Subject: Life Insurance Capital Adequacy Test

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Subsection 515(1), 992(1) and 608(1) of the Insurance Companies Act (ICA) requires federally regulated life insurance companies and societies, holding companies and companies operating in Canada on a branch basis, respectively, to maintain adequate capital or to maintain an adequate margin of assets in Canada over liabilities in Canada. Guideline A: Life Insurance Capital Adequacy Test is not made pursuant to subsections 515(2), 992(2) and 608(3) of the ICA. However, the guideline along with Guideline A-4: Regulatory Capital and Internal Capital Targets provide the framework within which the Superintendent assesses whether a life insurer maintains adequate capital or an adequate margin pursuant to subsection 515(1), 992(1) and 608(1). Notwithstanding that a life insurer may meet these standards; the Superintendent may direct the life insurer to increase its capital under subsection 515(3), 992(3) or 608(4).

This guideline establishes standards, using a risk-based approach, for measuring specific life insurer risks and for aggregating the results to calculate the amount of a life insurer’s regulatory required capital to support these risks. The guideline also defines and establishes criteria for determining the amount of qualifying regulatory available capital.

The Life Insurance Capital Adequacy Test is only one component of the required assets that foreign life insurers must maintain in Canada. Foreign life insurers must also vest assets in Canada per the ICA.

Life insurers are required to apply this version of the guideline for reporting periods ending on or after January 1, 2018. Early application of this version of the guideline is not permitted.

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For purposes of this guideline, “life insurers” or “insurers” refer to all federally regulated insurers, including Canadian branches of foreign life companies, fraternal benefit societies, regulated life insurance holding companies and non-operating life insurance companies.
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Chapter 1  Overview and General Requirements

This chapter provides an overview of the Life Insurance Capital Adequacy Test (LICAT) guideline and sets out general requirements. Details on specific components of the LICAT are contained in subsequent chapters.

1.1.  Overview

1.1.1.  LICAT Ratios

The LICAT measures the capital adequacy of an insurer and is one of several indicators used by OSFI to assess an insurer’s financial condition. The ratios should not be used in isolation for ranking and rating insurers.

Capital considerations include elements that contribute to financial strength through periods when an insurer is under stress as well as elements that contribute to policyholder and creditor protection during wind-up.

The Total Ratio focuses on policyholder and creditor protection. The formula used to calculate the Total Ratio is:

\[
\frac{\text{Available Capital + Surplus Allowance}}{\text{Base Solvency Buffer}}
\]

The Core Ratio focuses on financial strength. The formula used to calculate the Core Ratio is:

\[
\frac{\text{Tier 1 Capital}}{\text{Base Solvency Buffer}}
\]

1.1.2.  Available Capital

Available Capital comprises Tier 1 and Tier 2 capital, and involves certain deductions, limits and restrictions. The definition encompasses Available Capital within all subsidiaries that are consolidated for the purpose of calculating the Base Solvency Buffer, which is described below. Available Capital is defined in Chapter 2.

1.1.3.  Surplus Allowance

The amount of the Surplus Allowance included in the numerator of the Total Ratio is calculated based on provisions for adverse deviations (PfADs) that are calculated under the Canadian Asset Liability Method (CALM) or any other method prescribed under the Standards of Practice of the Canadian Institute of Actuaries that is used to calculate insurance contract liabilities reported on
the insurer’s financial statements, except where indicated otherwise.\footnote{2} The specific PfADs included in the Surplus Allowance are:

1) PfADs related to economic assumptions of capital gains arising from one-time changes in the value of non-fixed income assets, provided that:
   
a. The PfADs relate to assets currently reported on the insurer’s balance sheet. That is, the PfADs do not arise from non-fixed income assets that an insurer projects it will acquire after the balance sheet date in the determination of insurance contract liabilities under CALM valuation; and
   
b. The PfADs relate to a change in market value that does not exceed the capital requirement for the non-fixed income assets in sections 5.2 to 5.4.\footnote{3}

If a one-time change capital gain PfAD relates to non-fixed income assets not currently reported on the insurer’s balance sheet, or a change in market value that exceeds the capital requirement for the assets, the insurer should recalculate the PfAD only for the assets currently on the balance sheet, and with the one-time change set equal to the lower of the one-time change in the original PfAD or the capital charge for the assets. This recalculated PfAD may then be included in the Surplus Allowance.

2) All PfADs for insurance risks associated with insurance products

3) PfADs for mortality, morbidity and longevity risk associated with segregated fund products

4) All PfADs related to interest rate assumptions associated with insurance products

For clarity, all other PfADs are excluded from the Surplus Allowance, including the following:

1) PfADs related to economic assumptions for credit spreads on fixed income assets

2) PfADs related to economic assumptions for investment returns on non-fixed income assets that are based on a percentage margin applied to best estimate returns

3) PfADs related to economic assumptions for income on non-fixed income assets

4) Additional PfADs arising as the result of modifying the assumed CALM investment strategy so that the amount of non-fixed income assets supporting liability cash flows at each duration does not exceed certain limits

5) All PfADs associated with segregated fund business other than for mortality, morbidity and longevity risks

6) Any portion of liabilities relating to investment contracts

The PfADs included in the Surplus Allowance are calculated net of registered reinsurance\footnote{4}.

