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Robert M. Hammond

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Résumé de l'article

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by

Robert M. Hammond

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Editor's note: Mr. Hammond is the Deputy Superintendent, Insurance and Pensions Sector, in the Office of the Superintendent of Financial Institutions Canada.

The following article is from a document prepared by Mr. Hammond for distribution to participants at a spring 1991 insurance conference in Australia. Mr. Hammond's speech to that conference was based on this document.

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Background Information

Supervision of insurance companies in Canada is shared by the federal and provincial governments. The federal government is

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responsible for the solvency supervision of all foreign companies operating in Canada on a branch basis and all federally incorporated companies. These companies account for about 90 percent of the life insurance business in Canada. Provincial governments are responsible for the solvency supervision of all provincially incorporated companies. In addition, provincial governments have exclusive jurisdiction for all companies over matters such as contract wording and its interpretation, licensing of agents and premium rates.

The Office of the Superintendent of Financial Institutions (OSFI) is the federal supervisory agency for insurance companies, banks and other deposit-taking institutions. OSFI was created in 1987 by an amalgamation of the Department of Insurance and the Office of the Inspector General of Banks. The amalgamation was one of a number of measures taken by the federal government to strengthen the supervision of financial institutions in the wake of failure of some Canadian banks and property and casualty insurance companies.

At the present time, there are 56 federally incorporated life insurance companies operating in Canada. There are also 83 non-Canadian life insurance companies operating in Canada on a branch basis. At the end of 1989, the total assets of the Canadian life insurance companies amounted to $135 billion. At the same date, the 83 non-Canadian companies operating in Canada on a branch basis had assets in Canada of $19 billion. Total Canadian premium income in 1989 amounted to $19 billion.

Mutual life insurance companies play a very significant role in Canada. Fourteen life insurance companies account for about 75 percent of the business in Canada by premium volume; nine of these companies are mutual. A number of Canadian life insurance companies have significant operations in the U.S., U.K. and other countries.

In recent years, Canadian life insurance companies have aggressively competed with deposit-taking institutions for term savings business through the issuance of deferred annuities. In 1989, premium income in Canada from annuities accounted for about 50 percent of total premium income.

The main deposit-taking institutions in Canada are banks and trust and loan companies (similar to savings and loan companies in

the U.S.). The six Canadian controlled banks by far dominate the scene with total assets of $500 billion and an extensive system of branch offices across the country. The largest Canadian bank has assets of $126 billion, an amount that is approximately equal to 90 percent of the total assets of all Canadian life insurance companies combined.

Under existing legislation, deposit-taking institutions are not authorized to own insurance companies and vice versa. However, through a loophole in the existing legislation, life insurance companies have found a way to own trust and loan companies. The Bank Act prohibits a bank from acting as an insurance agent. However, banks are testing the limits of this prohibition by making special arrangements such as installing a direct telephone line from their lending office to an insurance company.

The capital base of the Canadian life insurance industry remains strong. However, with narrowing profit margins and rapid growth resulting from a new emphasis on savings business, capital, when expressed as a percentage of liabilities, has been declining.

The life insurance industry has established an industry operated and financed plan to protect policyholders in the event that their insurance company fails. Policyholders are protected up to $60,000 for savings policies and up to $200,000 for death claims. Depositors in deposit-taking institutions are protected up to $60,000 by a government operated scheme.

Supervisory Approach

The approach to supervising federally incorporated companies and the Canadian branch operations of foreign companies is basically the same. The main difference is that Canadian branch operations of foreign companies must maintain assets sufficient to cover their Canadian liabilities, plus any required capital margins, under the control of Canadian supervisory authorities.

The solvency supervisory framework contained in the current legislation is based on the following elements:

(i) control of entry into the business;

(ii) requirements for periodic financial reporting to OSFI;

(iii) periodic on-site examinations by OSFI personnel;

(iv) requirements relating to investment of assets;

(v) requirements relating to valuation of assets;

(vi) requirements relating to valuation of liabilities;

(vii) capital adequacy rules;

(viii) discipline provisions.

Control of Entry

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Incorporation of a new federal insurance company requires at least $10 million of capital, an acceptable business plan and reputable owners and managers. Foreign insurers can choose to operate in Canada either by establishing a branch operation or incorporating a new federal company. Companies wishing to establish a branch operation in Canada must have at least $200 million of assets, adequate capital and a track record of successful operations.

Financial Reporting

All federally incorporated insurance companies must submit an annual financial statement in a prescribed format, accompanied by an opinion from an auditor. All Canadian branch operations of foreign companies must also submit an annual financial statement in a prescribed format but an auditor's opinion is not required. The possibility of requiring an auditor's opinion is being considered.

