

## Insurance & Reinsurance - Canada

### Financial regulator releases stress-testing guideline

Contributed by [Lang Michener LLP](#)

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The Office of the Superintendent of Financial Institutions (OSFI) recently released its final Guideline E-18, Stress Testing. The guideline is effective immediately and is seen by many as a reaction to the recent global economic crisis. The purposes of the guideline are to develop a standard against which financial institutions' stress-testing programmes may be assessed and to ensure that the same specifications apply to all federally regulated financial institutions, including insurance companies, that operate in Canada.

#### Stress-testing programme requirements

Under Guideline E-18, a stress-testing programme should:

- classify and control risk, integrating risk management throughout the financial institution and taking into consideration interactions between units and businesses that might otherwise be ignored;
- complement other risk management tools, evaluating the strength of current risk management models using extreme events;
- support capital management, assessing how the financial institution will safeguard its capital in severe events, which may combine with market variations to cause strain on corporate resources; and
- improve liquidity, helping to identify, evaluate and control liquidity risks in the event that stress arises that is either institution specific or market wide.

#### Board and management obligations

As the principal decision-making body of the financial institution, the board of directors - or the chief agent for foreign companies - has primary responsibility for the stress-testing programme and should be aware of all findings from the execution of such programme. The board of directors should also ensure that its institution's stress-testing programme is commensurate with the needs of the financial institution; for instance, directors must ensure that the programme is deployed company-wide, and that there are policies requiring appropriate use of stress-testing models as a tool for risk management.

Senior management is responsible for execution of the programme and for ensuring that the financial institution has proper plans to deal with stress scenarios that, while unlikely, are plausible and could cause serious damage to the institution. The scenarios chosen should be relevant to the financial institution and sufficiently severe to make the stress-testing exercise useful and educational. Senior management should also define the risk tolerance of the financial institution and recognize the impact of various events on the institution's business and its solvency, including the use of risk mitigation strategies.

#### Risks addressed

Appropriate stress testing should consider risks that are significant and relevant to the financial sector generally, and to the financial institution specifically, which may include financial sector risks such as:

- credit risk, including counterparty and reinsurance risk;

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- market risk, including:
  - risk of changes in interest rates;
  - inflation;
  - foreign exchange rates; and
  - commodity prices; and
- insurance risk, including:
  - claim frequency and severity;
  - liquidity risks;
  - operational or legal risks;
  - risks in new businesses;
  - contagion risk;
  - regulatory risk; and
  - inflation risks.

Specific institutional risks may include:

- risk mitigation techniques selected, including reinsurance, hedging and use of collateral;
- securitization risks, including the effect of leverage, contractual arrangements and various triggers;
- reputational risks, including risks due to affiliated entities whether on or off the institution's balance sheet;
- counterparty credit risk, including the level and type of posted collateral; and
- concentration of risk among regions, industries, risk factors and off-balance sheet entities.

### **Role of OSFI**

While OSFI requires that stress-testing plans be implemented by management and overseen by the board of directors, at this point OSFI requires no specific reporting of stress-testing results; nor does it require that reporting to the board of directors be made on a defined schedule. OSFI generally assumes that institutions are capable of assessing their own stress-testing programmes and results, and are competent to identify gaps in their practices. OSFI expects that institutions will implement action plans to improve stress-testing practices. However, OSFI will evaluate institutions' stress-testing programmes as part of the regular OSFI supervisory assessment process to ensure that the principles of Guideline E-18 are integrated into the risk identification and risk management practices of financial institutions.

OSFI's right to supervise includes:

- reviewing the stress scenarios selected;
- measuring the suitability of the institution's portfolio;
- ensuring a timely management response to stress-testing results; and
- suggesting certain scenarios for testing by the institution.

OSFI reserves the right to measure a financial institution's capital reserves and capital tests under adverse scenarios and will consider the institution's ability to transfer capital within affiliated corporate groups under these adverse scenarios. OSFI will also make recommendations in order to improve an institution's stress-testing programme.

### **Implications and best practices**

While Guideline E-18 sets out a reasonably detailed set of obligations for institutions using stress testing, financial institutions possess a fair amount of flexibility in the implementation of stress-testing programmes. Financial institutions are advised to customize their stress-testing programmes to take into account their particular needs, complexity and risk profile. Stress testing is designed to be used flexibly and creatively in order to increase the chances of an institution discovering its vulnerabilities, and leaders of these institutions should use their own judgement and expertise when interpreting the results and making changes.

Financial institutions should consider the following best practices with regard to their stress-testing programmes:

- Ensure that stress testing plays a significant role in risk mitigation and contingency planning;
- Consider the size and complexity of the institution and the severity of risk to which the institution is exposed as part of its practice;
- Implement stress testing firm-wide;

- Develop written policies and procedures in support of the stress-testing programme;
- Ensure that stress testing exposes the institution to a variety of stressors, including extreme events that are capable of producing the most damage, whether financial or reputational; and
- Consider how various risk factors are interrelated. For life insurers, changes in economic conditions may affect the behaviour of a policy holder, such as the payment of premiums, use of options within the insurance contract, and death rates. For property and casualty insurers, changing conditions such as inflation may affect investment income, claimed damages and loss reserves. Insurers should also attempt to determine scenarios in which the presumed interrelationships break down as a result of changes in the business environment.

With Guideline E-18 having already come into force, financial institutions, including insurance companies, in Canada are advised to:

- ensure that they have a board-approved stress-testing policy;
- make certain that senior management understands the stress-testing policy and is prepared to implement it;
- review carefully the results of stress tests in order to find the institution's vulnerabilities and to ensure that the stress test is appropriate to the institution;
- regularly consider the risks that the stress-testing programme should assess and how to mitigate these risks; and
- consult with a lawyer if in doubt about their obligations under Guideline E-18 and how best to meet these obligations.

For further information on this topic please contact [Hartley Lefton](#) at Lang Michener LLP by telephone (+1 416 360 8600), fax (+1 416 365 1719) or email ([hlefton@langmichener.ca](mailto:hlefton@langmichener.ca)).

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