\footnote{2} If approximations are permitted by the CIA Standards of Practice and used to calculate the PfADs those approximations should continue to be used for LICAT purposes.

\footnote{3} The applicable capital requirements for non-fixed income assets backing participating products should be multiplied by 30% before being compared with the one-time change.

\footnote{4} These PfADs should include the PfADs for all business that an insurer has assumed under modified coinsurance arrangements, and should exclude the PfADs for business that the insurer has ceded under registered modified coinsurance arrangements.
1.1.4. **Base Solvency Buffer**

Insurers’ capital requirements are set at a supervisory target level that, based on expert judgment, aims to align with a conditional tail expectation (CTE) of 99% over a one-year time horizon including a terminal provision. The risk capital requirements in this guideline are used to compute capital requirements at the target level.

An insurer's Base Solvency Buffer (reference section 11.3) is equal to aggregate capital requirements net of credits, multiplied by a scalar of [1.15]. Aggregate capital requirements comprise requirements for each of the following five risk components:

1. credit risk (Chapters 3 and 4);
2. market risk (Chapter 5);
3. insurance risk (Chapter 6);
4. segregated funds guarantee risk (Chapter 7); and
5. operational risk (Chapter 8).

Aggregate requirements are reduced by credits for:

1. qualifying in-force participating and adjustable products (Chapter 9);
2. other risk mitigation and risk transfer (Chapter 10); and
3. risk diversification (Chapter 11).

1.1.5. **Foreign life insurers**

The Life Insurance Margin Requirements and Adequacy of Assets in Canada Test (LIMAT) Ratios are designed to measure the capital adequacy of foreign insurers. These ratios and their components (Available Margin, Surplus Allowance and Required Margin) are described in Chapter 12, “Life insurers Operating in Canada on a Branch Basis”.

The LIMAT is only one element in the determination of the required assets that foreign insurers must maintain in Canada. Foreign insurers must also vest assets in Canada pursuant to section 610 of the Insurance Companies Act.

1.2. **Minimum and Supervisory Target ratios**

OSFI has established a Supervisory Target Total Ratio of 100% and a Supervisory Target Core Ratio of [40%]. The Supervisory Targets provide cushions above the minimum requirements and facilitate OSFI’s early intervention process. The Superintendent may, on a case by case basis,

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5 Within this guideline, the term “foreign life insurer” has the same meaning as life insurance “foreign company” in section 2 of the Insurance Companies Act.

6 Industry-wide Supervisory Targets are not applicable to regulated insurance holding companies and non-operating insurance companies.
establish alternative targets in consultation with an insurer based on that insurer’s individual risk profile.

Insurers are required, at minimum, to maintain a Total Ratio of [90-95%] and a Core Ratio of [35-40%]. Insurers should refer to Guideline A4 - Regulatory Capital and Internal Capital Targets for OSFI’s definitions and expectations around the Minimum and Supervisory Target ratios and expectations regarding internal capital targets and capital management policies.

1.3. Accounting basis

Unless indicated otherwise, the starting basis for the amounts used in calculating Available Capital, Available Margin, Surplus Allowance, Base Solvency Buffer, Required Margin and any of their components are those reported, or used to calculate the amounts reported, in the insurer’s financial statements and other financial information contained in the LICAT Life Quarterly Return and LICAT Life Annual Supplement all of which are prepared in accordance with Canadian GAAP, OSFI instructions, accounting guidelines and the following specification:

For LICAT purposes, and as reported in the Life Annual Supplement deconsolidation reconciliation, the insurer’s balance sheet, financial statements and other financial information should be restated so that only subsidiaries (whether held directly or indirectly) that carry on a business that an insurer could carry on directly (e.g., life insurance, real estate and ancillary business subsidiaries) are reported on a consolidated basis; consolidated equity investments in non-life solvency regulated financial corporations that are controlled should be deconsolidated and reported using the equity method of accounting.

1.4. General requirements

1.4.1. Opinion of the Appointed Actuary

The Appointed Actuary is required to sign, on the front page of the LICAT Life Annual Supplement, an opinion as to the accuracy of the return in accordance with subsection 2480 of the CIA Practice-Specific Standards for Insurers (Standard). The text of the required opinion is:

“I have reviewed the calculation of the LICAT Ratios of [Company name] as at [Date]. In my opinion, the calculations of the components of Available Capital, Surplus Allowance and Base Solvency Buffer have been determined in accordance with the Life Insurance Capital Adequacy Test guideline and the components of the

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7 The Canadian Accounting Standards Board has adopted International Financial Reporting Standards (IFRS) as Canadian GAAP for publicly accountable enterprises, including insurers. The primary source of Canadian GAAP is the Chartered Professional Accountants of Canada Handbook.

