Office of the Superintendent of Financial Institutions Canada
Bureau du surintendant des institutions financières Canada

Guideline

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

Category: **Capital**

No: **A-2** **Date: July 2005**

Introduction

This Guideline sets out the capital framework for regulated insurance holding companies and non-operating life companies, collectively referred to as holding companies.

Subsection 515(1) of the *Insurance Companies Act* (ICA) requires federally regulated life insurance companies and societies to maintain adequate capital and subsection 992(1) requires insurance holding companies to maintain adequate capital. This Guideline is not made pursuant to subsections 515(2) and 992(2) of the Act; however, it sets out the framework within which the Superintendent assesses whether a holding company maintains adequate capital pursuant to subsections 515(1) and 992(1). In addition, the Superintendent may direct the holding company to increase its capital under subsection 515(3) or 992(3).

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Overview

OSFI's framework for assessing the adequacy of capital in a holding company compares capital available with a capital risk metric. In this assessment, the holding company includes the consolidated operations of all subsidiaries except non-life solvency regulated financial corporations and, with OSFI approval, significant foreign life subsidiaries. The investment[1] in these entities is deducted from capital. Holding companies may increase their capital available by taking credit for capital in significant foreign life subsidiaries that is reasonably above the level at which the foreign regulator would take action against that subsidiary. Where a capital deficiency exists in a significant foreign life subsidiary, the amount of the deficiency will be deducted from the group's capital. There are no minimum or target requirements; however, OSFI expects holding companies to manage their capital in a manner which is commensurate with the group risk profile and control environment.

Capital available

Capital available is adjusted for significant foreign life subsidiaries as follows:

- goodwill related to the investment is deducted from tier 1 capital,
- the remaining investment in the subsidiary[1] is deducted from the sum of tier 1 and tier 2 capital,
- the excess capital is added to, and any capital deficiency is deducted from, the sum of tier 1 and tier 2 capital.

Aside from the adjustment for significant foreign life subsidiaries, the definition of capital for holding companies, including the amortization rules, limits and restrictions, is the same as that used for operating Canadian life companies (as set out in *Guideline A, Minimum Continuing Capital and Surplus Requirements (MCCSR) for Life Insurance Companies*) with one exception - debt issued by the holding company that is not subordinated to policyholders may be included in tier 2B capital as long as it meets the other criteria for this type of capital (e.g., with a term of more than five years).

Capital risk metric

The capital risk metric is determined using:

(1) all MCCSR risk component factors for Canadian operating insurance subsidiaries and their subsidiaries,

(2) all MCCSR risk component factors for non-Canadian operating insurance subsidiaries (not included in (1) above) that represent at least 1 per cent of the consolidated assets of the holding company and are not significant foreign life subsidiaries,

[1] Includes any amount provided, directly or indirectly, by the holding company that is treated as capital available by the non-life solvency regulated financial corporations or significant foreign life subsidiary. All items that are deducted from capital are risk-weighted at zero per cent in the capital metric calculation.

(3) MCCSR asset default (C1) risk factors for on- and off-balance sheet items for the holding company, unregulated subsidiaries and the remaining non-Canadian operating life insurance subsidiaries, other than significant foreign life subsidiaries,
(4) a 7.5 per cent factor for excess capital in significant foreign life subsidiaries.

These amounts are summed to arrive at the total capital risk metric for the holding company.

The risk components set out in steps (1), (2) and (3) may be calculated on a consolidated basis as long as results are equivalent. OSFI expects each holding company to be consistent in its use of method.

Significant foreign life subsidiary

For a subsidiary to qualify as a significant foreign life subsidiary, the following conditions must exist:

- the holding company has requested OSFI to consider the subsidiary as a significant foreign life subsidiary,
- OSFI is satisfied that the foreign regulatory capital rules are risk-based, applying appropriate factors to capture significant risks of the jurisdiction,
- the subsidiary is subject to the foreign jurisdiction's regulatory capital rules and meets the relevant foreign regulator's well-capitalized or equivalent capital standards,
- the investment in the subsidiary is "significant,"
- the subsidiary's revenues are derived primarily from local operations and it is staffed commensurate with the business,
- there is no evidence that risks are being transferred between companies solely for the purpose of avoiding a particular capital regime.

Definition of "significant"

OSFI's prior approval is needed before a subsidiary or group of like subsidiaries operating in a foreign jurisdiction will be considered a "significant foreign life subsidiary" for purposes of this Guideline. Such treatment will be accorded in limited circumstances.

A subsidiary or group of like subsidiaries will be considered significant if average revenue for the last three financial years was 20 per cent or more of total revenue of the group and if the holding company's investment (carried on an equity basis) is at least 15 per cent of the group's common equity. In the case of new acquisitions, this assessment will be made based on reasonable projections over three years. In limited circumstances, at the request of a holding company, OSFI will consider factors other than these thresholds in determining if a subsidiary qualifies as a significant foreign life subsidiary. Relevant factors could include the subsidiary's net income and assets under management in relation to the total group and the significance of its operations in the markets in which it competes.

