OSFI DEVELOPMENTS
Canadian Insurance Accountants Association
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OSFI Developments - Outline

- OSFI Developments
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    - Regulatory Compliance Management and Corporate Governance
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The Global Context – Basel III

- **Overview**
  - Capital
  - Non-Viable Contingent Capital (NVCC)
  - Phase-out of Non-Compliant Capital
  - Domestic Systemically Important Banks (D-SIBs)
  - Leverage
  - Liquidity
  - Disclosure
- **Impact of regulatory reforms**
  - Financial Metrics
  - Strategies and Business Plans

The Global Context – Basel III (cont'd)

CAPITAL

- Basel III increases the quantity, quality and transparency of required minimum common equity (or core capital), required tier 1 capital, and the required minimum total capital ratio.
- Risk weighting definitions are tightened in relation to trading derivative and securitization activities in particular thereby indirectly imposing higher capital requirements.
- Introduces the concept of a capital conservation buffer to ensure banks maintain a buffer of capital in the form of common equity to absorb losses during financial and economic stress periods.
- Potential imposition of a counter-cyclical buffer.

The Global Context – Basel III (cont'd)

NON-VIABLE CONTINGENT CAPITAL (NVCC)

- Post-financial crisis, international regulators concluded that the forms of tier 1 capital (other than common shares) which had been issued globally did not - as designed - adequately absorb losses before taxpayers.
- All non-common tier 1 and tier 2 instruments to be included for purposes of regulatory capital are to either contractually or statutorily include a provision whereby the instrument is either written off or converted into common equity at the point of non-viability.

The Global Context – Basel III (cont'd)

- A capital instrument of a Canadian bank (including a Canadian subsidiary of a foreign bank) must:
  - have a clause requiring a full and permanent conversion into common shares of the bank upon a trigger event;
  - meet all other criteria for inclusion as tier capital as specified by Basel III;
  - include a trigger event (i.e., OSFI advises the bank that the bank has ceased or is about to cease to be viable or a federal or provincial government publicly announces that the bank has accepted a capital injection or equivalent support from the government without which the bank would have been determined to be non-viable);

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The Global Context – Basel III (cont'd)

- have a conversion mechanism that ensures that the NVCC investors receive commensurate voting rights;
- have conversion mechanism methodology reflecting the hierarchy of claims in liquidation;
- have no impediments to conversion, which is automatic and immediate on the happening of a trigger event;
- provide that the conversion does not constitute an event of default under the non-capital instrument and, applying a commercially reasonable efforts test, the conversion must not constitute an event of default under any agreement of the bank; and
- include a trust arrangement to hold shares that are issued on conversion to non-common share investors who are legally prohibited from owning common shares such as governments and their agencies.

The Global Context – Basel III (cont'd)

PHASE OUT OF NON-COMPLIANT CAPITAL

- In February 2011, when publishing its draft NVCC advisory OSFI also published an advisory relating to the transition and phase out of capital instruments that do not meet the Basel III requirements.

DOMESTIC SYSTEMICALLY IMPORTANT BANKS (D-SIBs)

- On October 11, 2012, Basel finalized twelve principles for the assessment methodology and higher loss absorbency for domestic systemically important banks (D-SIBs).
- Banks identified as D-SIBs may be required to increase their capital buffers beyond the level required by their non-D-SIB competitors, thereby increasing their relative cost of doing business.

The Global Context – Basel III (cont'd)

LEVERAGE

- The Basel Committee is in the process of finalizing a leverage ratio requirement for purposes of implementation in early 2018 whereby tier 1 capital must equal at least 3% of on and off balance sheet exposures.
- Canada, in the form of an assets to capital multiple (ACM), is one of a limited number of jurisdictions to have had a leverage constraint. For many years, Canadian banks have been required to limit all on and off balance sheet assets (not just risk weighted assets) to 20 times capital (or in certain cases up to 23 times capital – with OSFI approval).
- New leverage ratio requirement which supplements risk-based capital requirements and replaces the ACM became effective in 2015.