8 Non-life solvency regulated financial corporations include entities engaged in the business of banking, trust and loan business, property and casualty insurance business, the business of cooperative credit societies or that are primarily engaged in the business of dealing in securities, including portfolio management and investment counselling.
calculation requiring discretion were determined using methodologies and judgment appropriate to the circumstances of the company.”

[Note: For a foreign insurer “LICAT Ratios”, “Available Capital” and “Base Solvency Buffer” are replaced by “LIMAT Ratios”, “Available Margin” and “Required Margin”.]

The memorandum that the Appointed Actuary is required to prepare under the Standard to support this certification must be available to OSFI upon request.

1.4.2. Authorized official signature

Each life insurer is required to have an authorized Officer endorse the following statement on the LICAT Life Quarterly Return and the LICAT Life Annual Supplement:

“I confirm that I have read the Life Insurance Capital Adequacy Test guideline and related instructions issued by the Office of the Superintendent of Financial Institutions and that this form is completed in accordance with them.”

The Officer attesting to the validity of this statement on the LICAT Life Annual Supplement must be different from the insurer’s Appointed Actuary.

1.4.3. Audit requirement

Life insurers are required to retain an Auditor appointed pursuant to section 337 or 633 of the ICA to report on the LICAT Life Quarterly Return/LICAT Life Annual Supplement in accordance with the relevant standards for such assurance engagements, as promulgated by the Canadian Auditing and Assurance Standards Board (AASB).

1.4.4. Best Estimate Assumptions

Best Estimate Assumptions used to calculate the capital requirements for insurance and market risks are the assumptions used in the CALM base scenario and consist of:

1) base scenario assumptions for interest rates as specified by CIA standards of Practice; and

2) best estimates for all other assumptions, where these assumptions are consistent with the base scenario for interest rates.

1.5. Minimum amount of Available Capital

Notwithstanding the minimum and target Total and Core Ratios described in the Guideline, insurers are required to hold a minimum amount of Available Capital /Available Margin, as calculated in this Guideline, of $5 million or such amount as specified by the Minister of Finance.
Chapter 2   Available Capital

This chapter defines the elements included in Available Capital, establishes criteria for assessing instruments and sets capital composition limits.

The primary considerations for assessing the capital elements of an insurer include:

1) availability: the extent to which the capital element is fully paid and available to absorb losses;
2) permanence: the period for which the capital element is available to absorb losses;
3) absence of encumbrances and mandatory servicing costs: the extent to which the capital element is free from mandatory payments or encumbrances; and
4) subordination: the extent to which and in what circumstances the capital element is subordinated to the rights of policyholders and general creditors of the insurer in an insolvency or winding-up.

Total available capital comprises Tier 1 and Tier 2 capital, which are defined in sections 2.1 and 2.2 below.

2.1.   Tier 1

2.1.1.   Gross Tier 1

Gross Tier 1 is equal to the sum of:

1) Common shares that meet the criteria specified in section 2.1.1.1;
2) Tier 1 Capital Instruments other than Common Shares that meet the criteria specified in section 2.1.1.2;
3) Instruments issued by consolidated subsidiaries of the insurer and held by third parties that meet the criteria for classification as Common Shares as specified in section 2.1.1.1 or as Tier 1 Capital Instruments other than Common Shares as specified in section 2.1.1.2 and subject to section 2.1.1.5;
4) Tier 1 capital instruments issued prior to August 7, 2014 that meet the criteria specified in Appendix 2-B and Appendix 2-C9;
5) Contributed Surplus
   a. Share premium resulting from the issuance of capital instruments included in
      Gross Tier 110;
   b. Other contributed surplus, resulting from sources other than profits (e.g. members’ contributions and initial funds for mutual companies and other contributions by shareholders in excess of amounts allocated to share capital for

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9 These instruments may be subject to transitioning.
10 Where repayment of the premium is subject to the Superintendent’s approval.
joint stock companies) excluding any share premium resulting from the issuance of capital instruments included in Tier 2;

6) Adjusted Retained Earnings;

7) Adjusted Accumulated Other Comprehensive Income (AOCI);

8) Participating account (joint stock companies);

9) Non-participating account (mutual companies).

Retained earnings (deficit) is the accumulated balance of income less losses resulting from operations, including undistributed earnings (losses) held in the participating policyholders’ equity account for joint stock companies and in the non-participating account for mutual companies. To determine Adjusted Retained Earnings, the following items are reversed from retained earnings:

1) Changes to own credit risk: Accumulated after-tax gains or losses on fair-valued liabilities that arise from changes to the insurer’s own credit risk;

2) Real estate:
   a. After-tax fair value gains or losses on owner-occupied property upon conversion to IFRS (cost model);
   b. Accumulated after-tax revaluation loss on owner-occupied property (revaluation model);
   c. Accumulated net after-tax fair value gains after transition to IFRS on investment properties that do not back policy liabilities under CALM;
   d. Gains or losses up to the transfer date on owner-occupied property that was previously classified as investment property; and

3) Discretionary participation features reported in a component of equity that is included in Gross Tier 1.

and the following item is added to retained earnings:

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11 The amount of retained earnings reported by fraternal benefit societies for LICAT purposes should be the lower of the insurance fund surplus or the total surplus.

