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Bulletin: Changes to OSFI's Regulatory Capital Framework for Federally Regulated Property and Casualty Insurers

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The Canadian Office of the Superintendent of Financial Institutions ("**OSFI**") has recently completed a comprehensive review of the regulatory capital framework for federally regulated property & casualty (P&C) insurers, including both Canadian-domiciled companies and branches in Canada of foreign companies. OSFI released its findings in a Discussion Paper on May 24, 2013 (the "**Discussion Paper**"), with some significant changes proposed to the Minimum Capital Test For Federally Regulated Property and Casualty Insurance Companies ("**MCT**") and for P&C insurers.

The Discussion Paper sought to solicit feedback from P&C insurers to provide comments on the proposed revisions to the MCT. The final version of the new MCT Guideline is expected in the summer of 2014 after consultations with stakeholders conclude, and are tentatively scheduled to come into effect on January 1, 2015.

The Discussion Paper offers extensive proposals and amendments to the OSFI reporting requirements of P&C insurers. OSFI intends to create a more comprehensive framework to assess risk that harmonizes with the assessment models employed across various financial sectors. OSFI's goal is to position the new framework to more closely align with the concept of risk-based regulation, in tandem with similar regulatory developments on the international level, as well as OSFI's practice of focusing its attention on principles and risks, rather than rules.

OSFI outlined 15 proposed changes to 7 distinct areas with respect to the MCT, outlined below:

For Definitions of Capital, OSFI proposes to:

1. revise the composition of regulatory capital, qualifying criteria for eligible capital instruments, and applicable limits; and
2. clarify and amend regulatory adjustments to capital.

For Insurance Risk, OSFI proposes to:

3. revise the risk factors for insurance premiums and claims liabilities, recognizing an implicit diversification credit within the insurance risk factors;
4. apply risk factors to premium liabilities rather than unearned premiums;
5. eliminate the risk factors on deferred policy acquisition expenses; and
6. revise the calculation of the margin for reinsurance ceded to unregistered voters.

For Credit risk, OSFI proposes to:

7. review all credit risk factors for balance sheet assets; and
8. introduce effective maturity as an alternative approach in calculating capital requirements for instruments that are subject to a determined cash flow schedule.

For Risks Associated with Off-Balance Sheet Exposure, OSFI proposes to:

9. revise the risk factors for structured settlements, derivatives and other exposures with more granular risk factors based on a credit rating and term to maturity of an exposure; and

10. replace the standard 0.5% risk factor for letters of credit with more granular risk-based factors.

For Market Risk, OSFI proposes to:

11. calibrate the risk factors for investment sin common equity and real estate;

12. adjust the shock factor for interest rate margin risk; and

13. implement a more robust methodology for calculating foreign exchange risk requirements that would apply to the MCT.

For Operational Risk, OSFI proposes to:

14. introduce an explicit risk for operational risk.

For Diversification Credit, OSFI proposes to:

15. recognize an aggregation benefit arising from the diversification between insurance risk and the sum of credit risk and market risk.

In the near term, there is no action required by insurers as a result of the Discussion Paper and MCT-related submissions to OSFI for the 2013 year should be remitted in the ordinary course. We will continue to monitor developments from OSFI relating to the MCT and will advise when there is further progress.

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