The Global Context – Basel III (cont'd)

LIQUIDITY

- Basel III imposes liquidity requirements on banks in the form of two new ratios:
  - a liquidity coverage ratio (LCR); and
  - a net stable funding ratio (NSFR),

  and imposes new liquidity reporting requirements.
- LCR:
  - A short term 30 day test designed to strengthen the ability of banks to withstand adverse shocks.
  - Requires banks to maintain high quality liquid assets to cover 100% of net cash outflows that could be encountered under certain stress scenarios.

The Global Context – Basel III (cont'd)

- NSFR:
  - A longer term structural ratio designed to address liquidity mismatches.
  - Requires banks to maintain a minimum amount of secure medium and long term funding based on the liquidity characteristics of its assets over a one year period.
- New liquidity coverage ratio standard came into force in January, 2015 and requires a bank to have sufficient liquidity on its balance sheet (by way of high quality liquid assets) to satisfy its liquidity needs for a 30-day liquidity stress scenario.

The Global Context – Basel III (cont'd)

DISCLOSURE

- The Basel Committee noted that the financial crisis revealed that the level of the disclosure of the capital positions of banks and the lack of consistency in the way these positions were reported made assessments and comparisons difficult and arguably led to market uncertainty.
- All banks had to fully implement the Basel III disclosure rules in Q3 of 2013.

The Global Context – Basel III (cont'd)

FINANCIAL METRICS

- Increased and a better quality of capital will negatively impact ROE.
- Pressure on dividend growth as a result of the need for a greater re-investment of earnings, investors look to stable growth in dividends when determining value of bank shares.
- Fewer buy backs of bank common shares as banks need to preserve common equity tier 1 capital.
- Banks may, due to the increased emphasis on CET1 and the diminished emphasis on total capital, focus on assets to common equity capital and deleverage insofar as preferred shares and subordinated debt.

The Global Context – Basel III (cont'd)

- Enhanced capital requirements under Basel III magnified by transition to IFRS including in particular impacts resulting from the treatment of securitizations and shareholder equity (even after OSFI's transitional relief in both cases).
- Potential growing divergence between economic capital and regulatory capital may be a continuing source of tension between banks and their regulators.
- Liquidity coverage ratios will impact costs.
- Increased pressure on margins and profitability generally.
- Query whether stock prices could suffer as investors look for businesses with greater margins, lower capital requirements, reduced regulation and greater dividend returns.

The Global Context – Basel III (cont'd)

STRATEGIES AND BUSINESS PLANS

- Greater focus on return on capital in terms of business lines, products and acquisitions.
- Emphasis on capital re-allocation based on revised risk weighting and risk assessment concerns (e.g. geographic, business, product, counterparty, customer, etc.).
- The nature of acquisitions/dispositions by banks will likely change with increased appetite for investments in less capital-intensive, more liquid, and/or more profitable business lines and possible dispositions of certain capital-intensive, less liquid and/or less profitable business lines although significant dispositions by Canadian banks is unlikely.
- Less interest in businesses that are not banking related (e.g. insurance) as full deduction from CET1.

The Global Context – Basel III (cont'd)

- Possible exits from certain foreign jurisdictions which are potential "capital traps" (i.e. reallocation of capital among jurisdictions in which a bank operates).
- The relative competitive position of Canadian banks may be adversely impacted in situations where foreign regulators regulating foreign banks either interpret Basel III more liberally than OSFI or do not adopt Basel III.
- NVCC may be perceived as higher risk by fixed-income investors resulting in lower demand and requiring higher and more costly dividend/interest yields and may engender significant concerns for common share investors who risk significant dilution should a conversion event occur.
- Liquidity costs/requirements will reduce profits and therefore will be increasingly factored into the pricing of products and result in increasing loan spreads (to the extent commercially feasible).

The Global Context – Basel III (cont'd)

- Greater emphasis on improving liquidity models and stress testing which will require significant investments in newer and more sophisticated tools required for the better modeling, measuring and managing of liquidity risk.
- Managing liquidity risk may even be a greater challenge for banks than managing capital.
- Greater business line and administrative integration.
- Simplifying/collapsing legal structures and considering branch alternatives in order to ease capital strain.
- Increased complexity of Basel III coupled with a lack of international regulatory consistency will require significant investments to be made in the tools and personnel necessary to effectively manage the changes brought about by Basel III.
- Capital concerns will also consume an increased amount of board and senior management time.