12 The amount reversed should equal the difference between deemed cost on transition to IFRS, and the moving average market value immediately prior to conversion to IFRS.

13 For investment property acquired before transition to IFRS that was previously classified as owner-occupied property, the cost base for calculating the gain is either the property’s deemed cost on transition to IFRS (cost model) or its carrying value immediately after transition to IFRS (revaluation model). For similarly reclassified investment property acquired after transition to IFRS, the cost base for calculating the gain is the property’s original acquisition cost.

14 The amount of the reversal is the difference between the property’s deemed cost on the date of transfer into owner-occupied property, and either the moving average market value immediately prior to conversion to IFRS net of subsequent depreciation if the property was acquired before conversion to IFRS, or the original acquisition cost net of subsequent depreciation if the property was acquired after conversion to IFRS.
4) Accumulated gains reported in Other Comprehensive Income (OCI) up to the transfer date on investment property that was previously classified as owner-occupied property, and that does not back policy liabilities under CALM

To determine Adjusted OCI, the following items are reversed from total reported AOCI:

1) Changes in own credit risk: Accumulated after-tax gains and losses on fair-valued liabilities that arise from changes to an insurer’s own credit risk;

2) Cash flow hedge reserve: Accumulated fair value gains and losses on derivatives held as cash flow hedges relating to the hedging of items that are not fair-valued on the balance sheet (e.g., loans, debt obligations);

3) Owner-occupied property: Accumulated after tax fair value revaluation gains on own-use property (revaluation method);

2.1.1.1 Qualifying Criteria for Common Shares

Capital instruments classified as common shares must meet all of the following criteria:

1) The shares represent the most subordinated claim in liquidation of the insurer.

2) The investor is entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been paid in liquidation (i.e., has an unlimited and variable claim, not a fixed or capped claim).

3) The principal is perpetual and never repaid outside of liquidation (setting aside discretionary repurchases or other means of effectively reducing capital in a discretionary manner that are allowable under relevant law and subject to the prior approval of the Superintendent).

4) The insurer does not, in the sale or marketing of the instrument, create an expectation at issuance that the instrument will be bought back, redeemed or cancelled, nor do the statutory or contractual terms provide any feature that might give rise to such expectation.

5) Distributions are paid out of distributable items (retained earnings included). The level of distributions is not in any way tied or linked to the amount paid in at issuance and is not subject to a contractual cap (except to the extent that an insurer is unable to pay distributions that exceed the level of distributable items or to the extent that distributions on senior ranking capital must be paid first).

6) There are no circumstances under which the distributions are obligatory. Non-payment is therefore not an event of default.

7) Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital.

8) It is in the form of issued capital that takes the first and proportionately greatest share of any losses as they occur. Within the highest quality capital, each instrument absorbs losses on a going-concern basis proportionately and pari passu with all the others.
9) The paid-in amount is recognized as equity capital (i.e., not recognized as a liability) for
determining balance sheet solvency.

10) It is directly issued and paid-in\textsuperscript{15} and the insurer cannot directly or indirectly have funded
the purchase of the instrument. Where the consideration for the shares is given in a form
other than cash, the issuance of the common shares is subject to the prior approval of the
Superintendent.

11) The paid-in amount is neither secured nor covered by a guarantee of the issuer or a
related entity\textsuperscript{16}, and is not subject to any other arrangement that legally or economically
enhances the seniority of the claim.

12) It is only issued with the approval of the owners of the issuing insurer, either given
directly by the owners or, if permitted by applicable law, given by the Board of Directors
or by other persons duly authorised by the owners.

13) It is clearly and separately disclosed as equity on the insurer’s balance sheet, prepared in
accordance with relevant accounting standards.

The criteria for common shares also apply to instruments issued by non-joint stock companies,
such as mutual insurance companies and fraternal benefit societies, taking into account their
specific constitutions and legal structures. The application of the criteria should preserve the
quality of the instruments by requiring that they are deemed fully equivalent to common shares
in terms of their capital quality, including their loss absorption capacity, and do not possess
features which could cause the condition of the insurer to be weakened as a going concern during
periods when the insurer is under stress.

2.1.1.2 \textit{Qualifying Criteria for Tier 1 Capital Instruments Other than Common Shares}\textsuperscript{17}
Instruments, other than common shares, qualify as Tier 1 if all of the following criteria are met:

1) The instrument is issued and paid-in in cash or, subject to the prior approval of the
Superintendent, in property.

2) The instrument is subordinated to policyholders, general creditors, and subordinated debt
holders of the insurer.

3) The instrument is neither secured nor covered by a guarantee made by the issuer or a
related entity, and there is no other arrangement that legally or economically enhances the
seniority of the claim vis-à-vis the insurer’s policyholders and general creditors\textsuperscript{18}.

