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Guideline

Subject: **Standards of Sound Business and Financial Practices -- Capital Management**

No: **F-2** **Date:** **February 1998**

A. PURPOSE

This guideline sets out the minimum policies and procedures that each company needs to have in place and apply within its capital management program. It also sets out the minimum criteria that each company should use to ensure that it has adequate capital and effective plans to prudently manage its capital requirements and the demands on its capital base.

Capital is one of a number of factors to be considered when assessing the safety and soundness of each company. Adequate capital acts as a safety net for the variety of risks that a company is exposed to in the conduct of its business. It is available as a cushion to absorb possible losses and provides a basis for confidence in the company by policyholders, creditors and others.

OSFI considers the regulation of capital to be an important tool available to it. It is a measure by which a company's solvency is assessed.

B. DEFINITION

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 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.

Capital provides a stable resource to absorb any losses and thus provides a measure of protection to policyholders and other creditors in the event of liquidation.

C. CAPITAL MANAGEMENT PROGRAM

Managing capital is the on-going process of determining and maintaining the quantity and quality of capital appropriate for a company. Managing capital adequacy requires a clear understanding of a company's capital requirements and capital position related thereto. Since capital is an economically scarce and strategic resource, capital management is an important component in the safe and sound management and the strategic planning of companies.

The objective of capital management is twofold. On the one hand it ensures that capital is, and will continue to be, adequate to maintain the safety and stability of the company, one of the consequences of which is the maintenance of confidence in the company. On the other hand, it ensures that the return on capital is sufficient to satisfy the expectations of investors and/or policyholders to the extent of their participation in the returns of the company.

Although the particulars of capital adequacy and capital management will differ among companies, a comprehensive capital management program requires:

- establishing and implementing sound and prudent policies governing the quantity and quality of capital required to support the company; and

- developing and implementing appropriate and effective procedures to monitor, on an on-going basis, the company's capital requirements and capital position to ensure that the company meets its capital requirements and will continue to meet its future capital requirements.

Capital Management Policies

As part of its capital management program, each company needs to develop, implement and maintain such capital management policies that will ensure the quantity and quality of its capital is adequate to meet all applicable regulatory requirements.

In determining these policies for companies with share capital, regard must be had as to whether capital management policies in relation to shareholders' accounts should be different from capital management policies for participating policyholder accounts and, if so, to what extent.

Current capital requirements for life insurance companies that are subject to federal regulation are contained in the "Minimum Continuing Capital and Surplus Requirements for Life Insurance Companies" guidelines issued by OSFI. At a minimum, each company must comply with these requirements.

Capital Management Procedures

Each company needs to develop, implement and maintain appropriate and effective procedures to manage its capital position, including:

- on-going monitoring procedures to ensure that the company's capital position meets its minimum capital requirements; and

- a process of capital planning to ensure that the company will continue to meet its future capital requirements.

When measuring capital adequacy, it is not sufficient to consider only the current capital position. The conditions on which any such judgement is based will change over time. Therefore, each company needs to have a capital planning process in place in order to be prepared for changing conditions.

A company should develop, at least annually, a plan for maintaining adequate capital. Depending on circumstances, a longer term plan may be appropriate.

A capital plan needs to:

- project, consistent with the company's business plan, the company's capital requirements and position over five years, taking into account the company's current capital position and the effect on capital of foreseeable changes in the company's regulatory requirements and business, operational and financial position, including an assessment of potential capital requirements relating to the redemption of maturing capital instruments;

- identify the underlying assumptions supporting the projection;

- identify the quantity, quality and sources of additional capital required, if any;

- assess the availability of any external sources identified;

- estimate the financial impact of raising additional capital;

- take into account the plans and requirements of the various business units of the company;

- take into account the plans and requirements of the company's subsidiaries to the extent they may impact upon the company; and

- consider any conclusion or recommendations arising from the appointed actuary's report on dynamic capital adequacy testing, where applicable.

Anticipating the need for additional capital enables the company to take timely advantage of opportunities in the marketplace to raise capital on more favourable terms.

Factors that may necessitate capital additions include: changes in regulatory requirements; growth in assets and liabilities (both on- and off-balance sheet) including acquisitions; changes in the company's risk profile; operating or investment losses; and the company's dividend policy to investors and/or policyholders that participate in the returns of the company.

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