In some limited circumstances, for example because of a non-recurring loss, a subsidiary or group of like subsidiaries may no longer meet the qualifying criteria. In these cases, holding companies can request a temporary or permanent grandfathering exemption from the rule. These requests will be reviewed on a case-by-case basis taking into account the other criteria and the reason for the request.

Significant foreign life subsidiary – definition of "excess capital"

International best practices require regulators to establish solvency control levels that trigger supervisory intervention. Markets generally expect companies to operate above these levels. OSFI will take into account both these factors in giving credit for excess capital in a significant foreign life subsidiary (i.e., that amount that is available without restriction or negative market reaction to be transferred to other entities in the conglomerate).

OSFI will set the threshold above which excess capital will be determined on a country-by-country basis, as required. In the U.S., for example, companies generally operate above 200 per cent of Risk-Based Capital[2]. Therefore, OSFI will generally consider any amount above this threshold as excess capital for purposes of this calculation. OSFI may revise the threshold if market or regulatory expectations or the risk profile of the significant foreign life subsidiary changes. OSFI will approve similar thresholds for holding companies with significant foreign life subsidiaries in other jurisdictions.

OSFI will also set the threshold below which a capital deficiency exists by jurisdiction. For example, generally OSFI will require companies to take a charge if capital in a US subsidiary falls below 150 per cent of Risk-Based Capital[3] (i.e., deduct from available capital the amount of capital needed to bring the subsidiary's Risk-Based Capital to 150 per cent).

Excess capital is converted into Canadian dollars at the spot exchange rate in effect at the reporting date.

Holding companies are required to provide OSFI with the detailed regulatory filing that was submitted to the foreign regulator to support the capital adequacy calculation in the jurisdiction.

Capital management policies and procedures

OSFI expects holding companies and operating companies to maintain adequate capital for unexpected losses and to manage their capital in a manner that is commensurate with the group risk profile and control environment. Nevertheless, OSFI retains the option of requiring more capital, where warranted, or requiring that the holding company develop a plan to improve the overall quality of its capital. OSFI will continue to assess risk and apply its supervisory framework on a group-wide basis. It may consider any specific conditions in the market environment when evaluating companies' performance in relation to their capital plans.

[2] Note that 200 per cent of Risk-based Capital is twice the "No Action Level" for U.S. regulators.
[3] Note that 150 per cent of Risk-based Capital is twice the "Regulatory Action Level" for U.S. regulators.

Fundamental elements of a management framework include:

- board and senior management oversight,
- development of capital plans to ensure adequate capital is maintained in relation to risk,
- policies and procedures designed to ensure that the consolidated holding company identifies, measures and reports all material risks,
- a process that relates capital to the level of risk,
- a process that states capital adequacy goals with respect to risk, taking into account the company's strategic focus and business plan,
- a process of internal controls, reviews and audit to ensure the integrity of the overall management process.

The board of directors of the holding company should be actively involved in approving policies and monitoring capital levels. It should ensure that there are appropriate capital management plans in place at the holding company level as well as capital plans and targets for each FRFI in the group consistent with their risk profiles.

Intercompany risk mitigation techniques

Companies may use risk mitigation techniques involving other entities in the group for risk management purposes. Risk mitigation techniques include the provision of guarantees and reinsurance. The concept underlying the deduction approach for significant foreign life subsidiaries is that foreign capital rules best reflect the risks in their jurisdiction. Therefore, holding companies must obtain OSFI approval before taking credit in the capital risk metric for risk mitigation arrangements made within the group that transfer the risk to an entity with different capital requirements.

Stress testing

OSFI will continue to require group-wide stress testing and Dynamic Capital Adequacy Test (DCAT) methodology for the Canadian operating life companies. It is expected group-wide stress testing will normally follow the DCAT methodology as defined by the Canadian Institute of Actuaries standards. However, subject to prior approval, a holding company may use a reasonable alternative methodology for the group-wide testing. If a foreign subsidiary's methodology does not receive OSFI approval, the subsidiary would be subject to the DCAT requirements.

Disclosure

In its annual report to shareholders, a holding company should discuss its capital management practices. This discussion should describe the policies and practices for operating entities within the group and for the group as a whole. Such discussion is particularly relevant where the holding company manages its capital based on different methodologies.

Through a combination of qualitative and quantitative disclosures, a holding company should provide information on the quality and availability of capital. As well, it should describe capital required in relation to the significance of risks faced by the group. The MCCSR capital ratios should be disclosed for each Canadian incorporated operating company, as well as the relevant capital position of the significant foreign life subsidiaries in relation to their regulatory requirements.

Leverage is another key factor markets monitor to assess financial strength. Holding companies should provide information to the public on their amount of debt in relation to total capital.

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