\textsuperscript{15} Paid-in capital generally refers to capital that has been received with finality by the insurer, is reliably valued,
fully under the insurer’s control and does not directly or indirectly expose the insurer to the credit risk of the
investor.

\textsuperscript{16} A related entity can include a parent company, a sister company, a subsidiary or any other affiliate. A holding
company is a related entity irrespective of whether it forms part of the consolidated insurance group.

\textsuperscript{17} OSFI continues to explore the applicability of non-viability contingent capital (NVCC) to insurers. In the event
insurers become subject to this requirement, the qualifying criteria for Tier 1 capital instruments, other than
common shares, and Tier 2 capital instruments will be revised accordingly and further transitioning arrangements
may be established for non-qualifying instruments.

\textsuperscript{18} Further, where an issuer uses a Special Purpose Vehicle to issue capital to investors and provides support, including
overcollateralization, to the vehicle, such support would constitute enhancement in breach of Criterion # 3 above.
4) The instrument is perpetual, i.e., there is no maturity date, and there are no step-ups\textsuperscript{19} or other incentives to redeem\textsuperscript{20}.

5) The instrument may be callable at the initiative of the issuer only after a minimum of five years:
   a. To exercise a call option an insurer must receive prior approval of the Superintendent; and
   b. An insurer’s actions and the terms of the instrument must not create an expectation that the call will be exercised; and
   c. An insurer must not exercise the call unless:
      i. It replaces the called instrument with capital of the same or better quality, including through an increase in retained earnings, and the replacement of this capital is made on terms that are sustainable for the income capacity of the insurer\textsuperscript{21}; or
      ii. The insurer demonstrates that its capital position is well above the supervisory target capital requirements after the call option is exercised\textsuperscript{22}.

6) Any repayment of principal (e.g., through repurchase or redemption) requires Superintendent approval and insurers must not assume or create market expectations that such approval will be given.

7) Dividend / coupon discretion:
   a. The insurer must have full discretion at all times to cancel distributions/payments\textsuperscript{23}.
   b. Cancellation of discretionary payments must not be an event of default or credit event.
   c. Insurers must have full access to cancelled payments to meet obligations as they fall due.
   d. Cancellation of distributions/payments must not impose restrictions on the insurer except in relation to distributions to common shareholders.

\textsuperscript{19} A step-up is defined as a call option combined with a pre-set increase in the initial credit spread of the instrument at a future date over the initial dividend (or distribution) rate after taking into account any swap spread between the original reference index and the new reference index. Conversion from a fixed rate to a floating rate (or vice versa) in combination with a call option without any increase in credit spread would not constitute a step-up.

\textsuperscript{20} Other incentives to redeem include, a call option combined with a requirement or an investor option to convert the instrument into common shares if the call is not exercised.

\textsuperscript{21} Replacement issuances may be made concurrently when the instrument is called, but not subsequently.

\textsuperscript{22} For the definition of the Supervisory Target, refer to Guideline A-4 Regulatory Capital and Internal Capital Targets.

\textsuperscript{23} A consequence of full discretion at all times to cancel distributions/payments is that “dividend pushers” are prohibited. An instrument with a dividend pusher obliges the issuing insurer to make a dividend/coupon payment on the instrument if it has made a payment on another (typically, more junior) capital instrument or share. This obligation is inconsistent with the requirement for full discretion at all times. Furthermore, the term “cancel distributions/payments” means to forever extinguish these payments. It does not permit features that require the insurer to make distributions/payments in kind at any time.
8) Dividends/coupons must be paid out of distributable items.

9) The instrument cannot have a credit sensitive dividend feature, i.e., a dividend/coupon that is reset periodically based in whole or in part on the insurer’s credit standing.

10) The instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of insolvency law.

11) Other than preferred shares, instruments included in Tier 1 Capital must be classified as equity per relevant accounting standards.

12) Neither the insurer nor a related party over which the insurer exercises control or significant influence can have purchased the instrument, nor can the insurer directly or indirectly have funded the purchase of the instrument.

13) The instrument cannot have any features that hinder recapitalisation, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified timeframe.

14) If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g., it is issued out of a special purpose vehicle (SPV)), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 1 Capital.

Purchase for cancellation of Tier 1 Capital instruments Other than Common Shares is permitted at any time with the prior approval of the Superintendent. For further clarity, a purchase for cancellation does not constitute a call option as described in the above qualifying criteria.

Tax and regulatory event calls are permitted during an instrument’s life subject to the prior approval of the Superintendent and provided the insurer was not in a position to anticipate such an event at the time of issuance. Where an insurer elects to include a regulatory event call in an instrument, the regulatory event call date should be the same date as specified in a letter from the Superintendent to the Company on which the instrument will no longer be recognized in full as eligible Tier 1 capital of the insurer on a consolidated basis.

