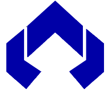

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Advisory

Subject: **MCT and BAAT Supervisory Targets**

Category: **Supervisory Practices**

Date: **December 2003**

This Advisory explains OSFI's approach to supervisory targets for federally regulated Property and Casualty Insurers (P&C), and addresses the subject of how the assessment of capital levels fits within the context of OSFI's supervisory framework. The approach outlined in this document for target capital levels and their application is the result of extensive discussion with the P&C industry over the course of developing the Minimum Capital Test (MCT) and Branch Adequacy of Assets Test (BAAT).

The Role of Target Capital Levels in the Supervisory Framework

OSFI's risk assessment process begins with an evaluation of the inherent risk within each significant activity of a financial institution. OSFI then examines the quality of risk management applied to mitigate these risks. Considering this information, OSFI arrives at an assessment of both the level of net risk of the significant activity and the direction of the net risk, i.e., whether it is decreasing, stable or increasing. Then, taking into account the materiality of each of the significant activities of a company, OSFI arrives at an overall net risk rating and its direction. Up to this point in the assessment, the financial condition of the company has not been considered.

However, OSFI then develops a composite risk rating (and direction) for the financial institution, taking into account both our assessment of the overall net risk (which includes an assessment of the adequacy of risk management processes) and our assessment of financial factors, such as capital and earnings. Capital can be assessed as "strong", "acceptable", "needs improvement" or "weak".

While the MCT/BAAT ratio is an important factor in this assessment, it is not the only factor. Assessment criteria include, for example: the quality of capital; the adequacy of capital to support the company's business plans and risk profile; the ability to access capital at reasonable rates to meet projected needs; and the strength of the company's capital management processes. Trends and the outlook regarding a company's capital and earnings are also relevant in assessing the adequacy of a company's current capital position. The various factors must all be considered in the context of the nature, scope, complexity and risk profile of the particular company.

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Capital adequacy will generally be considered "acceptable" where a company maintains capital that is appropriate for its risk profile. However, it is unlikely that capital adequacy will be considered "acceptable" if its ratio is below OSFI's MCT/BAAT supervisory target level of 150%.

OSFI's regulatory supervision does not attempt to ensure that no company can ever fail. Rather, OSFI attempts to intervene at an early enough stage in a company's difficulties for there to be a realistic prospect for the situation to be rectified. The purpose of having companies establish, and operate within, target capital levels at or above the supervisory target level is to provide adequate time for them to resolve financial problems that may arise, while minimizing the need for OSFI's intervention.

Application of the MCT and the BAAT

Supervisory Target

As risk-based tests, the MCT and BAAT primarily assess the credit and liability risks of P&C insurers and the general level of capital required to support these risks. It is recognized that risks specific to an individual institution cannot be addressed by an industry wide test alone. However, these risks exist and OSFI must account for them in OSFI's assessment. This is partly addressed by establishing a supervisory target that will provide an early signal to assure that intervention will be timely enough for there to be a reasonable expectation that action can be taken to address difficulties. However, companies have different risks and, accordingly, OSFI would not expect all companies to establish the same internal target. The 150% supervisory target should be viewed as a benchmark or standard against which companies should establish their own higher target.

Establishing Company Specific Supervisory Targets

OSFI requires each P&C insurer to establish an internal target capital level at no less than the supervisory target of 150%. OSFI may, on a case-by-case basis, in consultation with a company, establish an alternative supervisory target level based upon that company's risk profile. In exceptional circumstances, a company may be able to justify a target level lower than 150%. A company would need to make a convincing case that its risk profile is exceptionally low. OSFI expects such circumstances to occur rarely and does not encourage companies to pursue this possibility with us at this time. OSFI would not expect to be approached for a target below 150% by companies having a normal range of operations.

To establish their internal target, companies need to use appropriate stress and scenario testing to determine for themselves the level of capital necessary to mitigate the residual credit, market, liquidity, legal & regulatory, operational, strategic, and insurance risks in their business. For most companies, this requirement can be determined by extending Dynamic Capital Adequacy

Test (DCAT) scenarios to include more likely adverse scenarios. Additional consideration should be given to the variability of their test ratio and the consequences of it falling below 150%. Our supervisory practice in the Minimum Asset Test (MAT) and Deposit Adequacy Test (DAT) regime was to require institutions to maintain MAT/DAT at specific levels in excess of 10% where the risk profile of the institution warranted this action. Expecting companies to establish internal target MCT/BAAT ratios over 150% based on their risk profile is consistent with our approach under the former MAT/DAT framework.

Companies are expected to establish their own internal target capital levels and OSFI supervisory staff will assess whether such target capital levels are commensurate with the companies' risk profiles. While setting the target level is the responsibility of companies, they may wish to discuss their intentions with their Relationship Manager before seeking final approval by their Board of Directors. The supervisory target of 150%, while not measuring solvency in the strict sense of the term, is a regulatory trigger point. A company that breaches the supervisory target of 150% will attract increased regulatory attention and, at a minimum, an early warning intervention status (stage 1). The staging of companies, the consequences of such staging and the amount of time companies remain staged depend on the circumstances surrounding the companies in question. Where a company breaches its internal target level but remains above the supervisory target, OSFI supervisory staff will assess the circumstances and the company's remedial plans to return capital above its internal target, before deciding whether any regulatory intervention is warranted.

OSFI has committed to exercise some flexibility with respect to the supervisory target level to allow institutions to absorb unexpected losses, as well as to allow some limited flexibility for other temporary declines below the supervisory target level. However, OSFI would expect these instances to be very infrequent, and would not expect any institution to have repeat occurrences. This implies that, even in normal business environmental conditions, companies would establish their target levels to provide a reasonable cushion above the supervisory target in order to avoid falling below that target. OSFI believes that the inherent potential volatility of reserves and the "tightness of capital", arising in some cases from pressures on parent companies, create additional uncertainties that warrant the maintenance of capital levels appropriate to companies' risk profiles. OSFI's approach is consistent across financial services sectors.

Test neutrality

OSFI committed to ensuring that capital adequacy measures under MCT/BAAT versus the MAT/DAT were capital neutral, on an industry aggregate basis, in an average year. This was tested and established at 10% MAT/DAT being equivalent to 150% MCT/BAAT. It has always been recognized that results for individual companies would vary from this outcome, subject to their risk profile. OSFI is committed to reviewing, in 2004, the results of the new test based on industry returns for the first full year of implementation.

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