The Global Context – Basel III (cont'd)

- Greater premium on appropriate governance and risk management, and increased regulatory importance of the role of the Chief Risk Officer.
- Better data management will become a critical component of a bank's operations, requiring new and better IT systems (which may, or may not, be able to take advantage of new IT capabilities (e.g. cloud computing)) and highly trained personnel.
- Reduction in head-count and overhead generally.
- Streamlining of reporting both up and across banks.
- Increased emphasis on timely and accurate disclosure resulting in greater transparency.

Risk Management – Own Risk and Solvency Assessment (ORSA)

- ORSA originally developed in the UK almost 10 years ago.
- Guideline E-19 (Own Risk and Solvency Assessment) with an implementation date of January 1, 2014.
- Not a completely new task (i.e., Guidelines A-4, E-18, DCAT, Appointed Actuary reporting, and Enterprise Risk Management Framework).
- Comprehensive approach by an insurer to the analysis and management of its capital needs in the context of its risk profile (i.e., connecting risk to capital).
- Intended to be integrated into an insurer’s enterprise risk management process.
- ORSA should contain:
  - comprehensive identification and assessment of risk (i.e., forward-looking and comprehensive internal assessment of risks, risk appetite and corresponding capital needs);
  - relate risk to capital;
  - board oversight;
  - continuous monitoring (at least annually) and regular reporting;
  - internal controls and objective review; and
  - independent controls and review.

Risk Management – Own Risk and Solvency Assessment (ORSA) (cont'd)

- ORSA requires insurers to involve the following functions:
  - actuarial;
  - risk (insurance, market, credit and operational);
  - underwriting;
  - internal audit;
  - IT;
  - compliance;
  - finance; and
  - investment.
- Recent changes to Guideline A-4 (regulatory Capital and Internal Capital Targets) were required to make it consistent with ORSA.
- In considering appropriate capital levels insurers must consider a variety of adverse scenarios as part of its stress testing.
- ORSA can be on a group-wide or individual company perspective.
- OSFI approval of an ORSA is not required yet OSFI will review existing ORSA's as part of its supervisory mandate.

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Risk Management – Own Risk and Solvency Assessment (ORSA) (cont'd)

- Insurers part of a global platform must consider foreign operations.
- Insurers can no longer simply rely on generic MCT models as the MCT does not measure all risks and does not give credit where appropriate (although note the new MCT Guideline which places a greater emphasis on risk management).
- Builds consistency with enterprise-wide risk management processes.
- Will require a significant (and ongoing) investment in people and technology.
- Third party (i.e., objective) review will add cost.
- A significant burden for small branches and companies.

Regulatory Compliance Management and Corporate Governance

<u>REGULATORY COMPLIANCE MANAGEMENT</u>

- Revisions to Guideline E-13 have the following objectives:
  - emphasis on mitigating regulatory risk;
  - promotion of industry best practices;
  - encouraging consistency with the OSFI Supervisory Framework; and
  - ensure consistency with international risk management standards.
- RCM framework = structures, processes and other key control elements through which a FRFI and its subsidiaries manage and mitigate regulatory compliance risk inherent in their activities enterprise-wide.
- RCM is an essential component of an overall risk management program.
- Emphasizes role of CCO (and direct reporting to the board), senior management, internal audit, and board.
- RCM framework to be reviewed and updated regularly, at least annually.
- Emphasizes procedures for identifying, risk assessing, communicating, effectively managing and mitigating regulatory compliance risk and maintaining knowledge of applicable regulatory requirements.

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Regulatory Compliance Management (cont'd)

CORPORATE GOVERNANCE

- Good corporate governance directly contributes to an FRFI's safety and soundness.
- Seek to enhance the effectiveness of the board (i.e., responsibilities and competencies).
- Emphasizes the importance of best practices.
- Distinguishes between the board (direction-setting and macro oversight) and senior management (execution).
- Board independence from senior management is essential (e.g., separating role of Chair and CEO, meetings without senior management, etc.).
- Need for a risk committee of the board.
- Importance of CRO.
- Fully independent audit committee of the board is recommended but not required.
- Audit committee of board (and not senior management) is to recommend the appointment of the auditor.
- Need for risk appetite framework.

