MARKET DISCIPLINE
AS PART OF
THE SUPERVISORY MODEL
A CANADIAN PERSPECTIVE

Carl Hiralal  24 November 2005
Topics

• Public Disclosure
• Statutory Disclosure to Regulators
• International (IAIS) Disclosure Standards

There is increasing emphasis on earnings analysis, risk management and governance.
RISK PYRAMID

Systemic
Environmental
Competitive
Regulatory & Legal
Strategic
Reputational
Credit Market Liquidity Insurance Operational

Less Control & Influence

More Control & Influence
4 Main Drivers of Public Disclosure

- Insurance Companies Act
- OSFI Guidelines
- Canadian Institute of Chartered Accountants (CICA)
  - Life: Handbook section 4211; Guideline AcG-8
  - P & C
- Securities Regulator
Public Disclosure

Insurance Companies Act requires the following annual disclosure:

- Balance sheet
- Statement of income
- Statement of change of financial position
- Statement of changes in shareholders’ equity
- Statement of change in each participating account
Public Disclosure (cont’d)

Canadian Institute of Chartered Accountants (CICA) Handbook defines:
• Canadian GAAP rules.
• Minimum disclosure in annual report.

Disclosure appears in:
• Notes to the financial statements;
• Management Discussion and Analysis (MD&A);
• Supplemental Disclosure.
Public Disclosure (cont’d)

Typical insurance related disclosures are:
• Segmented income statements
• Investment income
  ▪ by segment and asset type
• Misc. asset information
  ▪ market value, defaults, provisions, capital gains/losses, etc.
• Technical provisions
  ▪ by plan and segmented
• Assets
  ▪ by asset type, backing technical provisions, by plan and segmented
• Change in technical provisions in the year
  ▪ by source
• Capital.
Public Disclosure (cont’d)

OSFI Public Requirements:
(Guidelines D-1A Life; D-1B P & C)

• Assets by type: carrying value and market value
• Impairment information
• Risk management and control practices
  ▪ Risks associated with policy liabilities
  ▪ Interest rate risk
  ▪ Reinsurance risk
  ▪ Foreign exchange risk
  ▪ Liquidity risk
  ▪ Catastrophe and reinsurance risk (P&C)
  ▪ P&C policy liabilities, split by property, automobile, liability, accident and sickness, and other lines of business
  ▪ Credit risk
• Guideline D-9: Sources of Earnings
Risk Management

Traditional Focus
• Reserves plus Capital
• Stress testing to evaluate the appropriateness of capital

Current Focus
• Risk Management plus Capital
• Greater use of internal modelling to establish capital and reserves
# Liquidity Risk

<table>
<thead>
<tr>
<th>$ Millions at year end</th>
<th>Immediate Scenario</th>
<th>Ongoing Scenario</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted liquid assets</td>
<td>100,000</td>
<td>90,000</td>
</tr>
<tr>
<td>Adjusted technical provisions</td>
<td>25,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Liquidity ratio</td>
<td>400%</td>
<td>300%</td>
</tr>
</tbody>
</table>
The true viability of any company is based on the integrity of its earnings.
## Credit Risk Measures

<table>
<thead>
<tr>
<th>Measure</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net impaired assets</td>
<td>400</td>
</tr>
<tr>
<td>Net impaired assets as a per cent of total invested assets</td>
<td>0.25%</td>
</tr>
<tr>
<td>Allowance for impairment</td>
<td>200</td>
</tr>
<tr>
<td>Provision for future credit losses included in technical provisions</td>
<td>4000</td>
</tr>
<tr>
<td>Performing assets coverage ratio</td>
<td>3%</td>
</tr>
<tr>
<td>Impaired assets coverage ratio</td>
<td>500%</td>
</tr>
</tbody>
</table>
# OSFI Guideline D-9
Source of Earnings Disclosure (Life Insurance Companies)

## Source of Earnings Analysis

<table>
<thead>
<tr>
<th></th>
<th>Protection</th>
<th>Wealth Management</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Expected Profit on In-Force Business</strong></td>
<td>500</td>
<td>400</td>
</tr>
<tr>
<td><strong>Impact of New Business</strong></td>
<td>(100)</td>
<td>(200)</td>
</tr>
<tr>
<td><strong>Experience Gains and Losses</strong></td>
<td>110</td>
<td>90</td>
</tr>
<tr>
<td><strong>Management Actions and Changes in Assumptions</strong></td>
<td>(10)</td>
<td>10</td>
</tr>
<tr>
<td><strong>Other</strong></td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Earnings on Surplus</strong></td>
<td>200</td>
<td>100</td>
</tr>
<tr>
<td><strong>Income Before Income Tax</strong></td>
<td>700</td>
<td>400</td>
</tr>
<tr>
<td><strong>Income Taxes</strong></td>
<td>(200)</td>
<td>(100)</td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td>500</td>
<td>300</td>
</tr>
</tbody>
</table>
Rating Agencies Impact:

• Management more responsive
• M & A pre-clearance
• Liquidity monitoring
• Capital requirements sometimes higher than regulatory requirements
• Holding company analysis
• More timely reporting
OSFI Overview

Risk Management Oversight Responsibility

Board

Senior Management

Independent Oversight

Risk Management

Internal Audit

Compliance

Financial Analysis

Operational Management

Risk Management Processes

Significant Activities

Wealth Management

U. L.

Major Subsidiary
Disclosure to Regulator

- Annual Return
- Appointed Actuary’s Report
  - Memorandum to the actuary
- Actuarial Peer Review
- Dynamic Capital Adequacy Test (DCAT)
DCAT

Types of adverse scenarios used:

1. Mortality
2. Morbidity
3. Persistency
4. Cash flow mismatch
5. Expense
6. Deterioration of asset values
7. New business
8. Reinsurance
9. Off balance sheet
10. Integrated – e.g. 6, 3, and 2
Participating Policies
New Initiatives

- **Department of Finance Regulations**
  - Par account management
  - Dividend and bonus policy
- **OSFI Guidance**
  - Transfers to shareholders
  - Methodologies for allocation of income and expenses
  - Disclosure requirements on the closed par blocks
- **OSFI’s proposal for the 2006 legislative review**
  - Definition of a ‘participating policy’
  - Definition of a ‘participating account’
Capital Requirement Benefits for Participating Policies

- “Qualifying” policies attract reduced risk factors in calculating their respective capital components.

- To be considered as “qualifying”, four criteria must be met. For example, criteria #2 states:

  The company’s participating dividend policy must be publicly disclosed and must make it clear that policyholder dividends will be adjusted to reflect actual experience. The company must publicly disclose the elements of actual experience that are incorporated in the annual dividend adjustment process. Such elements may include investment income, asset defaults, mortality, lapses and expenses.
Insurance Companies Act
Sections 457/458/460/461/462/464

For Participating Business

- The Appointed Actuary usually provides a written opinion in the Appointed Actuary’s Report that these sections are met.

- The allocation methods for investment income and expenses are not often changed. Most of these allocation methods were filed with OSFI in the 1990s.
Implications

- Enhanced public disclosure
  - provide sufficient information to par policyholders to establish the policyholders’ reasonable expectation (PRE)
- Enhanced OSFI disclosure
  - Understand how par accounts are managed
  - Reserve Standards
  - Peer review
Standard Setting Bodies

• Canadian Institute of Chartered Accountants
  ▪ Handbook and Guidelines
• Canadian Institute of Actuaries
  ▪ Standards of Practice
• IAIS
  ▪ Standards and Guidelines
IAIS Standards on Disclosure

• Three standards on disclosure
  ▪ Technical Performance and Risks for Non-life Insurers and Reinsurers
  ▪ Investment Risks and Performance for Insurers and Reinsurers
  ▪ Technical Performance and Risks for Life Insurers (scheduled release in 2006/7)
IAIS Investment Disclosure Requirements

Investment objectives, policies and management including changes:

- Asset-liability matching
- Investment management function
- Separate disclosure if variation between part of insurer
IAIS Investment Disclosure Requirements (cont’d)

Asset class segregation, description and profiling:

- Group assets with similar characteristics and/or risks into asset classes
- Disclose information segregated by asset class
- Disclosure of value – e.g., fair value, historical cost
IAIS Investment Disclosure Requirements (cont’d)

Performance measurement

- Return on assets

Risk exposure

- Currency risk
- Interest rate risk
- Credit risk
- Liquidity risk
- Concentration risk
SALES-RELATED DISCLOSURE

- Disclose compensation to intermediaries
- Brokers disclose any real or perceived conflict of interest
- Disclose ownership and other financing links to intermediaries
- Joint Forum of Financial Market Regulators
  - Code of Consumer Rights and Responsibilities
- Practice Standards for Sale of Products and Services
Corporate Governance (Guideline)

- Compensation practices
- Attendance at Board meetings
- Key initiatives and activities during the year, e.g.
  - Board Effectiveness Survey
  - Criteria for New Members
  - Monitored Corporate Governance Developments
What Does Disclosure Do For Us?

• Earnings now put under greater scrutiny by third parties e.g. rating agencies, SEC, etc.
• Incentives to smooth earnings reduced
• Volatility of earnings reduced by more effective risk management and governance
• Opens the black box
• Increases policyholder confidence
QUESTIONS
AND
DISCUSSION