



Guideline

Subject: Regulatory Capital and Internal Capital Targets

Category: Capital Management

No: A-4

Date: November 2015

This guideline sets out OSFI's expectations with regard to the capital and solvency assessment of federally regulated insurers (FRI or insurer)¹, within the context of OSFI's *Supervisory Framework*².

Table of Contents

I. The Role of Capital in OSFI's Risk Assessment Process	2
II. Regulatory Capital.....	3
III. Internal Capital Targets	4
IV. Capital Management Policy	5

¹ The current version of this guideline was originally dated January 2014 and, effective as of that date, applies to federally regulated insurers including Canadian branches of foreign life and property and casualty companies, as well as to fraternal benefit societies, except regulated insurance holding companies and non-operating insurance companies. Effective January 1, 2016, application of this guideline is expanded to regulated insurance holding companies and non-operating insurance companies.

² Consult OSFI's website (www.osfi-bsif.gc.ca) for more information regarding OSFI's *Supervisory Framework*, including related *Assessment Criteria* documents.



I. The Role of Capital in OSFI's Risk Assessment Process

OSFI's risk assessment process begins with an evaluation of the inherent risk within each significant activity of a FRI and the quality of risk management applied to mitigate these risks. After considering this information, OSFI determines the level of net risk and direction (i.e., whether it is decreasing, stable, or increasing) of the rating for each significant activity.

The net risks of the significant activities are combined, by considering their relative importance, to arrive at the Overall Net Risk (ONR) of the insurer. The ONR is a consolidated rating or assessment of the potential adverse impact that the significant activities collectively could have on the insurer's earnings performance and adequacy of capital. OSFI then develops a Composite Risk Rating (and its direction) for the insurer, after considering the assessments of its earnings and capital in relation to the ONR, and the assessment of liquidity.

While regulatory capital is an important factor in OSFI's capital assessment, other factors are also considered. OSFI's [*Capital Assessment Criteria*](#) include, for example:

- the adequacy of capital to support the insurer's risk profile and business plan, including risks that are not fully captured in the regulatory capital guidelines;
- the ability to access capital at reasonable rates to meet projected needs;
- the quality of capital;
- the quality or strength of the insurer's capital management policy, including its capital management processes; and
- Senior Management's and the Board of Directors'³ (Board) roles, responsibilities and effectiveness with respect to the insurer's capital management processes.

Capital considerations should include elements that contribute to financial strength through periods when an insurer is under stress as well as elements that contribute to policyholder and creditor protection during wind-up. Some elements may contribute to both, while others are less likely to do so.

OSFI expects the level and quality of an insurer's capital and its capital management to be commensurate with its circumstances, including its risk profile, appetite for risk and operating environment. Past and emerging trends, including the outlook for capital, earnings and liquidity, as well as the insurer's preparedness to deal with potential capital deficiencies, are relevant in assessing the adequacy of an insurer's capital position. In this regard, the number, severity and overall quality of the stress scenarios used by an insurer to assess its capital adequacy in relation to all relevant regulatory and internal capital expectations are important considerations for OSFI when it assesses the strength of an insurer's capital.

³ For foreign company branch operations in Canada, OSFI looks to the Chief Agent to oversee the management of the branch. Throughout this document, a reference to a Board of Directors' role and function is meant to refer to a Chief Agent's role and function with respect to foreign company branch operations in Canada.

Insurers should have risk and capital management processes that take into account their risk profile and business strategy, potential stress situations and future changes to enable them to effectively monitor and manage their ability to meet, on a continuous basis, regulatory as well as internal capital expectations.

II. Regulatory Capital

The *Insurance Companies Act* requires federally regulated insurance companies and fraternal benefit societies to maintain adequate capital and companies operating in Canada on a branch basis to maintain an adequate margin of assets in Canada over liabilities in Canada. Guidelines A: Minimum Continuing Capital and Surplus Requirements (MCCSR) and Minimum Capital Test (MCT) (together referred to as Capital Guidelines) provide the framework within which the Superintendent assesses whether a life insurer or a P&C insurer, respectively, maintains adequate capital or margin of assets over liabilities⁴.

The Capital Guidelines establish standards for measuring specific insurer risks and for aggregating these results to calculate the amount of an insurer's regulatory capital needed to support these risks (Base Required Capital). In relation to Base Required Capital, OSFI has determined industry minimum and target capital levels⁵. These serve as a gauge of a financial institution's regulatory capital adequacy and can trigger intervention⁶ actions.

The Capital Guidelines also define and establish criteria and limits for determining the amount of an insurer's qualifying regulatory available capital (Available Capital). For life insurers, the MCCSR includes additional criteria for determining the amount that qualifies as adjusted net tier 1 available capital (Tier 1), which is comprised of only the highest quality capital elements.

Minimum Capital

The Capital Guidelines address specific insurer risks and determine minimum capital levels (Minimums) to support these risks.

Minimums: *The minimum levels of capital necessary for an insurer to cover the risks specified in the Capital Guidelines.*

If an insurer's Available Capital approached, or were to fall below, the Minimums, OSFI would be very concerned about the ongoing viability of the insurer and/or the level of risk to policyholders and creditors.

⁴ In this guideline, the use of concepts applicable to companies and societies also includes the equivalent concepts applicable to foreign companies' and societies' branch operations in Canada. For example, the concept "capital" includes the equivalent concept of "margin" as it applies to branches; "Base Required Capital" includes "Required Margin"; "Available Capital" includes "Available Margin" and "Tier 1" includes "Core" and "Available Margin excluding Other Admitted Assets".