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Risk Management – New Product Lines and Technology

- New products in the marketplace include:
  - Drone insurance
    - Proliferation of commercial and personal use unmanned aerial vehicles (UAV's) / unmanned aerial systems (UAS's).
    - Not covered by typical commercial liability insurance as use of drones will fall under the broad aviation exclusions of most general liability insurance.
    - Zurich Canada has launched a drone insurance product (first-party property coverage, third party liability coverage, and additional coverage extensions.
    - Previously only available through specialist aviation insurers.
  - Flood insurance
    - Canada is the only G-8 country without residential flood insurance with the federal and provincial governments being the de facto insurer for floods.
    - In 2013, flooding was the main cause of natural catastrophe-related losses globally.
    - Widespread flooding in GTA and Alberta (this isn't a Manitoba problem anymore).
    - Overland flooding not currently covered under home insurance policies.
    - Aviva Canada has launched a new flood insurance product.
    - 5% of homeowners are in high-risk flood zones.
    - A national industry approach will require sophisticated flood-mapping technology.
  - Cyber insurance
    - Identity theft.
    - Proliferation of social media.

Risk Management – New Product Lines and Technology (cont'd)

- New technologies include:
  - Vehicle telematics
    - here to stay;
    - significant increase in insurer pilot projects; and
    - has engaged the broker community.
  - Big data
    - Allowing for better predictive models and enhanced product pricing.

Risk Management – Cloud Computing

- February 29, 2012 OSFI Memorandum
  - Not just cloud computing but all new technology-based outsourcing arrangements.
  - Only applies to material (which is both a quantitative as well as a qualitative analysis) cloud computing arrangements.
  - Emphasis on:
    - confidentiality, security and separation of property;
    - contingency planning;
    - location of records;
    - access and audit rights;
    - subcontracting; and
    - monitoring the material outsourcing arrangements.
  - Unusual for OSFI to issue such a memorandum and therefore underscores a significant regulatory concern with respect to the risks associated with cloud computing.

Risk Management – Cloud Computing (cont'd)

- OSFI's approach and philosophy:
  - Benefits and risks for FRFI's with respect to cloud computing:
    - Still at the relatively embryonic stage for FRFI's but growing in use more generally.
    - Potentially very significant cost savings for FRFI's which by their very nature operate data-intensive, not to mention date-sensitive, businesses.
    - Huge systemic risk (e.g. reputational, financial, loss of data, counter-party, etc.) in the context of material cloud computing arrangements (particularly the case for smaller FRFI's).
    - Engenders significant third party dependency.
  - Process leading up to the OSFI Memorandum
    - Reluctant to open up Guideline B-10 (i.e. it is expected that Guideline B-10 can still work in a cloud computing environment).
    - The result of extensive industry consultation (i.e. both FRFI's and service providers).
    - OSFI looked to foreign regulatory approaches and philosophies for guidance.

Risk Management – Cloud Computing (cont'd)

- Benefits of the OSFI Memorandum
  - Gives contractual "ammunition" to FRFI's when negotiating with IT service providers.
  - Not prescriptive (i.e., still flexible reflecting principles-based approach).
  - Acknowledges the benefits of cloud computing to FRFI's (i.e., not an outright prohibition in concept).
  - Gives direction to the IT service provider industry to allow it to develop a cloud computing model which is regulatorily compliant.
- Draw-backs of the OSFI Memorandum
  - Curtails/limits the benefits of cloud computing in that it is arguably difficult, if not impossible, to satisfy all criteria in the context of a "true" cloud computing arrangement (e.g. location of data, access and audit rights for both the FRFI and OSFI, etc.) thereby necessitating changes to the model.
  - Perhaps not prescriptive enough.

Risk Management – Cloud Computing (cont'd)

- OSFI disputes the claim made by IT service providers that FRFI's will lag their competitors because of excessive regulation in the area.
- In comparison to other regulators (e.g. Australia, Singapore, United States and Germany) OSFI is generally more supportive of cloud computing.
- OSFI does not manage risk – it merely provides guidance and therefore will not opine on any outsourcing arrangements (including with respect to material cloud computing arrangements) because OSFI does not:
  - know your business as well as you do;
  - want to be pulled into contractual negotiations; and
  - want its supervisory staff to be held hostage to prior regulatory "views" or "comfort".
- Cloud computing emphasizes geographic and political risk for FRFI's (i.e. OSFI prefers "localized" cloud computing).
- FRFI's should move slowly and cautiously with a view to managing risk, engaging risk management protocols, and involving internal audit and legal at the very early stage of any material cloud computing arrangement (i.e. don't cut corners).
- The IT service provider industry should develop bespoke products and services which complies with regulatory expectations as there is the perception that those cloud computing products and services currently available may not be necessarily compliant.

