



Guideline

Subject: Standards of Sound Business and Financial Practices - Glossary

No: F-12

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Approval Authority

The process by which a proposal to commit the company to risk is agreed upon and by which such an authorization is translated into specific transactions.

Asset/Liability Management

The management and control, within set parameters, of the impact of changes in the volume, mix, maturity, quality, and interest and exchange rate sensitivity of assets and liabilities on a company.

Associated Counterparties

A group of persons related financially or by common ownership, management, research and development, marketing or any combination thereof that are affected, directly or indirectly, by the obligations (financial, legal or otherwise) of the other members of the group. Identification of associated counterparties requires analysis of the impact of these factors on the financial dependency of the parties involved.

Associated Issuers of Securities

A group of persons related financially or by common ownership, management, research and development, marketing or any combination thereof. Identification of associated issuers requires analysis of the impact of these factors on the financial dependency of the parties involved.

Board Committees

Committees of the board of directors assigned to carry out specific functions to assist and advise the board in fulfilling its responsibilities.

Capital

Capital may be defined or calculated according to different criteria depending on the purpose of the definition or calculation. For regulatory purposes, current capital requirements for companies are referred to in the Capital Management Guideline (F-2) under the heading "Capital Management Policies". For purposes of the annual financial statement of a company, statutory or other regulatory requirements mandate its preparation, and the determination of capital, in accordance with generally accepted accounting principles, except as otherwise specified by the Superintendent. For planning purposes, a company's capital will be determined in accordance with the company's capital plan.

Capitalization Rate

For the purposes of real estate appraisals, the rate used under the income capitalization approach to convert the income generated by an income-producing property into an estimate of value.

Company

The standards of sound business and financial practices are intended to apply to all life and health insurers regulated by OSFI. For greater certainty, the standards are intended to apply to all federally incorporated or regulated life and health insurers, including reinsurance companies and fraternal benefit societies. (See APPLICATION section of Guideline F-1 for more details.)

The term "company" or "companies" in each guideline refers to a life and health insurer to which these standards apply.

Conflict of Interest

Situations wherein an individual's personal interest may compromise, or appear to compromise, their legal and moral duties of loyalty and care; or wherein a company's corporate interest may compromise, or appear to compromise, its fiduciary responsibilities.

Credit

In the context of a company's investment and lending activities, credit is the provision of funds on agreed terms and conditions to a debtor who is obliged to repay the amount borrowed together with interest thereon. Credit may be extended, on a secured or unsecured basis, by way of instruments such as mortgages, bonds, private placements, derivatives, and leases.

Credit Risk

The risk of financial loss, despite realization of collateral security or property, resulting from the failure of a debtor to honour its obligations to the company.

Credit Risk Classifications

- Satisfactory -
An acceptable risk.
- Especially Mentioned -
An asset or contingent risk which, although considered collectible on the basis of the debtor's repayment capacity and the security held at present, has apparent weaknesses and/or undesirable features which could jeopardize ultimate collection of all principal and interest. These would include under-capitalization, continuing operating losses, and/or other undesirable features.
- Below Standard -
A substandard asset or contingent risk not adequately supported by security values and/or repayment capacity and/or carrying capacity. There are well-defined weaknesses which would likely jeopardize ultimate collection of all principal and interest. Loans in this category may be designated "accrual" or "non-accrual" depending on the current status of interest payments and the value of the underlying security.
- Loss -
An asset or contingent risk where a partial or full write-off is the most likely outcome. These assets or contingent risks should invariably be designated as "non-accrual" and a full or partial appropriation established, based on an analysis of the security and repayment source(s).

Credit Risk Management

Credit risk management is the process of controlling the impact of credit risk-related events on the company. This management involves identification, understanding, and quantification of the degree of risk of loss and the consequent taking of appropriate measures.

Detective Controls

Controls designed to provide reasonable assurance that errors and illegal acts do not go unreported.

Discount Rate

For the purposes of real estate appraisals, the rate of return used to convert cash flows generated by an income-producing property to present value.

Discounted Cash Flow Approach

A method of estimating value derived by applying a discount rate that converts the cash flow, that can be reasonably expected from an income-producing property, to present value.

Exception Reports

Reports that identify situations in which exception criteria are breached or authority limits are exceeded. These reports assist companies to concentrate their efforts on exceptional situations

Foreign Currency Translation Gain/Loss

The unrealized gain or loss that is recorded when assets and liabilities, both on- and off-balance sheet, denominated in foreign currencies are translated into Canadian dollars on the balance sheet date when the exchange rates on that date differ from the corresponding rates on the previous balance sheet date or from the corresponding rates when the specific assets and liabilities were acquired.