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24 Insurers may use a broad index as a reference rate in which the issuing insurer is a reference entity; however, the reference rate should not exhibit significant correlation with the insurer’s credit standing. If an insurer plans to issue a capital instrument where the margin is linked to a broad index in which the insurer is a reference entity, the insurer should ensure that the dividend/coupon is not credit-sensitive.

25 An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.

26 For greater certainty, the only assets the SPV may hold are intercompany instruments issued by the insurer or a related entity with terms and conditions that meet or exceed the Tier 1 criteria. Put differently, instruments issued to the SPV have to fully meet or exceed all of the eligibility criteria for Tier 1 Capital as if the SPV itself was an end investor – i.e., the insurer cannot issue a lower quality capital or senior debt instrument to an SPV and have the SPV issue higher quality capital instruments to third-party investors so as to receive recognition as Tier 1 Capital.
Dividend stopper arrangements that stop payments on Common Shares or Tier 1 Capital Instruments Other than Common Shares are permissible provided the stopper does not impede the full discretion the insurer must have at all times to cancel distributions or dividends on the Tier 1 Capital Instrument Other than Common Shares, nor must it act in a way that could hinder the recapitalization of the insurer pursuant to criterion # 13 above. For example, it would not be permitted for a stopper on Tier 1 Capital Instruments Other than Common Shares to:

a. attempt to stop payment on another instrument where the payments on the other instrument were not also fully discretionary;

b. prevent distributions to shareholders for a period that extends beyond the point in time that dividends or distributions on the Tier 1 Capital Instruments Other than Common Shares are resumed; or

c. impede the normal operation of the insurer or any restructuring activity, including acquisitions or disposals.

A dividend stopper may also act to prohibit actions that are equivalent to the payment of a dividend, such as the insurer undertaking discretionary share buybacks.

Where an amendment or variance of a Tier 1 instrument’s terms and conditions affects its recognition as Available Capital, such amendment or variance will only be permitted with the prior approval of the Superintendent.

An insurer is permitted to “re-open” offerings of capital instruments to increase the principal amount of the original issuance subject to the following:

a. the insurer may not re-open an offering if the initial issue date for the offering was on or before August 7, 2014 and the offering does not meet the criteria in section 2.1.1.2; and

b. call options may only be exercised, with the prior approval of the Superintendent, on or after the fifth anniversary of the closing date of the latest re-opened tranche of securities.

Defeasance options may only be exercised on or after the fifth anniversary of the closing date with the prior approval of the Superintendent.

2.1.1.3 Tier 1 Capital Instruments Other than Common Shares issued to a Parent

In addition to the qualifying criteria and minimum requirements specified in this Guideline, Tier 1 Capital Instruments Other than Common Shares issued by an insurer to a parent, either directly or indirectly, can be included in Available Capital subject to the insurer providing prior written notification of the intercompany issuance to OSFI’s Capital Division together with the following:

27 Any modification of, addition to, or renewal of an instrument issued to a related party is subject to the legislative requirement that transactions with a related party be at terms and conditions that are at least as favourable to the insurer as market terms and conditions.
1) a copy of the instrument’s terms and conditions;
2) the intended classification of the instrument for Available Capital purposes;
3) the rationale for not issuing common shares in lieu of the subject capital instrument;
4) confirmation that the rate and terms of the instrument are at least as favourable to the insurer as market terms and conditions;
5) confirmation that the failure to make dividend or interest payments, as applicable, on the subject instrument would neither result in the parent, now or in the future, being unable to meet its own debt servicing obligations nor would it trigger cross-default clauses or credit events under the terms of any agreements or contracts of either the insurer or the parent.

2.1.1.4  Tier 1 Capital Instruments Other than Common Shares issued out of Branches and Subsidiaries outside Canada

In addition to any other requirements prescribed in this Guideline, where an insurer wishes to include, in its consolidated Available Capital, Tier 1 Capital Instruments Other than Common Shares issued out of a branch or subsidiary of the insurer outside Canada, it must provide OSFI’s Capital Division with the following documentation:
1) a copy of the instrument’s terms and conditions;
2) certification from a senior executive of the insurer, together with the insurer’s supporting analysis, that confirms that the instrument meets the qualifying criteria for the tier of Available Capital in which the insurer intends to include the instrument on a consolidated basis; and
3) an undertaking whereby both the insurer and the subsidiary confirm that the instrument will not be redeemed, purchased for cancellation, or amended without the prior approval of the Superintendent. Such undertaking will not be required where the prior approval of the Superintendent is incorporated into the terms and conditions of the instrument.

2.1.1.5  Tier 1 Capital Instruments issued by Consolidated Subsidiaries to Third Parties

Common Shares and Tier 1 Capital Instruments other than Common Shares (including those that generate a non-controlling interest) issued by a fully consolidated subsidiary of the insurer to a third party investor may receive limited recognition in the consolidated Tier 1 Capital of the parent insurer.