⁵ For life insurers, regulatory minimum and target capital levels are calculated on the basis of both total and tier 1 capital, while P&C insurers base theirs solely on total capital.

⁶ The [Guide to Intervention for Federally Regulated Life Insurance Companies](#) and [Supervisory Guide Applicable to Federally Regulated Insurance Companies](#) can be found on OSFI's website.

Supervisory Target Capital⁷

OSFI's mandate includes an early intervention approach. This is partly addressed by establishing supervisory target capital levels (Supervisory Targets) above the Minimums that provide an early signal so that intervention will be timely and for there to be a reasonable expectation that actions can successfully address difficulties.

Supervisory Targets: *The target levels of capital necessary for an insurer to cover the risks specified in the Capital Guidelines as well as to provide a margin for other risks.*

From a supervisory perspective, an insurer's failure to maintain its Available Capital above the Supervisory Targets is indicative of material safety and soundness concerns and a vulnerability to adverse business and economic conditions that require immediate attention. An insurer whose Available Capital approaches or falls below the Supervisory Targets will attract increased supervisory attention, which would generally include an early warning intervention status (i.e. stage 1). The intensity and nature of supervisory intervention would depend on the circumstances of the particular insurer.

Regulatory Capital Levels

OSFI has set the following capital levels expressed as a percentage of the amount of an insurer's Base Required Capital:

Regulatory Capital Levels			
	MCT / BAAT	MCCSR / TAAM	
	Total Capital	Total Capital	Tier 1 Capital
Minimums	100%	120%	60%
Supervisory Targets	150%	150%	105%

For monitoring purposes and in OSFI supervisory and other documentation, the amount of Available Capital is generally expressed as a percentage of the amount of an insurer's Base Required Capital and compared to the above capital levels.

III. Internal Capital Targets

All risks specific to an individual insurer cannot be explicitly addressed by industry-wide Capital Guidelines alone. The Minimums and Supervisory Targets are based upon simplifying assumptions applicable on an industry-wide basis, and are not tailored to individual insurers' risk profiles. Accordingly, an insurer should not unduly rely on these regulatory capital measures but should conduct its Own Risk and Solvency Assessment (ORSA) and, based on this process, determine its own capital needs and establish Internal Capital Targets (Internal Targets)⁸.

⁷ Supervisory Targets are not applicable to regulated insurance holding companies and non-operating insurance companies.

⁸ Guideline E-19: [Own Risk and Solvency Assessment](#) outlines OSFI expectations and principles with respect to setting Internal Targets, based on an insurer's ORSA.

Internal Targets: The target levels of capital, determined as part of an insurer's Own Risk and Solvency Assessment, needed to cover all the risks of the insurer, including the risks specified in the Capital Guidelines.

Insurers are expected to determine an Internal Target of total capital needed to protect policyholders and creditors in a wind-up. Life insurers are expected to determine, in addition to the Internal Target of total capital, an Internal Target of core capital that should only include very high quality capital elements. OSFI should be notified when an insurer changes its Internal Targets.

Internal Targets should be set above Supervisory Targets. To determine whether Internal Targets are above Supervisory Targets, insurers should compare their total and core capital Internal Targets to the Total and Tier 1 Supervisory Targets, respectively⁹.

Parent/head office guarantees, potential future injections of capital or other management actions are not assumed in the determination of the Supervisory Targets¹⁰ and should therefore not be assumed in the setting of Internal Targets. These factors should only be considered when determining the level at which the insurer will operate above the Internal Targets.

Insurers are expected to operate at Available Capital levels above the Internal Targets. OSFI understands that an insurer's Available Capital levels may fall below its Internal Targets on unusual and infrequent occasions. If this happens, or is anticipated to happen within two years¹¹, the insurer should inform OSFI promptly and provide plans on how it expects to manage the risks and/or restore its Available Capital levels to its Internal Targets within a relatively short period of time.

IV. Capital Management Policy

Capital management is the on-going process of determining and maintaining the quantity and quality of capital appropriate to support an insurer's planned operations. Capital should be managed to maintain financial strength, absorb losses so as to withstand adverse economic conditions, allow for growth opportunities and meet other risk management and business objectives. It should also be managed in order to provide, in extreme cases such as imminent failure or insolvency, sufficient assets to transfer or run-off policyholder obligations and pay creditor claims.

⁹ For monitoring whether Internal Targets are above Supervisory Targets, Internal Targets should be expressed as a percentage of the amount of an insurer's Base Required Capital and compared to the Regulatory Capital Levels.

¹⁰ Parent/head office guarantees, potential future injections and other management actions are also not considered in the calculation of the Minimums. For P&C insurers, Regulatory Capital Levels include financial resources used to calculate earthquake reserves. P&C insurers may therefore include such amounts in the determination of Internal Targets.

¹¹ As may be contained in financial forecasts or other reports (e.g. projections of very likely scenarios) prepared for Senior Management, the Board, investors or the public.

The insurer's ORSA and its strategic and business plans should support Senior Management and the Board in establishing capital management policies and procedures that include, among other things¹²:

- Clearly defined roles and responsibilities with respect to the design and execution of relevant policies and procedures;
- A policy that states capital adequacy goals relative to risk, taking into account the insurer's strategic focus and business plan, and that sets its Internal Targets;
- A policy with respect to the Board's regular review¹³ and discussion of the insurer's capital management policy and ORSA.

– END –

¹² For additional guidance on how an insurer's ORSA links risk management, capital management and other management processes, please refer to OSFI's Guideline E-19: [Own Risk and Solvency Assessment](#).

¹³ The review should be conducted at least annually or more frequently if conditions warrant.