Foreign Exchange Contract

A commitment to buy or sell a specified amount of foreign currency at a set time and rate of exchange.

Foreign Exchange Forward Position

The extent to which forward or future purchases and inflows of a currency exceed future sales and outflows. That is, the net foreign exchange position of a company's future foreign exchange transactions.

Foreign Exchange Overnight Position

The net foreign exchange position (i.e., holdings of any commitments in foreign currencies) of a company at the close of each business day.

Foreign Exchange Risk

The exposure of a company's financial strength to the potential impact of movements in foreign exchange rates. The risk is that adverse fluctuations in exchange rates may result in a reduction in measures of financial strength.

Foreign Exchange Transactional Position

Foreign exchange exposures that arise from daily foreign currency dealing or trading activities.

Foreign Exchange Translational or Structural Position

Foreign exchange exposures that arise from a company's overall asset/liability infrastructure, both on- and off-balance sheet.

Hedging

A risk management technique to reduce or eliminate price, interest rate or foreign exchange risk exposures. The elimination or reduction of such exposures is accomplished by entering into transactions that create offsetting risk positions. The concept is that when a company has an open position which entails a risk that it wishes to avoid or minimize, the company can undertake a further transaction which compensates for the risk and acts as a hedge. If the hedge is effective, any gain or loss on the hedged risk position will be offset by a loss or gain on the hedge itself.

Income Capitalization Approach

A method of estimating value derived by applying a capitalization rate that converts to present value the net operating income that can be reasonably expected, after making allowance for all appropriate expenses, from an income-producing property.

Interest Rate Risk

The potential for financial loss arising from changes in interest rates. Interest rate risk arises when a company's principal and interest cash flows from assets do not coincide with the principal, interest and benefit cash flows arising from liabilities.

Internal Control

Internal control is the process, effected by a company's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the effectiveness and efficiency of operations, the reliability of financial reporting and compliance with applicable laws, regulations, and internal policies.

Internal Controls

Internal controls are the policies and procedures established and implemented alone, or in concert with other policies or procedures, to manage and control a particular risk or business activity, or combination of risks or business activities, to which the company is exposed or in which it is engaged.

Internal Control Environment

Internal control environment is the framework under which internal controls are developed, implemented and monitored. It consists of the mechanisms and arrangements that ensure internal and external risks to which the company is exposed are identified, that appropriate and effective internal controls are developed and implemented to soundly and prudently manage these risks, and that reliable and comprehensive systems are in place to appropriately monitor the effectiveness of these controls.

Investment Portfolio Management

The management of a company's portfolio of securities investments, both on- and off-balance sheet.

Liquid Assets

Cash and securities and other assets readily convertible to cash.

Liquidity

Liquidity is the availability of funds, or assurance that funds will be available, to honour all cash outflow commitments (both on- and off-balance sheet) as they fall due. These commitments are generally met through cash inflows, supplemented by assets readily convertible to cash or through the company's capacity to borrow. The risk of illiquidity increases if principal and interest cash flows related to assets, liabilities and off-balance sheet items are mismatched.

Liquidity Management

Managing assets and liabilities (on- and off-balance sheet), both as to cash flow and concentration, to ensure that cash inflows have an appropriate relationship to approaching cash outflows.

Liquidity Planning

Assessing potential future liquidity needs, taking into account various possible changes in economic, market, political, regulatory or other external or internal conditions and weighing alternative asset/liability management strategies to ensure that adequate cash inflows will be available to a company to meet these needs.

Loan Substitute Securities

Customer financings that have been structured as after-tax securities investments rather than conventional loans in order to provide the issuers with a borrowing rate advantage over what would otherwise be applicable on a conventional loan. Loan substitute securities are identical in risk and security to conventional loans of comparable term.

Management

Those persons appointed to manage the operations of a company.

Market Value

The most probable price that a property should bring in a competitive and open market under current conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimuli. Conditions under which a fair sale exists are that a reasonable time is allowed for exposure in the open market, payment is made in cash or in terms of financial arrangements comparable thereto, and the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

Net Operating Income

For the purposes of real estate appraisals, the gross income from an estate or interest in a property supporting a real estate-related transaction including tenant recoveries less the aggregate of all operating expenses and allowances for vacancies, bad debts, non-recoverable expenses and normal management expenses.