Tier 1-type capital instruments issued by a subsidiary to third party investors for the funding of the parent are included in Tier 1 capital if they meet all of the following criteria:
1) The terms and conditions of the issue, as well as the intercompany transfer, ensures that investors are placed in the same position as if the instrument were issued by the parent insurer;
2) The subsidiary uses the proceeds of the issue to purchase a similar instrument from the parent; and
3) The instrument held by third party investors is not effectively secured by other assets, such as cash, held by the subsidiary.
Tier 1-type capital instruments issued by a subsidiary to third party investors that do not meet the above criteria may be included in the consolidated Available Capital of the parent insurer (i.e. the eligible amount), subject to materiality and determined by applying the following limit formula:

$$\text{Third Party Share Percentage} \times (\text{Marginal capital requirement for the subsidiary} + \text{Total capital deductions arising from assets in the subsidiary})$$

where:

1. Third Party Share Percentage is equal to the total amount of all Tier 1 and Tier 2 capital instruments issued by a subsidiary and held by third party investors, divided by the total of all Tier 1 and Tier 2 capital instruments issued by the subsidiary.
2. Marginal capital requirement for the subsidiary is equal to:
   a) the difference between the Base Solvency Buffer (reference section 11.3) of the insurer, and the Base Solvency Buffer of the insurer excluding the subsidiary, with both requirements calculated net of all reinsurance, if the total amount of Tier 1 and Tier 2 capital instruments issued by a subsidiary and held by third parties is equal to or greater than 1% of Gross Tier 1.
   b) the capital requirement of the subsidiary calculated based on local regulatory requirements at the equivalent local level of the LICAT supervisory target,\(^{28}\) if the total amount of Tier 1 and Tier 2 capital instruments issued by a subsidiary and held by third parties is less than 1% of Gross Tier 1.

Tier 1 capital instruments above that are included in the consolidated Available Capital of the parent insurer that meet the relevant criteria in Appendix 2-B of this Guideline but do not meet the relevant criteria specified in sections 2.1.1.2 to 2.1.1.5 may be subject to transitional measures in due course.

### 2.1.2. Deductions from Gross Tier 1 Capital

The items below are deducted from Gross Tier 1 to determine Net Tier 1. Credit risk factors are not applied to items that are deducted from Gross Tier 1.

#### 2.1.2.1. Goodwill and other intangible assets

Goodwill related to consolidated subsidiaries\(^ {29}\) and goodwill included in the carrying amount of equity accounted substantial investments\(^ {30}\) is deducted from Gross Tier 1. The amount deducted

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\(^{28}\) Insurers should contact OSFI to determine the equivalence for a subsidiary’s local jurisdiction if that jurisdiction has not established a CTE99 or Var99.5 supervisory target level of confidence measure.

\(^{29}\) The amounts of goodwill and other intangible assets relating to controlled investments in non-life financial corporations that are deconsolidated per section 1.3 and then deducted from Gross Tier 1 are included in the equity-accounted amount of the investment on the balance sheet, and are already included in the deduction for non-life financial corporations. These amounts are therefore excluded from this deduction.
is net of any associated deferred tax liabilities (DTLs) that would be extinguished if the goodwill were to become impaired or otherwise derecognized.

Additionally, all other intangible assets (including software intangibles) are deducted from Gross Tier 1, including intangible assets related to consolidated subsidiaries and intangible assets included in the carrying amount of equity-accounted substantial investments. The amount deducted is net of any associated DTLs that would be extinguished if the intangible assets were to become impaired or otherwise derecognized.

2.1.2.2. Investments in own Tier 1 Capital

An insurer’s investments in its own common shares (e.g., treasury stock) and its own Tier 1 Capital Instruments other than Common Shares, whether held directly or indirectly, are deducted from Gross Tier 1 unless they are already derecognized under IFRS.

In addition, any Tier 1 capital instrument that the insurer could be contractually obliged to purchase is deducted from Gross Tier 1.

2.1.2.3. Reciprocal Cross Holdings of Tier 1 Capital of banking, insurance and financial entities

Reciprocal cross holdings in Tier 1 capital instruments (e.g., Insurer A holds investments in Tier 1 capital instruments of Insurer B, and in return, Insurer B holds investments in Tier 1 capital instruments of Insurer A), whether arranged directly or indirectly, that are designed to artificially inflate the capital position of insurers are deducted from Gross Tier 1.

2.1.2.4. Net Defined Benefit Pension Plan Assets

Each net defined benefit pension plan asset (DB pension plan) (inclusive of the impact of any asset ceiling limitation) is deducted from Gross Tier 1, net of any associated DTLs that would be extinguished if the asset should become impaired or derecognized.

Insurers may reduce this deduction by the amount of available refunds of surplus assets in the plan to which the insurer has unrestricted and unfettered access, provided they obtain prior written OSFI supervisory approval.

