Navigating Regulatory Alphabet Soup

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Robert W. McDowell, Koker Christensen, Marvin Mikhail
Supervisory Framework

- Since August 1999, it has been all about identify, assess and mitigate risk
- “A FRFI’s Board of Directors and Senior Management are responsible for the management of the FRFI and ultimately accountable for its safety and soundness” (OSFI Supervisory Framework)
- Focus on material risk
- Understand the drivers of risk given the insurer’s business model (i.e., products and their design, activities, strategies and risk appetite)
Supervisory Framework (Cont’d)

• Focus on significant activities, a line of business or a process fundamental to an insurer and its business model
• Inherent risks are credit risk, market risk, insurance risk and operational risk
• Oversight functions include financial, compliance, actuarial, risk management, internal audit, Senior Management and the Board
Overview Comments

• The universe of regulation, governance, risk management and compliance requirements that apply to financial institutions has been rapidly expanding
  • Refer to applicable Guidelines including new ones since 2008 federal P&C insurers are required to have and refer to Schedule A
  • Refer to applicable risk management policies including new ones since 2008 federal P&C insurers are required to have and refer to Schedule B
Overview Comments (Cont’d)

• Much of this is a reflection of the usual evolution of law, it develops as needs be, wrong things happen and we react to issues to prevent them happening again. Is there any hope to anticipate next risks/threats?
  • Example 1
    • Financial crisis caused (in part) by inadequate regulation and risk management.
    • Reaction: Greatly increased focus on regulation and risk management.
• Example 2
  • Financial crisis caused (in part) by inadequate global coordination and oversight of internationally active financial institutions.
  • Reaction: Significant efforts to articulate global standards and to get countries to implement these domestically. Here one can consider those done and being done by BCBS, FSB, World Economic Forum, IAIS, and the Geneva Association among others. Canada is committed to being viewed as a country that leads and plays by high standards. This is heightened by the fact that the Chairman of the FSB is the Governor of the Bank of Canada. It is inevitable that in the current environment these international developments will impact Canadian institutions.
At the same time that regulation, risk management and compliance requirements have been expanding, there have been increasing governance expectations applicable to Boards and Senior Management.

- Increasing accountability
- Expectation that Boards and Senior Management are engaged in various aspects of risk management
- Expectation that Boards and Senior Management can validate that internal controls are working effectively – this has always been important but it is increasingly important
- Monitoring implementation of strategy – from a regulatory and risk management point of view
• This puts Boards and Senior Management in a very difficult position – they are expected to have a higher degree of responsibility and accountability and engagement with respect to an expanded array of regulatory, risk management and compliance requirements. This strain is likely to become greater. Boards are asking questions that until recently would have been thought to be the purview of management because of these expectations, requirements
• Canada ostensibly has a principles-based regulatory environment. However, when principles are articulated in great detail and it is clear there would well be consequences if these principles are not followed, the line between a principles-based approach and a rules-based approach starts to blur. The risk is that institutions could face the more challenging of all worlds – (1) numerous specific requirements that need to be complied with and (2) requirements that require judgment and a risk-based approach to comply. As a result, institutions are directed and constrained in how they deal with regulatory risk management and governance, but at the same time they do not have the benefit of a safe harbour that comes with a rules-based approach (i.e., if the rules are specific and mechanical, you know when you have complied).
Overview Comments (Cont’d)

• How can Boards and Senior Management effectively discharge their duties in the current environment? More on this later and to be discussed.

• The most important pieces of OSFI guidance for Boards and Senior Management are the Supervisory Framework and the Corporate Governance Guideline. It can almost be said that the rest of the Guidelines, Advisories, etc. and Policies pursuant to them are more specific pursuant to that. More on the Governance Guideline later.
Insurance Banana Skins

- Regulation is the #1 risk facing the insurance business – across life, non life, reinsurance, etc.
- Interesting point is that the Regulators said Regulation is the #8 risk
- Regulation comes out in different ways:
  - Cost – includes diversion of talent and resources away from the business
Centre for Study of Financial Innovation (CSFI) (Cont’d)

• Volume – many fronts, regimes, etc. – different bodies, capital, finance and straight regulation among others, different parents from different jurisdictions can have different implications
  • Capital – higher requirements and higher costs
  • Banking spill over concerns
• Uncertainty – regulation creates uncertainty and complicates business planning – this is key to the risk
What are the Consequences?

