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

Advisory

Subject: **Conversion to International Financial Reporting Standards (IFRSs) by Federally Regulated Entities (FREs)**

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I. Introduction

All federally regulated entities (FREs) are required to implement International Financial Reporting Standards (IFRSs for their fiscal year commencing in 2011. This Advisory outlines OSFI's requirements for the implementation of IFRSs for banks, foreign bank branches, bank holding companies, federally regulated trust and loan companies, cooperative credit associations, life insurance companies, foreign insurance companies, fraternal benefit societies, property and casualty insurance companies, and insurance holding companies (collectively referred to as FREs). The Advisory also outlines additional requirements for FREs' semi-annual reports (Progress Reports) to OSFI detailing their progress being made to move to IFRSs and the first quarter regulatory financial returns filed with OSFI under IFRSs. The Advisory applies to FREs converting from pre-IFRSs Canadian Generally Accepted Accounting Principles (CGAAP).

The legislation governing FREs[1] requires that the financial statements be prepared in accordance with generally accepted accounting principles, the primary source of which is the Handbook of the Canadian Institute of Chartered Accountants, except as otherwise specified by OSFI. This authority will continue when IFRSs are adopted as the CICA Handbook will incorporate IFRSs. Through this authority, OSFI may specify additional accounting guidance or additional disclosure or require that a specific accounting option be followed. OSFI makes these specifications in rare situations where there is a need for additional accounting guidance.

OSFI's ability to make specifications for additional disclosure or to specify an IFRS option is addressed in *International Standard on Auditing 210* (ISA 210) and the equivalent *Canadian Auditing Standard 210* (CAS 210). OSFI believes that the specifications made in this Advisory will not impair an FRE's ability to obtain an audit opinion that states that the financial statements are in accordance with IFRSs as issued by the IASB. OSFI believes this Advisory aligns FREs' application of IFRSs with other financial entities reporting under IFRSs and is not to be interpreted in a way that is inconsistent with or contrary to IFRSs.

This Advisory refers only to specific IFRSs where OSFI is of the view that additional guidance or clarification is beneficial for FREs and responds to or addresses specific regulatory concerns.

In developing these requirements, OSFI consulted with many stakeholders including accounting standard setters, FREs, audit firms and industry associations both domestically and internationally.

i) Applicable IFRSs

Unless otherwise indicated, this Advisory refers to IFRSs issued as at March 31, 2010 that are effective for fiscal years beginning on or after January 1, 2011. International Accounting Standards Board (IASB) projects that might result in a new or revised IFRS being effective on or before January 1, 2011 have been reviewed and considered by OSFI. While the changes to

[1] Sections 308(4) and 840(4) of the *Bank Act* (BA), sections 331(4) and 887(4) of the *Insurance Companies Act* (ICA), section 313(4) of the *Trust and Loan Companies Act* (TLCA), and subsection 292(4) of the *Cooperative Credit Associations Act* (CCAA).

IFRSs resulting from these projects will require consideration when final, the likely outcomes (standards) of the IASB projects are not expected to require changes to this Advisory.

The IASB is currently working on several projects that will be finalized in 2010 and 2011. Projects completed in 2010 and 2011 are likely to have mandatory effective dates no earlier than 2012, 2013 or 2014. Some of the projects on the IASB's work plan for the next two years have been identified by OSFI and the FREs as having a potential material impact to financial reporting and/or regulatory capital. OSFI will consider allowing early adoption by FREs on a standard by standard basis once a particular IFRS is issued in final form. After OSFI has completed an impact analysis and consultation on each new standard that is potentially relevant to FREs, OSFI will separately communicate its decision on early adoption for that IFRS. Accordingly, unless otherwise communicated by OSFI, FREs should not early adopt IFRSs.

For *IFRS 9 Financial Instruments,* financial liabilities, impairment and hedging form an integral part of the comprehensive Financial Instruments standard. As these areas are still being developed by the IASB, OSFI will perform an analysis of the impacts of the comprehensive standard once all the components are issued and will decide at that time whether to permit early adoption. OSFI will communicate its decision once the analysis and consultation phases have been completed. In the meantime, the current IFRS 9, which addresses only the classification and measurement of financial assets, should not be adopted earlier than its mandatory effective date.

ii) Disclosure

In addition to the specific disclosures addressed in this Advisory, OSFI maintains a number of disclosure guidelines. These guidelines, which are being revised to align with IFRSs requirements, are targeted to be issued for consultation during the summer of 2010, and in final form during the fall of 2010.

II. Principles

In developing accounting and regulatory capital policy requirements in this Advisory, OSFI considered three broad principles:

1. ***Where possible, preference should be given to maintaining one set of financial statements for both public and regulatory reporting.***

2. ***To facilitate regulatory monitoring and supervision, where possible, it is preferable that financial statements of different FREs be materially comparable.***

3. ***The specification of accounting options or the requirement of additional disclosures for financial reporting purposes should be kept to a minimum. Only changes that are required for prudential monitoring or for assessing regulatory capital should be made.***

In determining accounting and regulatory capital policy requirements for the initial IFRS conversion, OSFI decided that, where possible, previous OSFI decisions and policy will be maintained.