On-Site Examinations

On-site examinations by OSFI examiners are carried out every two years and more frequently if deemed desirable.

Investment of Assets

The current legislation establishes both qualitative and quantitative requirements for investments. For example, investments in mortgages must be limited to mortgages which do not exceed a 75% loan to value ratio unless they are insured. Investments in the shares or debentures of corporations are generally restricted to corporations which have a certain earnings record. Investments in real estate must not exceed 15 percent of assets.

Valuation of Assets

Life insurance companies may report bonds and mortgages at amortized values unless they are in default. However, a general reserve must be established equal to the larger of 1/3 percent of book values or 10 percent of the market deficiency.

Traded equity shares held by life insurance companies are reported at cost written up or down each year by 15 percent of the market excess or deficiency, as the case may be, and realized capital gains and losses are recognized as adjustments to the amount of the writing or down. A similar approach using a 10% rate is used for real estate. The objective of this approach is to promote equity between generations of participating policyholders by reflecting some portion of unrealized gains and losses in income. Another motivation is to encourage the making of investment decisions for investment reasons rather than income reporting reasons.

Valuation of Liabilities

The legislation stipulates that the actuarial reserves must be determined by a valuation actuary appointed by the Board using assumptions relating to mortality, interest, expenses, withdrawal rates, etc. that are appropriate to the circumstances of the policies and the company and acceptable to the Superintendent. The legislation also stipulates that the actuarial reserves must not be less than those determined using a specified method which places a limit on the deferral of expenses.

The valuation actuary must submit an annual report justifying the assumptions (much emphasis must be placed on matching) and methods used. The valuation actuary must also sign a statement that the requirements of the legislation have been followed and that the actuarial reserves make "good and sufficient provision for all unmatured obligations guaranteed under the terms of the policies in force." The acceptability of the assumptions to the Superintendent and the compliance of the reserves with the legislation are monitored through review of the actuarial reports and on-site examinations.

Capital Adequacy Rules

Although a lot of work has been done by OSFI and the industry on the development of rules, the final rules are not yet in place.

Discipline Provisions

The Superintendent must report to the Minister if the assets of a company are not sufficient, having regard for all the circumstances, to provide adequate protection to its policyholders. In such circumstances, after giving the company the opportunity to be heard, the

Minister may take one or more of the following actions:

(i) place limitations or conditions on the company's operations;

(ii) give the company a specified period to correct the situation;

(iii) direct the Superintendent to take control of the company and exercise the powers of its management and board of directors.

Legislative and Administrative Actions Taken in 1987 to Strengthen the Supervision of Insurance Companies and Other Financial Institutions

Based on the findings of a judicial enquiry into the failure of some small banks and lessons learned from the failure of property and casualty insurance companies, a number of legislative and administrative actions were taken to strengthen the supervision of financial institutions.

Legislative Actions

(a) Creation of OSFI

To ensure a consistent supervisory approach of different types of financial institutions as they increasingly compete for the same type of business, legislation was passed to create OSFI and make it responsible for the supervision of all federally regulated financial institutions. In addition, the Superintendent was given more flexibility in regard to dollar and person resources, with OSFI's

costs of operations being assessed against the supervised financial institutions.

(b) Increased Regulatory Powers

The new legislation gave the Superintendent some significant new regulatory powers. For example, subject to certain safeguards to ensure that principles of natural justice are followed, the Superintendent has the right to issue directions of compliance to stop what he believes to be unsafe or unsound business practices. He has the right to obtain independent market valuations of real estate related assets and insist that they be used for purposes of determining compliance with capital adequacy rules. The Superintendent can also now require financial institutions to file financial statements more frequently than annually. The most significant power gives the Superintendent the authority under certain circumstances to take control of a troubled company and exercise the powers of its management and board of directors.

(c) Capital Adequacy Rules for Life Insurance Companies

The 1987 legislation gave the government the authority to establish capital adequacy rules for life insurance companies. Such rules have long been in place in Canada for banks, trust, loan and property and casualty insurance companies. OSFI has been working closely with the life insurance industry to develop capital adequacy rules and hopes they will be in place by the end of the year. The intended approach is not too different in concept to the capital adequacy rules developed for banks by the Bank for International Settlements. The capital requirement for banks is a function of risk weighting of assets. Because life insurance liabilities also involve risk, the capital requirement for life insurance companies will be a function of risk weighting of both assets and liabilities.