- Regulation leads to change.
- M&A; new business strategies, sudden exits
- Some will not keep up, probably smaller ones – too costly, or insurers get out of less profitable lines
- Concern with over application of bank driven rules re capital and its cost
- Contrasting comment: too much capital already causing soft market – compare recent stress testing required by OSFI of P&C in Canada and capital positions found to be strong
What are the Consequences? (Cont’d)

- Risk Management fell a lot, to 15 from 6, on the list of risks, suggesting insurers are getting good at it – came out of the crisis quite well
- Uneven playing field between countries or areas. Europe - UK - US - etc. putting a country at a disadvantage
- Solvency II, Pillar 1 will raise bar – ORSA – mostly we are there in Canada
What are the Consequences? (Cont’d)

- Concern about the push for internal models in Solvency II and in Canada, place more reliance on models; less on judgement by risk management and underwriters.
- Overall regulation is creating pressures to avoid risks rather than manage risk.
- Rating agency accuracy is a real concern – always thought the crisis gave them a light consequence.
- If one wants more focus in P&C insurance rather than inherit bank spill over, one might consider being careful about what one wishes for, more attention can bring more regulation.
What are the Consequences? (Cont’d)

  
- Governance refers to oversight mechanisms – Governance Guideline to establish and implement oversight functions and processes

- Role of Board
  - Assisting management in defining strategy
    - Appropriate mix of risk and return
What are the Consequences? (Cont’d)

• Monitoring performance of management
  • Internal controls and reliance
  • Process in place to monitor implementation of strategy
  • Need to trust internal controls – Board needs to verify basis for trust
What are the Consequences? (Cont’d)

- Can the Board rely on control functions
  - Engage third party independent reviews to assess if controls effective
  - Are control functions independent – business heads have input to the planning, budget and performance reviews
  - Is Risk Management credible – is it able to counter businesses?

- Do Chief Risk Officers sign off on strategic decisions?

- Themes to Date
1. Independence of control functions
2. Lack of clarity of roles and responsibilities with respect to risk management
3. Assessment and adequacy of risk management budgets and resources
4. Lack of independent 3rd party reviews of controls including risk management
5. Reviewing reporting lines of Appointed Actuary & Chief Risk Officer – further guidance to come
What are the Consequences? (Cont’d)

• Since then I note Draft Revised Guideline E-15 – appointed actuary: legal requirements, qualifications and Peer Review

• Business of P&C Insurance is transfer and assessment of risk, as a result P&C Insurance has been ahead of other sectors in management of risks. P&C industry has diverse institutions in size, number and complexity of lines, risk appetites
What are the Consequences? (Cont’d)

• So it is a competitive industry, risks are dynamic and always emerging

• In speaking to OSFI very recently regarding the Corporate Governance Guideline, there will be clarifications, heightening of responsibilities of the Board, formalization of the CRO, clarity on internal controls and inclusion re the FSB principles of compensation
A study of insurer failures in Canada 1960-2005 has shown the leading cause of insurance failures to be inadequate pricing and deficient loss reserves (31%), followed by foreign parent impairment (29%), rapid growth (17%), alleged fraud (9%) over stated assets (6%) and reinsurance (3%) and others.

The incidents of insurer failures varies with industry profitability and the underwriting cycle.
Why Insurers Fail? – PACCIC (Cont’d)

- Canadian insurers fail because of a result of their exposure to the Canadian economic/underwriting environment
- Branch companies may fail because the home office company failed due to the economic/underwriting environment in a foreign jurisdiction
There is a lot of research re insolvency in P&C internationally; the primary causes for failure in the U.S. for non life companies 1969-2009 were deficient loss reserves and inadequate pricing (38% of failures) followed by rapid growth (14%), affiliate impairment and catastrophe losses (8% each), investment losses (7%) with reinsurance way down the list.

The point of mentioning reinsurance is that people mention it as a risk but it has been commented upon as very well spread internationally among many players.
• It is interesting to note that the very core functions of an insurer, inadequate pricing and deficient loss reserves, are the leading causes of failure while at the same time it is remarked that insurers are more used to managing risks than other financial sectors.

• Of course, the foregoing are related to deficiencies in risk management and governance.
Why Insurers Fail? – PACCIC (Cont’d)

• Generally speaking the IAIS study on insurance and financial stability showed that traditional insurers withstood the financial crisis better than other financial institutions and that they were neither contributors to nor affected by systemic risks. This has a lot to do with the business model.

• As we know, there were problems with non-traditional and non-insurance activities.
Why Insurers Fail? – PACCIC (Cont’d)

- Good news – P&C industry in Canada has a high level of core common equity which is a focus of Basel III applicable to banks; stress tests on low inflation, high inflation, slow growth, depreciation in value of investments, have all shown capital ratios remain strong; ORSA as part of Solvency II, Pillar 2 are areas where we could argue we are there or close to it; Canada meets 26 of the 28 core principles for supervision of the IAIS, the highest of any country – so there should not be a push for more regulation based on those principles
Conclusion/Observations

• Four observations about how Boards and Senior Management may discharge their duties in relation to risk management and governance:

1. Focus on the framework – strategy, risk appetite and culture

2. Take a more macro, comprehensive and key risk-based approach. Cut-through the details of regulation, risk management and compliance and focus on (1) identifying the key risks faced by the institution and (2) how can these risks be appropriately mitigated and managed
3. Need for a clearly defined risk management function with sufficient strength and independence so the Board and Senior Management can rely on this function