These broad principles support OSFI's prudential regulatory system, which is based on a tripartite division of responsibilities involving:

- The FREs' management and oversight processes;
- The use of independent external reviewers (i.e. the external auditor, and in the case of insurance companies, the appointed actuary); and
- Monitoring and supervision by OSFI.

III. Securitization and Off Balance Sheet Structures

Current *International Accounting Standard* (IAS) *27, Consolidated and Separate Financial Statements* and *Standing Interpretations Committee (SIC) 12, Consolidated – Special Purpose Entities* will likely require that many Canadian securitizations and off balance sheet structures be reported on the balance sheets of FREs. Further, current *IAS 39 Financial Instruments: Recognition and Measurement* will likely permit fewer assets to be derecognized in comparison to those permitted under current CGAAP. If so, adoption of these standards will likely increase the Asset-to-Capital Multiple (ACM) of Deposit Taking Institutions (DTIs), the borrowing multiple of cooperative credit associations and the Capital Equivalency Deposit (CED) of foreign bank branches.

With respect to life insurance entities, current CGAAP specifically requires that segregated funds should be accounted for separately (off balance sheet). However, IFRSs do not specifically address accounting for segregated funds. As a result, most segregated funds are expected to require consolidation treatment because of the "control" tests in IAS 27 and SIC 12. Most life insurers are, therefore, expected to report their segregated fund assets and liabilities on balance sheet through a one-line reporting format, rather than commingled with other asset and liability categories.

As a result of the above, *Guidelines D-3, Accounting for Mortgage-backed Securities*, *D-4, Transfers of Financial Assets with Recourse*, and *D-8, Accounting for Transfers of Receivables Including Securitizations* will need to be revised or rescinded.

Accounting

OSFI is not issuing any additional accounting guidance or clarification in this area at this time[2].

[2] The IASB has a project for consolidation as well as one for derecognition. At the issuance date of this Advisory, the standards are targeted to be finalized in the fourth quarter of 2010 and between the fourth quarter of 2010 and the first quarter of 2011, respectively.

OSFI will consider requiring the separate disclosure of segregated funds if it becomes apparent that life insurers intend to commingle segregated funds with other assets and liabilities, rather than use the expected one-line reporting format to separately report segregated funds, in their financial statements.

Regulatory Capital

OSFI notes that during the recent financial turmoil, DTIs increased their balance sheet assets during times of stress in respect of previously off balance sheet assets that no longer qualified to be derecognized and in respect of securitization conduits that were no longer exempted from consolidation under CGAAP. Lessons learned in the recent financial turmoil are that certain securitization structures did not transfer as much risk out of the FREs as expected.

OSFI is of the view that, until an international review of this area is complete, the existing risk-based regulatory capital framework for securitization exposures (Capital Adequacy Requirements, Guidelines A/A-1, Chapters 5/6) remains appropriate[3]. However, the ACM is a Canadian rule that seeks to impose a simple, comprehensive measure of risk that, by design, supplements risk-based regulatory capital requirements for specific DTI exposures. As the accounting rules are the starting point for the ACM, securitization assets which are not derecognized or which are not exempted from consolidation should be included in the calculation of the ACM.

Furthermore, irrespective of the IFRS determination of what is on balance sheet, the ACM should also reflect the originator's exposure as a result of the securitization. Where the originator's balance sheet exposure is not deemed to be materially reduced by the securitization, continued inclusion in the ACM may be appropriate, regardless of accounting treatment.

Given that the implementation of IFRSs is expected to increase FREs' on balance sheet assets and liabilities[4] and therefore to increase the ACM of DTIs, the borrowing multiple of cooperative credit associations and the CED for foreign bank branches, OSFI is of the view that, in some cases, an immediate application of those rules may be difficult for FREs to meet. As such, OSFI has provided some specific transition provisions as discussed below.

Specific Transition for NHA MBS/CMB/IMPP Transactions

Insured mortgages securitized through the Canada Mortgage and Housing Corporation's (CMHC's) National Housing Act Mortgage-Backed Securities (NHA MBS) and Canada Mortgage Bond (CMB) Programs, as well as the Insured Mortgage Purchase Program (IMPP), collectively referred to hereafter as the CMHC Programs, are unlikely to achieve derecognition, and if so, will therefore be brought on balance sheet under IFRSs. To facilitate compliance with the ACM under

[3] The BCBS is currently conducting a review of the Basel II securitization framework – this review is expected to be completed in 2011 and may lead to changes in this framework.

[4] OSFI recognizes that the IASB has projects on derecognition and consolidation, but at the time of the release of this Advisory, the standards have not been finalized. As noted in Section I (i) of this Advisory, OSFI will examine the final standards once issued and consider our positions at that time.

IFRSs and permit an orderly transition, OSFI will permit mortgages sold through CMHC Programs, up to and including March 31, 2010, to be excluded from the ACM calculation under IFRSs.

For CMB/IMPP transactions completed up to and including March 31, 2010, all existing and future reinvestments newly reported on the balance sheet as a result of IFRSs[5] will also be excluded from the ACM upon conversion to IFRSs.