Agreement has been reached on the risk weights. However, discussions continue on the definition of capital and the treatment of subsidiaries. For example, OSFI does not agree with the industry's proposal that 100 percent of unrealized gains on real estate should be treated as capital. Also, in regard to subsidiaries, OSFI believes that capital requirements must be applied in a manner that prevents double leveraging of capital. The industry is proposing a somewhat less stringent approach.

Administrative Actions

(a) Strengthening of Examination Procedures

On-site examinations have been strengthened through a risk analysis approach. Areas of risk are identified based on previous examination findings, results of financial and operational analyses, review of work done by internal and external auditors and discussions with management. The objective is for examiners to zero in on the perceived areas of risk and avoid duplicating work done by internal and external auditors. Retired senior bank credit officers, who were brought in to assist in the examination of banks after the bank failures, now also assist in the review of life insurance company assets, particularly real estate loans and commercial loans.

(b) Increased Communication with Boards of Directors

In response to criticism from directors of failed companies that they were unaware of the regulator's concerns, OSFI is placing great stress on improving contacts and relationships with audit committees of boards of directors and in some cases with the full board. For example, the Chair of the Audit Committee is now routinely provided with a copy of examination findings.

(c) Encouraging a Strong Audit Function

OSFI has tried to encourage a strong audit function through the establishment of an auditors' advisory committee, reliance on auditors' work in circumstances where a review of working paper files indicates it is appropriate to do so, communication of examination findings to auditors and the implementation of a "reliance" letter exercise.

These annual "reliance" letters to the auditors of all federally registered Canadian insurance companies remind the auditors that in carrying out its supervisory responsibilities, OSFI will be relying on their opinion in the financial statements; ask the auditors to make a commitment in writing to advise senior company management and OSFI if, during their examination, they encounter any violation of the legislation or any matter that may have a significant impact on the company's ability to meet its obligations; and request the auditors to commit to give OSFI access to their working papers at the time of

our on-site examinations. In return, OSFI undertakes to provide the auditors with any information in its possession it thinks they should be aware of when carrying out their year-end audit examination.

New Legislation

Since 1983, there has been much discussion and controversy in Canada regarding complete revision of federal legislation relating to financial institutions. In the fall [of 1990], the Government announced its policy on a new legislative framework for federal financial institutions. This announcement was followed by the introduction in Parliament of bills to revise the Trust and Loan Companies Acts and the Bank Act. A bill to revise the insurance legislation is expected to be introduced in March or April. The Government has indicated that all legislation will come into effect the same date, possibly January 1, 1992.

(a) Increased Competition

One of the major objectives of the Government is to establish a new framework for competition in the financial sector by removing many of the remaining restrictions on financial institutions fully competing with one another. As a result, under the new legislation, banks, trust, loan and insurance companies will have the opportunity to offer a similar range of services either directly or through subsidiaries.

For example, trust, loan and insurance companies will be given the full consumer lending powers now available to banks. They will also be given full commercial lending powers provided they have $25 million of capital and satisfy the Superintendent they are capable of managing a commercial loan portfolio.

Banks and insurance companies will not be given in-house trust powers. However, they will be able to own trust companies as subsidiaries. Widely held financial institutions such as mutual life companies will be able to own banks.

Banks, trust and loan companies will be able to own insurance companies as subsidiaries. However, deposit-taking institutions will be prevented from retailing insurance in their deposit-taking branches except for credit life and accident and sickness policies in connection with loans. Also, deposit-taking institutions will be

prevented from passing on to insurance companies or brokers detailed information about their clients such as age, marital status, financial position, etc.

(b) Ownership

Issues such as whether financial institutions should be widely held and whether there should be a ban on commercial enterprises owning financial institutions have been hotly debated in Canada. The Government has now proposed a pragmatic approach by allowing both wide and close forms of ownership. Major domestic banks must continue to be widely held. However, trust, loan and insurance companies may continue to be closely held. However, a closely held financial institution with consolidated capital of $750 million will be required to ensure, within five years, that at least 35 percent of its voting shares are widely held and listed for public trading.

In the future, changes in ownership of more than 10 percent of any class of a federal financial institution's shares will require Ministerial approval. The Government has indicated that potential concentration in financial service markets will be a factor considered in this regard. However, the Government has also indicated that approval for one large financial institution to acquire another large financial institution of another type will not automatically be turned down.

(c) Prudential Safeguards

The new legislation will include more stringent controls over related party transactions. Related party transactions which are permissible will have to be approved by a Conduct Review Committee of the Board. The majority of the members of the Committee must be independent of the institution.

