using internal models, is the most desirable option, as models should best reflect the specific risk profile of the conglomerate group. However, OSFI has found that models are not sufficiently developed for all risk areas to be relied upon for supervisory purposes. It will take significant supervisory and industry resources to develop these systems.

Thus we recommend Option 5 as an interim solution pending a move to more comprehensive models (or a total balance sheet approach). Restricting the deduction approach to major foreign entities limits application but allows flexibility for acquisitions where warranted. In addition, it allows institutions to compete in markets based on the capital approach developed in that market.

VI. Consultations

OSFI consulted with the insurance sector when considering alternatives, and issued a formal discussion paper in May 2004. A draft guideline was circulated for comment in January 2005. The industry indicated that it does not object to OSFI finalizing the guideline as issued for comment.