For greater clarity, the specific transition provisions above apply to CMHC Programs only and are not available for any other types of securitizations.

As outlined in *Section VIII. Transition to IFRSs*, FREs may elect to phase in the one time net impact of the transition to IFRSs when calculating regulatory capital and, with respect to securitization, will be permitted to include the impact associated with any reversal of prior period gains on sales associated with CMHC Programs, as well as any losses resulting from bringing assets back on balance sheet when previously securitized assets are no longer derecognized. Additional details of this transition will be provided in forthcoming draft instructions for regulatory capital returns.

Securitized assets, including insured mortgages securitized through CMHC Programs after March 31, 2010, and all related reinvestments, will be included in the calculation of the ACM under the current ACM definition and limits if such assets are on balance sheet under IFRSs or if such assets are off balance sheet under IFRSs but OSFI (as discussed above) determines that the securitizing FRE's balance sheet exposure has not been materially reduced by such securitization. With respect to such assets, no changes will be made to the non-capital regulatory returns and FREs will be required to report in accordance with IFRSs; FREs will be required to adjust their assets included in their ACM calculation to give effect to the transition provisions.

OSFI recognizes that there continues to be uncertainty in how international fora will ultimately conclude on the matter of derecognition and consolidation, and on how an internationally applicable leverage ratio will affect FREs[6]. The transition arrangements proposed herein may need to be adjusted to take any such changes into consideration.

OSFI expects FREs experiencing a material impact from the introduction of IFRSs, or from these future changes, to file business and capital plans explaining how they will meet applicable regulatory requirements, and to periodically (at least annually) report to OSFI on the compliance with those plans. OSFI recognizes that, based on the plans, there may need to be some recalibration of authorized ACMs. Finally, OSFI will work closely with affected FREs as the

[5] As on balance sheet instruments, OSFI expects that sale and repurchase agreements executed by FREs for reinvestment purposes are already included in the ACM and will therefore not be subject to the transition provisions contained herein.

[6] The Basel Committee on Banking Supervision has announced its intention to create a leverage test applicable to all internationally active banks (see BCBS December 17, 2009 consultative document entitled *Strengthening the resilience of the banking sector* available on the BIS Web site at: http://www.bis.org/publ/bcbs164.pdf?noframes=1).

international requirements become better known to identify whether such plans require modification.

OSFI will permit cooperative credit associations and foreign bank branches a similar transition for the borrowing multiple and the CED, respectively, where liabilities increase as a result of assets related to CMHC Programs no longer achieving derecognition treatment.

With respect to segregated funds, risk based regulatory capital requirements already exist and OSFI requires that the current treatment continue. Therefore, although segregated funds will appear on the balance sheet, they would not attract asset specific regulatory capital charges outside of the existing Segregated Fund Risk charge.

IV. Financial Instruments – Fair Value Option

IAS 39 allows entities an option to designate a financial asset or financial liability at fair value through profit or loss upon initial recognition (i.e., the Fair Value Option (FVO)). This is similar to the option available in CGAAP. When the Canadian financial instruments standard was introduced, OSFI issued *Guideline D-10, Accounting for Financial Instruments Designated as Fair Value Option* to provide additional guidance to FREs that use the FVO.

OSFI continues to have the same concerns with the FVO that arose under CGAAP and the issuance of the original D-10 in 2006. The original guideline was issued to address OSFI's concern over the reliability of fair values when observable market prices are not available; the need for a documented risk management strategy as a prerequisite to using the FVO; and the decrease in the potential need for separate reporting of financial results for regulatory purposes.

Accounting

OSFI will retain D-10 and only make consequential amendments, mainly to delete direct quotes of IAS 39 and *International Financial Reporting Standard* (IFRS) *7, Financial Instruments: Disclosure*[7].

Regulatory Capital

Given that OSFI will maintain D-10, no regulatory capital adjustments are necessary.

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[7] In April 2009, the IASB announced a project to replace IAS 39 on an accelerated basis in three phases, as follows: Phase One addresses the Classification and Measurement of financial instruments, including the FVO; Phase Two addresses Impairment Methodology; and Phase Three addresses Hedge Accounting. IFRS 9, *Financial Instruments* which addresses classification and measurement of financial assets was issued in November 2009. At the issuance date of this Advisory, the IASB expects to finalize the other phases, including the classification and measurement of financial liabilities by the fourth quarter of 2010, with an expected mandatory effective date of 2013.

V. Loan Provisioning

IAS 39 outlines the requirements for impairment of financial assets including loan provisioning. The relevant OSFI guidelines related to loan provisioning are *C-1, Impaired Loans* and *C-5, General Allowances for Credit Risk.*

Impairment of financial assets under IAS 39 and CGAAP under Section 3025 is considered to be similar given they are both incurred loss models and, as such, should not result in significant change to the total loan provision balance. While it is recognized that IAS 39 requires a detailed documented provision methodology that incorporates historical loan loss experience, FREs must ensure they take into account the important requirements to use expert judgement, as detailed in paragraph 62 of IAS 39. Additionally, FREs should note that subparagraph 59(f)(ii) of IAS 39 provides good examples of objective evidence relating to national or local economic conditions for incorporation into collective provisions. The Basel Committee on Banking Supervision's (BCBS) June 2006 paper *Sound Credit Risk Assessment and Valuation for Loans* [8] emphasises that a bank's use of experienced judgement and reasonable estimates is an essential part of the recognition and measurement of loan losses under IAS 39 and all FREs are advised to incorporate these expectations into their provisioning processes.

