Capital requirements of life insurance companies : Where do we stand ?

February 1, 2014

AT THE INTERNATIONAL LEVEL

On December 16, 2013, the International Association of Insurance Supervisors (the "**IAIS**"), which groups the regulators of 140 countries, including Canada, published a consultation document proposing to the international community a series of regulatory capital safeguard requirements applicable to global systemically important insurers[1]. Earlier in 2013, the IAIS had established some criteria to allow the Financial Stability Board, an economic group related to the G20, to identify these global systemically important insurers which may, in the event of bankruptcy, disrupt the international financial system due to their size, complexity, global scale and degree of interdependence with other financial institutions or the exclusive nature of the services they provide.

Having for mission to promote effective supervision of the global insurance industry and contribute to its financial stability, the IAIS has undertaken the first step of its project which should lead to the adoption, by G20 countries, of a first set of international capital requirements for global systemically important insurers deemed to be "too big to fail".

It had indeed become necessary to implement such regulatory framework given the absence of consistent international capital requirements for global systemically important insurers, the inadequacy of the requirements applicable to banking institutions in the Basel agreements having regard to the specificity of insurance companies and, as the 2008 financial crisis remin-ded us, the importance of ensuring better resiliency of these important insurance institutions in the event of possible economic disruptions.

Following the consultations currently conducted by the IAIS, it is anticipated that the conclusion of this first step will consist in the final adoption of these first international requirements by the G20 in November 2014 at the next G20 summit in Brisbane, Australia.

The IAIS anticipates completing the second step of its project on or about late 2015 by adopting a series of additional requirements with higher loss-absorbing capacity targets for all global systemically important insurers.

The final step of the project will consist in the adoption by the G20 of a risk-based international capital standard applicable to global systemically important insurers, called "risk-based group-wide global insurance capital standards" or "ICS". These ICS standards will be applicable to globally active insurance companies, which particularly includes the global systemically important insurers. The work respecting the ICS standards is due to be completed by the end of 2016.

The IAIS anticipates that the full implementation of its global regulatory framework for insurance

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companies should begin in 2019, after two years of field testing and adjustment of its standards, to be carried out in 2017 and 2019.

Lastly, it should be noted that on July 18, 2013, the Financial Stability Board published a first list of global systemically important insurers. No Canadian insurance company was included among the nine identified companies[2]. However, this list will be updated annually beginning in November 2014.

IN CANADA

In Canada, the Office of the Superintendent of Financial Institutions ("**OSFI**") participates in the initiatives of the IAIS for promoting the harmonization between these initiatives and its own framework of regulatory capital applicable to federal life insurance companies, which is currently provided for in some OSFI guidelines[3].

In September 2012, the OSFI published its *Life Insurance Regulatory Framework*, a document stating the priorities of the OSFI as to the regulation of federally chartered life insurance companies[4] and particularly announcing an in-depth review of the capital adequacy requirements for these insurers. In a press release issued on November 12, 2013, the OSFI was reviewing the first year following the coming into force of this regulatory framework.

The new proposed regulatory framework provides for the adoption of a new guideline respecting the regulatory capital requirements, which will, among other things, (i) incorporate new risks not explicitly covered by the current framework; (ii) accommodate smaller companies, as well as larger, more complex companies; (iii) link risk measures to the quality of capital available to absorb losses; and (iv) take into account the interaction between risks (diversification/concentration).

Although it was originally anticipated that the consultation of industry members would be completed in 2014 with the progressive implementation of the changes being made between 2014 and 2016, the OSFI stated in its press release dated November 12, 2013 that the deadline for completing the new capital framework was postponed to 2016 and it was therefore anticipated that it would come into force in 2018.

The OSFI intends to continue its work on its new regulatory capital framework and publish in 2016, for public consultation purposes, a provisional version of its new guideline. The period between 2016 and 2018 will be used to conduct parallel tests prior to the complete implementation of this new guideline anticipated for 2018.

At the same time, the OSFI announced in December 2013 the adoption of revisions of its MCCSR guideline. The revisions take into account the change of accounting standards, provide clarifications to users and take into account the recent A-4 and E-19 guidelines on the implementation of internal risk and capital assessment systems by life insurance companies. The revisions of the MCCSR guideline came into force on January 1, 2014.

IN QUEBEC

Lastly, it is to be noted that on December 18, 2013, the Autorité des marchés financiers ("**AMF**") announced the adoption of modifications to its *Capital adequacy requirements guideline* applicable to insurers holding a permit to operate in the insurance of persons industry in Quebec[5].

The changes made on this occasion remain minor. They mainly constitute measures for harmonizing Quebec regulations with the standards of the OSFI or the OECD, adapting the accounting language and clarifications made in response to questions raised by industry members.

The most obvious change is certainly the one concerning the treatment of the risks specific to the

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damage insurance subsidiaries held by insurance of persons companies. The AMF explains that the changes made to this effect will now take into account some risks which were not previously considered.

The changes to this AMF guideline came into force on January 1, 2014. However, the modifications pertaining to the treatment of damage insurance subsidiaries will only come into effect on January 1, 2015.

CONCLUSION

The recent initiatives of the various regulating bodies of the insurance industry, both at the national and international level, demonstrate the growing concern about the issue of creditworthiness and proper capitalization of these financial institutions.

As international standards respecting capital were up until now mainly applicable to the banking industry, the international community has recognized the systemic importance of insurance companies and the need to provide that industry with global standards specifically adapted to their operating model. At the Canadian and Quebec level, the OSFI seems to closely monitor these developments and the AMF demonstrated that it was continuing its harmonization efforts.

The 2008 crisis and particularly the case of AIG certainly confirmed the fundamental need for ensuring the strength of life insurance companies in order to increase the capacity of the financial system to absorb the shocks caused by financial and economic tensions and proportionally reduce the risk of repercussions on the real economy.

The challenge now facing the financial and regulatory communities is certainly the speed at which the standards developed may become obsolete in view of the speed at which financial markets evolve. Regulatory authorities must ensure that the adaptation of their normative schemes follows the pace of the development of financial operations which are increasingly complex and sophisticated. It is therefore expected that the prudential regulatory scheme will be called upon to constantly adjust. Insurance companies will have no choice but to keep ahead of developments.

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[1] *Basic Capital Requirements (BCR) for Global Systemically Important Insurers (G-SIIs): Proposal*.

[2] In alphabetical order: Allianz SE; American International Group, Inc.; Assicurazioni Generali S.p.A.; Aviva plc; Axa S.A; MetLife, Inc.; Ping An Insurance (Group) Company of China, Ltd.; Prudential Financial, Inc.; Prudential plc.

[3] Minimum Continuing Capital and Surplus Requirements (MCCSR), Guideline A-4: Regulatory Capital and Internal Capital Targets and Guideline E-19: Own Risk and Solvency Assessment (ORSA).

[4] Although the provinces have jurisdiction to regulate issues respecting the capital adequacy of insurance companies operating in their respective territories, many of them have decided, for convenience purposes, to delegate this role to the OSFI. Therefore, the capital requirements of the OSFI apply not only to federally chartered insurance companies, but also to those chartered by a province having an agreement with the OSFI to this effect. For its part, Quebec has chosen to regulate itself the operation of insurance company operating in its territory.

[5] However, in practice, insurance of persons companies, whether federally chartered or incorporated under a provincial law, which submit to the regulatory capital requirements of the OSFI, are deemed to also satisfy the AMF requirements in this respect.

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