Because of pressure overleveraged owners have put on financial institutions in the past, the new legislation will give the Superintendent the power to require an owner of a federal financial institution to provide such information on its own financial condition as the Superintendent thinks is necessary to be satisfied about the financial health of its financial institution subsidiary.

(d) Access to Capital

To provide greater access to capital, life insurance companies, including mutual life insurance companies, will be able to issue preferred shares and debentures to the extent that they meet the criteria to qualify as capital under the capital adequacy rules.

(e) Investment Rules

Subject to certain concentration limits and limits on real estate and share investments, the existing tests for investments will be replaced by the prudent portfolio approach. Under this approach, the onus will be on companies to develop prudent investment policies and implement appropriate control procedures.

(f) Corporate Governance Rights of Participating Policyholders

Corporate governance rights of participating policyholders will be enhanced to bring them more in line with those of shareholders. However, the rules will recognize that the position of participating policyholders is not exactly the same as that of shareholders and that there are practical constraints on the ability of insurance companies to provide participating policyholders all the information that would normally go to shareholders. For example, a proposal could not be submitted regarding the nomination of directors or regarding a list of special business matters unless the support of the lesser of 500 or one percent of policyholders is obtained.

(g) New Actuarial Reserving Method

In the context of action by the Canadian Institute of Actuaries to develop appropriate technical professional standards, OSFI has agreed to recommend that the new legislation embrace a new actuarial reserving method called the "policy premium method." Under this method which very much resembles a bonus reserve valuation method, reserves are calculated as the present value of future benefits and expenses less the present value of future gross premiums, using assumptions that are both appropriate to the current circumstances of the company and the policies and that are acceptable to the Superintendent. A major effect of this amendment will be to remove the limit on deferral of acquisition expenses.

Among the objectives of adopting the new method are a better measure of income, thereby enabling better monitoring of profitability of different classes and generations of business, and bringing the Canadian life insurance industry within the ambit of generally accepted accounting principles (GAAP). The Canadian Institute of Chartered Accountants has stipulated that the policy premium method must be used for GAAP purposes. Consequently, when the policy premium method is adopted, it is expected that one financial statement will be able to be used for both regulatory and general financial reporting purposes. Negative reserves can arise

under the policy premium method and they will be recognized for income purposes. However, for solvency purposes, a provision will have to be established on the balance sheet equal to the aggregate of any negative reserves produced by the method.

(h) Strengthening the Role of the Actuary

The valuation actuary concept will be replaced by an appointed actuary concept. Appointments will be made and terminated by the Board and the appointed actuary will have access to the Board. In addition to responsibilities for determining and reporting on the actuarial reserves, the appointed actuary will be responsible for reporting to the Board at least once each year on the financial prospects of the company. Also, if the appointed actuary becomes aware of any circumstances that may have a material impact on the ability of the company to meet its obligations, he or she must bring the matter to the attention of management and the board. If in the opinion of the appointed actuary, satisfactory action is not taken to correct the situation within a reasonable period of time, the appointed actuary will have a statutory obligation to make the Superintendent aware of the situation. The appointed actuary will also be responsible for confirming to the board that policyholder dividends proposed to be paid are in accordance with the company's statement of dividend policy and that the allocation of investment income and expenses as between participating and non-participating accounts is reasonable.

Current Debate on the Proposals

Reaction to the proposals has generally been positive subject to two major reservations. The banks are very unhappy that they will

not be able to market insurance through their branches. They claim that if they could market insurance through their branches, there would be considerable savings for the consumer. On the other hand, the life insurance companies argue strongly that the banks should not even be permitted to own insurance companies. The concern of the life insurance companies is that if banks are permitted to own insurance companies, even if they are not permitted to market through their branches, they will soon come to dominate the insurance market because they are so large, so dominant and pervasive in the Canadian economy.

Conclusions

When the new legislation is enacted, Canadian life insurance companies will have new opportunities for expansion and diversification. However, the challenge will be to continue to compete effectively if, as expected, the six very large and powerful Canadian banks exercise their new rights to acquire or establish life insurance companies.

Erratum

Dans la «Chronique juridique» de notre précédent numéro (59e année, nº 1, avril 1991, p. 143), la conclusion exprimée dans le deuxième paragraphe de l'article VIII (Accident survenu au Québec impliquant un non-résident), est erronée. En effet, l'article 8 de la *Loi sur l'assurance-automobile du Québec* est applicable aux victimes d'un accident survenu au Québec, même si elles n'y sont pas résidentes, à condition qu'elles ne soient pas responsables de l'accident. Cette erreur nous a été aimablement signalée par un de nos lecteurs.