Accounting

OSFI will retain C-1 and C-5, with some modifications to align terminology with IAS 39, given both are incurred loss models and the same prudential issues continue to apply[9]. OSFI is making modifications to align terminology as follows:

- Replacement of the terms "specific" and "general" allowances with "individual" and "collective" to promote consistency with terminology in IAS 39.
- Removal of the requirement in C-5 that the level of general allowance chosen be conservative when a range of estimates exists. This will be replaced with the IAS 39 requirement that the collective allowance reflects the best estimate within that range.
- Replacement of references to specific sections and wording in CGAAP with the appropriate references and wording in IFRS.

Guideline C-1

C-1 lists a number of indicators of impairment or "loss events". OSFI believes the indicators of impairment in C-1 regarding the number of days payments are in arrears to be within the principles outlined in IAS 39, paragraph 59 of IAS 39, which indicates these loss events are objective evidence that a financial asset or group of assets is impaired. Accordingly, the existing indicators of impairment detailed in C-1 will be retained.

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[8] Available on the Bank for International Settlements (BIS) Web site at: http://www.bis.org/publ/bcbs126.htm

[9] Phase Two of the IAS 39 replacement project (referred to in footnote 7 in Part IV of this Advisory) explores an expected loss approach and may result in changes to the loan impairment standards. At the date of issuance of this Advisory, the IASB expects to publish the revised impairment methodology standard in the fourth quarter of 2010.

Guideline C-5

OSFI continues to believe that the methodology for establishing general or collective allowances is very important and needs to be stressed beyond that done in the accounting standards. A key regulatory need is to establish that the allowance is appropriate in relation to the inherent loss in an institution's risk portfolio. C-5 will focus on the need for expert judgement to be an integral part of the allowance methodology, in addition to FRE's historical loss experience. OSFI will also reinforce its expectation that loan provisioning be robust and incorporate sound management judgement via incorporation of aspects of the loan loss provisioning principles detailed in the BCBS paper *Sound Credit Risk Assessment and Valuation for Loans.*[10]

Learnings from the financial crisis have shown that greater transparency is necessary to instil market confidence. The IFRSs do not specifically require separate disclosure of individual and collective allowances; OSFI believes, however, that this is useful information for users of financial statements. Further, OSFI notes that:

- Canadian banks have continued to provide detailed loan loss allowance continuity information, even when not required to do so;
- analysts rely upon this information; and
- some leading international banks reporting under IFRSs provide detailed disclosure of collective and individual allowances.

Accordingly, OSFI will require separate disclosure by FREs of individual and collective allowances under IFRSs, which is consistent with, to the extent practicable, current public disclosure.

Regulatory Capital

No changes to OSFI's regulatory capital rules are required to adopt IFRSs for loan provisioning.

VI. Own Use and Investment Property

IAS 16, Property, plant and equipment, permits property being held for an entity's own use to be valued at cost or using the revaluation model. *IAS 40, Investment Property,* permits investment property to be valued at cost or fair value.

Accounting

OSFI is not issuing any additional guidance or clarification in this area at this time.

Regulatory Capital

OSFI requires that, for own use property, any fair value gains or losses upon transition and

[10] Available on the BIS Web site at: http://www.bis.org/publ/bcbs126.htm

subsequent revaluation gains and losses would not be included in regulatory capital, as these assets are not easily sold without disrupting the operations of the entity. These exclusions from regulatory capital will be addressed in the regulatory capital returns. For life insurers, the moving average market value of own use property just prior to conversion to IFRSs can be used as the cost for regulatory capital purposes.

For investment property, OSFI requires that any fair value gains or losses upon transition and in subsequent periods be recognized in regulatory capital.

Where a company has a mixed-use facility, the regulatory capital treatment will be based on the GAAP reporting requirements.

VII. Insurance Contracts: IFRS 4 and Related Considerations

i. Contract Classification and Measurement of Contract Components

IFRS 4, Insurance Contracts was developed as a stepping stone towards a more comprehensive insurance contracts accounting standard (termed 'Phase II' of the insurance contracts project). While a Phase II discussion paper was released by the IASB in 2007, and an exposure draft is expected to be issued in mid 2010, it is not anticipated that a comprehensive standard will be developed and become effective before 2013[11]. As a result, the current IFRS 4 will apply in Canada upon transition to IFRSs in 2011.

As an initial standard, which was not intended to be comprehensive, IFRS 4 currently provides a limited set of definitions, requirements and restrictions. It largely allows for the continuation of many accounting practices as established by previous local jurisdiction accounting standards. In addition, to address situations where the previous local accounting practices are viewed as incomplete or inadequate, IFRS 4 allows insurers to change their accounting policies for insurance contracts, beyond the permitted options explicitly outlined within IFRS 4, if those changes make the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs[12].