Risk Management – Cloud Computing (cont'd)

- Consequences to FRFI's for implementing a cloud computing arrangement which does not comply with Guideline B-10 or the OSFI Memorandum:
  - deficiency letters;
  - unwinding contractual arrangements;
  - negative impact on supervisory ratings (and if serious enough, will impact capital requirements); and
  - exercise by OSFI of its residual authority to mandate that services be provided in Canada.

P&C Demutualization

- Draft regulations released by Department of Finance on February 28, 2015.
- Two sets of regulations depending whether the mutual has only mutual policyholders or a mix of mutual and non-mutual policyholders.
- Following comment and promulgation the regulations will allow mutual P&C insurers to demutualize.
- Point of contention: who is entitled to vote on whether a company should demutualize and who is entitled to benefit.
- For companies with both mutual and non-mutual policyholders the process will be more complicated characterized by a negotiation between court-appointed counsel and court-appointed policyholder committees.
- Basis for apportioning benefits to a policyholder must take into account:
  - his/her obligations, rights and benefits;
  - premiums paid;
  - length of time as a policyholder with the company; and
  - historical growth of the company’s surplus account.

P&C Demutualization (cont'd)

- Process:
  - Board passes a resolution recommending conversion and determining eligible policyholders.
  - Mutual policyholders vote whether to proceed to negotiate the conversion proposal with non-mutual policyholders.
  - Committees for mutual and non-mutual policyholders (composed of court-appointed members and represented by court-appointed counsel) negotiate.
  - Mutual policyholders vote to amend by-laws to permit non-mutual policyholders to vote.
  - OSFI authorization required to send notice of meeting to all eligible policyholders.
  - Vote by eligible policyholders.
  - Approval of Minister of Finance (Canada) for conversion.
  - Subsequent approval of an acquisition of a converted company within first two years of conversion only if it would not result in the converted company having a major shareholder (> 20% votes or >30% of any class of non-voting shares) = no sponsored demutualization allowed.

The Supervisory Process

- OSFI priorities:
  - Anticipating & responding to risks from the economy and financial system.
  - Enhancing supervisory processes.
  - Anticipating and responding to regulatory reforms.
  - Retaining a high-performing working force.
  - Enhancing corporate infrastructure.

The Supervisory Process (cont'd)

- Regulatory Process*

1. Initial Analysis
   - Issue identification and development of options.
2. Initial Consultations
   - Internal and external consultations.
   - Circulate draft regulations and policy document.
3. Legal Examination
   - Department of Justice performs legal examination and blue stamps draft regulations.
4. Pre-publication
   - Ministerial approval for pre-publication package.
   - Privy Council Office (PCO) review pre-publication package and submit to Treasury Board (TB) for approval.
   - Draft regulations and *Regulatory Impact Analysis Statement* published in Part I of the *Canada Gazette* for comment.
5. Final Publication
   - Prepare regulatory package for final submission to Minister, PCO, and TB.
   - Final regulations and RIAS published in Part II of the *Canada Gazette.*
   - Registration of regulations.

* Source: Office the Superintendent of Financial Institutions

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The Supervisory Process (cont'd)

- Guidelines Process*

1. Initial Analysis
   - Issue identification and development of options.
2. Development of Draft Guideline
   - Draft guideline developed based on research and input from internal/external stakeholders.
3. Internal Consultations
   - Draft guideline sent to appropriate OSFI staff for comment.
4. External Consultations
   - Draft guideline posted on OSFI's external website for comment.
5. Final Posting
   - Final guideline package prepared and submitted to Deputy Superintendent, Regulations for sign off.
   - Guideline package posted on OSFI's external website.

* Source: Office the Superintendent of Financial Institutions

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