Objectives

Objectives identify the specific results a company seeks to achieve. They may pertain to the company as a whole, or target specific activities within the company. Usually, objectives relate to a company's strategic direction (target markets or business activities), financial performance (specific performance indicators), operational efficiency and the effectiveness of the company's resources.

Operating Liquidity

The liquidity required to meet day-to-day cash outflow commitments, taking into account asset/liability management techniques for controlling liquidity through the management of cash flows, supplemented by assets readily convertible to cash or by a company's ability to borrow.

Position Risk

The exposure of a company to the effect of price changes on the market value of those elements of the company's portfolio of securities, both on- and off-balance sheet, which are not already cash flow matched against specific liabilities. Price changes may occur because of several factors, such as those solely related to the specific security (e.g., a change in the credit status of an issuer of a security) or those unrelated to any specific attribute of an individual security (e.g., investor preferences/demand, political and economic developments, and broad market price movements). The effect of the price change is a function of the size of the securities position, and the degree of price movement between the purchase date and the date of valuation or sale, as the case may be.

Preventive Controls

Controls designed to provide reasonable assurance that errors and illegal acts do not occur.

Product Design and Pricing Risk

Product design and pricing risk is the exposure to financial loss resulting from transacting insurance and annuity business where the costs and liabilities assumed in respect of a product line exceed the expectation in pricing the product line.

Prudent Risk Management

The common law duty to act with the care, skill and diligence that a person of ordinary prudence acting in a like capacity and familiar with such matters would exercise in dealing with the property of another person.

Real Estate Appraisal

A written report prepared by a qualified appraiser who is independent of the mortgagor or seller of the subject property, setting forth an opinion as to the market value (as of a specific date) of a property that is the subject of a real estate-related financial transaction. An appraisal is based on research into appropriate market data, the application and justification of suitable analytical techniques, and the knowledge, experience, and judgement necessary to develop an appropriate opinion of market value.

Real Estate-Related Financial Transaction

Any transaction involving:

- the sale, lease, purchase, investment in or exchange of real property, including interests in property, or the financing thereof;
- the refinancing of real property or interests in real property; or
- the use of real property or interests in real property as security for a loan or investment, including mortgage-backed securities.

Reconciliation of Appraisal Value and Approaches

The function in the real estate valuation process in which an appraiser analyzes alternative conclusions and selects a final market value estimate from among two or more indications of value. A thorough review of the entire valuation process needs to precede reconciliation.

Replacement Cost Approach

A method of estimating the market value of a property by adding the estimated value of the land, as if it were vacant, to an estimate of the depreciated reproduction or replacement cost of a building and other improvements.

Risk Management

The process of controlling the impact of risk-related events on a company.

Risk Philosophy

A statement of principles and objectives that outlines a company's willingness to assume risk. A company's risk philosophy will vary with the nature and complexity of its business, the extent of other risks assumed, its ability to absorb losses and the minimum expected return acceptable for a specific level of risk.

Risk Position

The amount of a company's exposure to a particular risk.

Sales Comparison Approach

A method of estimating the value of a property in which a subject property is compared with recent sales of similar and comparable properties in the market. The basic premise of the sales comparison approach is that the market will establish a value for the subject property in the same manner that the values of comparable, competitive properties are established.

Scope of the Appraisal

The process of collecting, confirming and reporting appraisal data. A responsibility is imposed on the appraiser to determine the extent of the work and of the report in relation to the nature of the property to be appraised.

Securities Marketability/Liquidity Risk

The risk that a security cannot be sold quickly or that there is no market for the security.

Securities Portfolio Concentration

Concentration that occurs when a company's securities portfolio contains an excessive level of exposure to a single issuer, a group of associated issuers, or a class of security.

Securities Portfolio Management Policy

A written description of authorized securities activities and the goals and objectives the institution expects to achieve through its securities activities.

Securities Portfolio Management Strategy

A written description of the way a company intends to achieve its securities investment policies.

Significant Risk

Risks that have a high probability of occurring and the occurrence of which is likely to have a significant impact on the company's ability to meet its stated objectives.

Single Counterparty

A borrower that is capable of satisfying its commitments from internal sources and is independent from the obligations (financial, legal, or otherwise) of others.

Single Issuer of a Security

An issuer of a security that is capable of satisfying its commitments without support from external sources and is independent from the obligations (financial or otherwise) of others.

Statutory Liquidity

The liquidity that a company may be required to hold for statutory or regulatory purposes.

Underwriting and Liability Risk

Underwriting and liability risk is the exposure to financial loss resulting from the selection and approval of risks to be insured, the adjudication of claims, and the management of contractual and non-contractual product options.

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