As a result of the fundamental changes expected from the Phase II accounting and other initiatives, OSFI is in the process of re-developing its regulatory capital regime for insurers.

Currently, CGAAP requires that life insurers value their policy liabilities using the Canadian Asset Liability Method (CALM) under the CIA Standards of Practice (SoP) for the Valuation of Policy Liabilities of Life Insurers established by the Canadian Institute of Actuaries (CIA). Under CALM, actuarial liabilities are determined based on the balance sheet value of assets that support them, taking into consideration the relevant asset and liability future cash flows and assumptions.

[11] IASB project plans and timelines can be viewed under the Projects section of the IASB Web site: http://www.iasb.org

[12] IFRS 4, paragraph 22.

With the introduction of IFRS 4 in 2011, life insurers will be able to continue to use CALM to value insurance contract liabilities for financial reporting purposes.

With the implementation of IFRS 4, there may be contracts or contract components that are not valued under CALM for financial reporting purposes. This is mainly[13] due to the definition in IFRS 4 of an "insurance contract" and the related interpretations with respect to that definition. The key concept is that the contract must involve the transfer of significant insurance risk to be considered an insurance contract.[14] Contracts and components that will not be considered insurance will need to be valued using IAS 39 for financial instruments or *IAS 18, Revenue* for service contracts.

As a result, both the Minimum Continuing Capital and Surplus Requirements (MCCSR) capital required and capital available could be materially impacted by certain policyholder contract or component liabilities not valued using CALM and any changes to the future emergence of earnings.

OSFI does not expect P&C (property and casualty) insurers to be significantly affected by issues related to contract classification and measurement of contract components.

Accounting

A letter was issued to all OSFI regulated insurers on October 31, 2008 that advised insurers to inform OSFI, in writing, at least 24 months in advance[15] if they intended to implement an accounting policy change under IFRS 4 paragraph 22. To date, no such requests have been received. OSFI continues to expect that insurers will adhere to the requirements set forth in the October 31, 2008 letter.

OSFI's requirements on IFRS 4 and related considerations, including certain matters relating to contracts that may not, as discussed above, meet the IFRS 4 definition of an insurance contract (for example, investment contracts), are outlined below under the heading Regulatory Capital.

Regulatory Capital

OSFI will require life insurance companies to continue to use the current practice for CALM valuation of insurance liabilities as the basis for establishing relevant MCCSR capital available and capital required. For contracts and components that are not considered insurance under IFRSs, the related liabilities are to be valued using IAS 39 - Financial Instruments or IAS 18,

[13] Note that other considerations, such as the bifurcation of embedded derivatives and the unbundling of certain contracts, would also impact the extent to which CALM could be used to value certain contract components.
[14] See IFRS 4, Appendix A (Definitions).
[15] The October 31, 2008 OSFI letter also outlines that, where changes will not require OSFI to materially alter its reporting or capital requirements or supervisory practices, OSFI may decide on a case-by-case basis to consider proposals with less lead time. http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/guidelines/accounting/advisories/CIA_Standards_Ins_Pub_Fin_Rep_LET_e.pdf

Revenue. These contracts will be subject to regulatory capital requirements under the MCCSR's "Changes in Interest Rate Environment (C-3) risk" regime.

OSFI will require existing pre-IFRSs P&C valuation methods to be continued for regulatory capital purposes after the introduction of IFRSs.

ii. Reinsurance of Short-Term Insurance Contracts by Federally Regulated Property and Casualty Insurance Enterprises

OSFI *Guideline D-7, Accounting for Reinsurance of Short-Term Insurance Contracts by Property and Casualty Insurance Enterprises* outlines the conditions that reinsurance of short-term insurance contracts must meet in order to be accounted for as reinsurance by federally regulated P&C Enterprises. It also sets out the accounting standards to be applied to these reinsurance contracts. IFRS 4 will introduce different requirements and thresholds for the accounting for reinsurance arrangements than those that currently exist.

When it was issued (February 1998), the D-7 guidance was considered helpful to industry in the absence of more specific guidance in CGAAP. OSFI is of the view that D-7 is no longer required because there is now greater understanding and guidance available to actuaries and accountants on reinsurance risk transfer considerations – examples include the detailed *Report of CIA Task Force on the Appropriate Treatment of Reinsurance* (October 2007) and the recent draft CIA educational note on *Accounting for Reinsurance Contracts under International Financial Reporting Standards*[16].

Accounting

OSFI will rescind D-7, effective on the transition date to IFRSs. However, most of the disclosure requirements within D-7 will continue to be applicable, as OSFI will incorporate them into its *Guideline D-1B, Annual Disclosures*.

Regulatory Capital

OSFI will not issue additional regulatory capital guidance or clarification in this area.

iii. Structured Settlements

OSFI's *Guideline D-5, Accounting for Structured Settlements*, which applies only to P&C insurers, establishes OSFI accounting requirements with respect to structured settlement transactions. D-5 was developed to be consistent with, but also to be more specific than, CGAAP criteria for offsetting financial assets and liabilities relating to structured settlement transactions.