4. Has to be an overall coherent policy framework and it must be a very real part of the business
• There will be more regulation around independence and strength of all control functions – financial, compliance, actuarial, risk management, internal audit, Senior Management and the Board
Conclusion/Observations (Cont’d)

- There will be more regulation including for the reason regulators want more aligned supervisory practices
- There will be more regulation pertaining to internationally active insurance groups – note the crisis experience with banks in relation to systemic risks and Com Frame from the IAIS
Conclusion/Observations (Cont’d)

- I do not see it mentioned anywhere but just like there are US and UK initiatives to separate proprietary trading from banks, I would think there would be regulatory initiatives to not allow non-traditional insurance and non-insurance to be done by insurance companies.
- Since this all started in 1999 and grown piecemeal but significantly over the years, is it time for a review to determine if we have coherency or too many pieces?
Conclusion/Observations (Cont’d)

• OSFI is a top regulator in the world, they are pretty good at consultation. I think we have to reinforce that and communicate both ways even more

• I think we need more exchanges of personnel between OSFI and the regulated financial institutions so there is more, deeper information and understanding (a) of the businesses being regulated by OSFI and other regulators and (b) of the responsibilities of regulators so the right overall approach, initiatives and changes, including any simplification, and most importantly, balance, can be taken. Please forgive me, seek to understand the other party, then to be understood. It is more effective and better for both parties.
Let’s discuss

a) all and any points of concern, complaints, frustrations, observations and then, hopefully,

b) there will be some consensus of what these are so

c) we can try to discuss some ways forward, some possible solutions
SCHEDULE A
OSFI GUIDELINES

• Post-2007

• 2008
  • Feb. 2008 – E-17 - Background Checks on Directors and Senior Management of FREs
  • Aug. 2008 – E-6 -Draft Materiality Criteria for Related Party Transactions

• 2009
  • Mar. 2009 – B-10 - Outsourcing of Business Activities, Functions and Processes
  • Dec. 2009 – E-4A - Revised – Role of the Canadian Chief Agent & Record Keeping Requirements (Nov. 1992)
  • Dec. 2009 – E-18 - Stress Testing
• **2010**
  - July 2010 – C-1 - Impairment – Sound Credit Risk Assessment and Valuation Practices for Financial Instruments at Amortized Cost
  - July 2010 – D-1B - Annual Disclosures
  - July 2010 – D-5 - Accounting for Structured Settlements
  - July 2010 – D-6 - Derivatives Disclosure
  - July 2010 – D-10 - Accounting for Financial Instruments Designated as Fair Value Option
  - Dec. 2010 – B-3 - Sound Reinsurance Practices and Procedures
• **2011**
  
  - June 2011 – A-4 - Internal Target Capital Ratio for Insurance Companies
  

• **2012**
  
  
SCHEDULE A
OSFI GUIDELINES (Cont’d)

• **Pre-2007**
  • 1993
    • Jan. 1993 – B-1 - Prudent Person Approach
    • Dec. 1993 – E-6 - Materiality Criteria for Related Party Transactions

• **1994**
  • Mar. 1994 – B-2 - Investment Concentration Limit

• **1995**
  • May 1995 – B-7 - Derivatives Best Practices
SCHEDULE A
OSFI GUIDELINES (Cont’d)

• 1996
  - Sept. 1996 – B-4 - Securities Lending
  - Dec. 1996 – E-10 - Use of Depositories by Insurance Companies

• 1998
  - May 1998 – B-9 - Earthquake Exposure Sound Practices & Annexes

• 2002
  - Nov. 2002 – E-4A - Role of the Canadian Chief Agent & Record Keeping Requirements
SCHEDULE A
OSFI GUIDELINES (Cont’d)

• 2003
  • Jan. 2003 Corporate Governance Guideline
  • Mar. 2003 – E-13 Legislative Compliance Management (LCM) Guideline
  • May 2003 – B-11 Pledging
• 2004
  • Nov. 2004 – B-5 Asset Securitization
• 2006
  • Nov. 2006 – E-15 Appointed Actuary: Legal Requirements, Qualifications and External Review
SCHEDULE B
Risk Management Policies

- **Post-2007**
  2. Liquidity
  3. Reserving
  4. Internal Control
  5. Legislative/Regulatory Compliance
  6. Governance
  7. Outsourcing
  8. Reinsurance
  9. Assessment of Responsible Persons
  10. Stress Testing
SCHEDULE B
Risk Management Policies (Cont’d)

- **Pre-2007**
  11. Credit
  12. Market
  13. Insurance
  14. Interest Rate and Inflation Risks
  15. Foreign Exchange
  16. Investments
  17. Product Design and Pricing
  18. Underwriting and Liability Management
SCHEDULE B
Risk Management Policies (Cont’d)

19. Operational
20. Business Continuity
21. Anti-Money Laundering and Anti-Terrorist Financing
22. Privacy
23. Code of Conduct, Conflicts of Interest and Confidential Information
24. Related Party Transactions
25. Complaints
26. Records Management