[16] Both publications can be obtained from the Canadian Institute of Actuaries Web site: www.actuaries.ca

D-5 makes a distinction between "Type 1" and "Type 2" structured settlements[17], with only Type 1 structured settlements being eligible for derecognition (i.e. off-balance sheet treatment) of the claim liability and related annuity asset from the financial statements of the P&C insurer. D-5 also requires note disclosures of the financial guarantees and any contingent gains associated with the derecognized structured settlement arrangements.

Under current IFRSs, an insurer can only remove an insurance liability (or part of an insurance liability) from its statement of financial position when it is discharged, i.e. when the obligation specified in the contract is discharged or cancelled or it expires[18].

It is OSFI's view that the current accounting set-off and disclosure of substantive remaining risks approach towards derecognition of structured settlements under D-5 is consistent with current IFRS requirements and that D-5 continues to provide useful application guidance for the consistent accounting for structured settlement transactions by P&C insurers.

Accounting

OSFI intends to maintain D-5, as it is consistent with current IFRS requirements, provides application guidance specific to structured settlement transactions and reduces potential concerns with inconsistent Canadian insurance industry accounting for these arrangements[19].

Regulatory Capital

OSFI will not issue additional regulatory capital guidance or clarification in this area.

iv. Insurance Liabilities and Premiums to be Presented Gross of Reinsurance

IFRS 4 prohibits the offsetting of reinsurance assets against related insurance liabilities or the offsetting of income or expense from reinsurance contracts against the expense or income from related insurance contracts[20].

The gross presentation requirement will cause a change in the treatment of reinsurance for life companies as, currently, life insurance policy liabilities are calculated net of reinsurance. Modifications are being made to SoP to allow for gross presentation of reinsurance, and it has been clarified that the modifications are only intended to have presentation, not measurement, impacts[21].

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[17] The various criteria for classification as a Type 1 structured settlement are meant to establish that the claim has been effectively discharged, with no reversionary interest in the purchased annuity by the insurer. Type 2 structured settlements are those arrangements that do not qualify as Type 1, based on the facts and circumstances.
[18] See IAS 39 paragraph 39, repeated within IFRS 4 paragraph 14(c).
[19] As noted in Part III of this Advisory, IFRS requirements for consolidation and for derecognition are being revised by the IASB and, at the date of issuance of this Advisory, are targeted to be finalized in the fourth quarter of 2010 and between the fourth quarter of 2010 and the first quarter of 2011, respectively.
[20] IFRS 4, paragraph 14(d)
[21] See CIA Actuarial Standards Board's July 2009 Exposure Draft: Revised Standards of Practice – Part 1000 General and Part 2000 Insurers, to conform to International Financial Reporting Standards (IFRS).

Accounting

OSFI will not issue additional accounting guidance or clarification in this area.

Regulatory Capital

For life insurers, the reporting of insurance liabilities and premiums gross of reinsurance will lead to reinsurance assets appearing on the balance sheet. The existing regulatory capital charge regime covering cessions to unregistered reinsurers will continue to apply.

The issues surrounding the treatment of reinsurance in general are being considered under OSFI's Reinsurance Policy Review[22]. For life insurers, unless changes arise from that project, C-3 risk will continue to be addressed on a net CALM basis.

v. Presentation Options for Discretionary Participation Features of Insurance Contracts

Under IFRS 4, life insurers have the option to treat discretionary participation features (DPF)[23] as part of the liability, to show the DPF as a separate liability, or to show it as a separate component of equity. If shown as equity, the portion of profits or loss attributable to the DPF should be recognized as an allocation of profit/loss, not as expense/income.[24]

Current valuation methods provide that all expected future policyholder dividends or other DPFs are included in the determination of the actuarial liability. The CIA Practice Council believes that certain key concepts pertaining to DPFs under IFRSs are consistent with the concept of "policyholders' reasonable expectations" in current Canadian methods of insurance liability valuation and, as such, no changes to the measurement of contracts with these features will be required.[25]

Accounting

OSFI expects that insurers will report DPFs as insurance obligations within their IFRS Statement of Changes in Financial Position reporting.

[22] In December 2008, OSFI initiated a review of its reinsurance regulatory and supervisory framework through the release of a discussion paper, entitled *Discussion Paper on OSFI's Regulatory and Supervisory Approach to Reinsurance*. (The 2008 discussion paper can be found on OSFI's Web site at: http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?DetailID=111.) OSFI's response paper, entitled *Reforming OSFI's Regulatory and Supervisory Regime for Reinsurance,* was released in March 2010 and can be found on OSFI's Web site at: http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/notices/osfi/rscp_reins_e.pdf

[23] See IFRS 4, Appendix A for definition of discretionary participation features.

[24] IFRS 4, paragraph 34. Note that all contracts that include discretionary participation features are included within the scope of IFRS 4, even if the contract itself does not meet the definition of an insurance contract (paragraph 35).

[25] See discussion around 'constructive obligations' in CIA Research Paper *Recognition and Measurement of Contracts with Discretionary Participation Features under International Financial Reporting Standards* (June 2009)

Regulatory Capital

If an insurer wants, and is able, to elect an equity treatment for its DPFs under IFRSs, OSFI will require that the insurer reverse the impacts of this election from its regulatory capital determination.

vi. Option to Use Shadow Accounting Practices

The shadow accounting option allows an insurer to treat an adjustment to the insurance liability (or deferred acquisition cost or intangible asset) directly in equity if the unrealized gains/losses from the related assets are also directly recognized in equity.

Accounting

OSFI believes that accounting matching considerations for insurance assets and liabilities are adequately addressed through current actuarial practices and D-10. As a result, OSFI does not expect insurers will use the shadow accounting option[26].

Regulatory Capital

If an insurer uses the shadow accounting option, OSFI will require the insurer to adjust its regulatory capital to reverse the impact of shadow accounting transactions.

vii. Accounting for Financial Guarantee Type Insurance Contracts

Under IFRSs, a financial guarantee contract "requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument"[27]. Note that this broad definition and terminology does not specifically align with the classes of insurance definitions within the *Insurance Companies Act.*

Based upon OSFI's assessments and discussions with industry participants, it seems that some Canadian credit insurance type products are expected to meet the IFRS definition of a financial guarantee contract. As a result, insurers will have an option under IFRSs to irrevocably elect to account for each type of credit insurance contract as either a financial instrument under IAS 39 or an insurance contract under IFRS 4.[28]

OSFI expects that all Canadian insurers with issued, or who intend to issue, credit insurance products that meet the IFRS definition of a financial guarantee contract will account for these contracts as insurance, consistent with the purpose of their license granted under the *Insurance Companies Act*.

[26] If use of the shadow accounting option becomes prevalent, OSFI will consider options to ensure consistency of financial reporting.
[27] IFRS 4, Appendix A definitions.
[28] IFRS 4, paragraph 4(d)

Accounting

OSFI expects that insurers will report credit insurance type products that meet the IFRS definition of a financial guarantee contract as insurance.

Regulatory Capital

If insurers report their financial guarantee type insurance contract products as financial instruments, OSFI requires that the insurer reverse the impacts of this election from their regulatory capital determination and that such contracts will be reported as insurance contracts for regulatory capital purposes.

VIII. Transition to IFRSs

IFRS 1, First-time Adoption of International Financial Reporting Standards, sets out the procedures that a FRE must follow when it adopts IFRSs for the first time. In the absence of IFRS 1, retrospective application of all standards would be required upon transition. IFRS 1 instead provides a set of optional and mandatory exceptions and exemptions to IFRSs that are designed to provide FREs some relief from full retrospective application. The choices made by FREs with respect to the IFRS 1 exemptions will impact the opening retained earnings, which will, in turn, have an impact on regulatory capital.

One example of an option under IFRS 1 concerns employee benefit plans and the ability to recognize cumulative actuarial gains or losses in opening retained earnings at the date of transition to IFRSs. In the current environment, a number of FREs that could adopt this option could see an underfunded liability on the balance sheet and a reduction in retained earnings. A number of FREs have indicated that they might choose this option when they move to IFRSs.

Accounting

OSFI is not providing any additional accounting guidance or clarification in this area at this time. However, OSFI requires FREs to submit a report (that reconciles equity at the date of transition to IFRSs as reported in accordance with previous CGAAP to equity in accordance with IFRSs) to their Relationship Manager (RM) when they file their first quarter regulatory financial returns after conversion to IFRSs. For those FREs that do not file quarterly financial returns, the report should be submitted to their RM 45 days after the end of their first quarter after conversion to IFRSs. This report should provide sufficient detail to enable OSFI to understand the significant adjustments to equity that could impact regulatory capital. OSFI does not require this report to be audited.

Regulatory Capital

OSFI requires that the net impact to retained earnings from conversion to IFRSs be recognized in available capital. However, since the net impact on individual institutions may be material, recognizing the whole effect in the first quarter under IFRSs reporting may be too extreme.

FREs may therefore elect to phase in the impact of conversion to IFRSs on retained earnings. This election must be made at the time of conversion and is irrevocable.

The amount that may be phased in excludes the impacts related to:

- own use property (refer to Part VI);
- the reversal of gains on sale related to securitizations other than CMHC Programs (refer to Part III);
- shadow accounting (refer to Part VII, vi);
- equity treatment of discretionary participation features (refer to Part VII, v); and
- financial guarantee insurance contracts reported as financial instruments (refer to Part VII, vii).

Although FREs should be taking steps in advance of conversion to IFRSs to minimize its impact, the phase in period for regulatory capital purposes begins at the date of conversion to IFRSs and must be completed by the quarter ending on or after December 31, 2012. The phase in is made on a straight-line basis.

FREs that elect to phase in the impact of conversion on retained earnings must disclose in the notes to the audited financial statements that they have made this election and what their regulatory capital position would be without the election.

Guidance on transition to IFRSs will be incorporated into the regulatory capital guidelines for FREs and those guidelines will be considered the definitive source for guidance on the phase in.

OSFI will adjust regulatory capital returns and related guidance over the coming months so that final versions of all documentation are available in advance of the IFRSs conversion date.

In addition to these adjustments, P&C insurers will begin to report on a consolidated basis. The existing Minimum Capital Test (MCT) includes capital available from and required capital for qualified subsidiaries (i.e., regulated financial institution subsidiaries) and subtracts investments in these entities. The MCT has been modified to specifically exclude all non-qualifying investments in subsidiaries and associates and certain joint ventures. This is expected to result in minimal changes to regulatory capital requirements and reflects a high degree of harmonization with the Life and DTI sectors.

IX. Information Requirement for Progress Report Issued Prior to Date of Conversion

IFRS 1 requires an entity to explain, among other issues, how the change from previous accounting standards to IFRSs affects its reported financial position. To comply with this requirement, entities are required to include a reconciliation of its equity reported in accordance with previous accounting standards to its equity in accordance with IFRSs for the date of transition to IFRSs. The date of transition to IFRSs is the starting point for its accounting in accordance with IFRSs. Canadian entities with a December 31 year end, for example, would have a conversion date of January 1, 2011, but have a transition date of January 1, 2010.

IAS 1, Presentation of Financial Statements requires entities to report comparative financial information in respect of the previous period for all amounts required in the current period's financial statements. In order to ensure a smooth conversion, entities typically prepare the comparative IFRSs financial statements in parallel with the last year of preparing the financial statements under the previous accounting standards. Given this, OSFI expects that FREs will have a very good appreciation of the impact to transition date opening equity in advance of conversion. As such, OSFI requires that FREs include a report that reconciles equity at the date of transition to IFRSs, as reported in accordance with previous CGAAP, to equity in accordance with IFRSs on such date; further, FREs should provide accompanying explanations in their Progress Reports issued prior to their conversion date of such reconciliation. This reconciliation should provide sufficient detail to enable OSFI to understand the significant adjustments to equity that will impact regulatory capital. For further clarity on the timing of the report, the following table is provided.

	Key Dates			
Year End of FRE	**December 31**	**March 31**	**September 30**	**October 31**
FRE IFRSs date of transition	Jan. 1, 2010	Apr. 1, 2010	Oct. 1, 2010	Nov. 1, 2010
FRE IFRSs conversion date[29]	Jan. 1, 2011	Apr. 1, 2011	Oct. 1, 2011	Nov. 1, 2011
Due date of Progress Report issued prior to date of conversion	Jul. 30, 2010	Oct. 30, 2010	Apr. 30, 2011	May 30, 2011

OSFI does not require this reconciliation to be audited and understands that this information, while being a fair estimate of the impact to opening equity, is subject to change. Any changes to the estimate should be submitted separately to the FRE's RM as they become known.

X. Timing of Last Progress Report

OSFI recognizes that FREs have adopted different approaches to their IFRSs conversion process, having regard to their size, complexity, risk profile, structure, ownership and the nature of their business. As such, these approaches may include processes that continue past the FRE's actual conversion date. Irrespective of the approach taken, FREs will not be required to file a semi-annual Progress Report[30] with OSFI past the date of the first IFRSs quarterly regulatory financial reporting.

[29] The conversion date is the fiscal year beginning on or after January 1, 2011.

[30] OSFI's letter of October 7, 2008 outlined expectations with respect to the content of the semi-annual progress reports but did not include the timing of the last report for OSFI purposes: http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/guidelines/accounting/advisories/Imp_of_IFRS_Let_e.pdf

XI. Clarification Regarding Regulations for Legislative definition of *Regulatory Capital*

The *Regulatory Capital Regulations*[31] define "regulatory capital" for legislative purposes for FREs. The current regulations are based on CGAAP and for all FREs, except insurance companies, the calculation includes the aggregation of subordinated indebtedness, non-controlling interest (referred to as minority interests in the regulations), and shareholders' equity. As financial statements prepared under IFRSs have non-controlling interests included in shareholders equity, a literal reading of the regulations in their current form could suggest that non-controlling interests should be included twice in the calculation of "regulatory capital" for the purpose of these Regulations. OSFI will propose the amendment of these Regulations going forward to clarify that non-controlling interests should not be included twice in this calculation. In the interim, OSFI expects FREs will not double count non-controlling interests in the calculation of their regulatory capital under the *Regulatory Capital Regulations*.

[31] Regulatory Capital (Banks) Regulations – SOR/92-531, as am. SOR/94-82 (Sched., s. 1); SOR/2001-421.
Regulatory Capital (Bank Holding Companies) Regulations— SOR/2001-420.
Regulatory Capital (Trust and Loan Companies) Regulations – SOR/92-530, as am. SOR/94-64 (Sched., Pt. II); SOR/2001-425.
Regulatory Capital (Cooperative Credit Associations) Regulations – SOR/92-528, as am. SOR/94-63 (Sched., s. 2); SOR/2001-422.
Regulatory Capital (Insurance Holding Companies) Regulations – SOR/2001-424.