30 As defined in section 10 of the Insurance Companies Act.
31 DB pension plans of controlled investments in non-life financial corporations that are deconsolidated per section 1.3 and then deducted from Gross Tier 1 are included in the equity accounted amount of the investment on the balance sheet and are already deducted along with the non-life financial corporation. These DB pension plans are therefore excluded from this deduction.
32 To obtain supervisory approval, an insurer must demonstrate to the Superintendent’s satisfaction that it has clear entitlement to the surplus and that it has unrestricted and unfettered access to the surplus pension assets. Evidence required may include, among other things, an acceptable independent legal opinion and the prior authorization from the pension plan members and the pension regulator.
2.1.2.5. **Deferred tax assets**

The regulatory adjustments described in this section are based on non-discounted deferred tax amounts as reported on the insurer’s balance sheet, and on the deferred tax position of each legal entity that is consolidated for LICAT purposes.

Insurers should calculate, for each legal entity in a net Deferred Tax Asset (DTA) position, the difference between:

i) the amount of DTAs arising from temporary differences, and  
ii) eligible deferred tax liabilities (DTL) as defined below

Recognition of the sum of these differences in Available Capital is limited to 10% of Net Tier 1 capital. Any excess is deducted from Net Tier 1 capital. All other DTAs (e.g. DTAs relating to tax credits, and carry forwards of operating losses), net of eligible DTLs, are deducted from Gross Tier 1 capital.

Eligible DTLs are limited to those permitted to offset DTAs for balance sheet reporting purposes at the legal entity level, excluding DTLs that have been netted against the deductions for goodwill, intangible assets and defined benefit pension plan assets. Eligible DTLs should be allocated on a pro rata basis between DTAs arising from temporary differences, and other DTAs.

Any DTAs recognized in Net Tier 1 capital are subject to a 25% credit risk factor (reference section 3.1.8).

No regulatory adjustments are required under this section for legal entities in a net DTL position.

The following is an example for a single legal entity reporting LICAT results:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>DTA: temporary differences</td>
<td>300</td>
</tr>
<tr>
<td>DTA: loss carry forward</td>
<td>100</td>
</tr>
<tr>
<td>DTL: associated with goodwill</td>
<td>50</td>
</tr>
<tr>
<td>DTL: other</td>
<td>100</td>
</tr>
<tr>
<td>Net DTA position</td>
<td>250</td>
</tr>
<tr>
<td>Net Tier 1 capital</td>
<td>2 000</td>
</tr>
<tr>
<td>DTL allocated to temporary difference</td>
<td>(\frac{300}{400} \times 100 = 75) (excludes DTL associated with goodwill)</td>
</tr>
<tr>
<td>DTL allocated to loss carry forward DTA</td>
<td>(\frac{100}{400} \times 100 = 25) (excludes DTL associated with goodwill)</td>
</tr>
</tbody>
</table>

33 DTA amounts associated with CALM liabilities are those that are reported on the balance sheet (i.e. non-discounted DTAs).
<table>
<thead>
<tr>
<th>Regulatory adjustments for DTA to:</th>
<th>Gross Tier 1: $100 - 25 = 75$ (for loss carry forward DTA and reflected in Net Tier 1 capital of 2 000)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Net Tier 1: $(300 - 75) - 10% \times 2 000 = 25$ (for temporary difference DTA)</td>
</tr>
<tr>
<td>Capital requirement for DTA</td>
<td>$200 \times 25% = 50$</td>
</tr>
</tbody>
</table>

2.1.2.6. **Encumbered Assets**

Encumbered assets in excess of the allowable amount are deducted from Gross Tier 1\(^{34}\). The allowable amount is equal to the sum of:

1) the value of on-balance sheet liabilities secured by the encumbered assets; and
2) the marginal capital requirement for the encumbered assets and the liabilities they secure.

The deduction is reduced by the following amount:

3) 50% of the calculated deduction amount relating to real property pledged to secure mortgage borrowing activities.

For the purpose of calculating the allowable amount, the marginal capital requirement is equal to the difference between the Base Solvency Buffer (reference section 11.3) of the insurer, and the Base Solvency Buffer of the insurer excluding the encumbered assets and the liabilities they secure\(^{35}\), where both requirements are calculated net of all reinsurance.

The balance sheet amount of liabilities secured by encumbered assets not in excess of the allowable amount and not deducted from Available Capital is subject to section 3.5 of this guideline.

The following encumbered assets are exempt and should not be included in the calculation of the encumbered assets deduction above:

1) assets relating to off-balance sheet securities financing transactions (i.e., securities lending and borrowing, repos and reverse repos) that do not give rise to any liability on the balance sheet; and
2) assets pledged to secure centrally cleared and non-centrally cleared derivatives liabilities.

Encumbered assets relating to off-balance sheet securities financing transactions that are exempt under 1) above are subject to section 3.5 of this guideline.

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\(^{34}\) Encumbered assets are still subject to the requirements for credit and market risk in chapters 3 and 5, as these requirements offset the deduction from Gross Tier 1.

\(^{35}\) Encumbered assets of controlled investments in non-life financial corporations that are deconsolidated per section 1.3 and then deducted from Gross Tier 1 are included in the equity-accounted amount of the investment on the balance sheet and are already deducted along with the non-life financial corporations. These encumbered asset amounts are therefore excluded from this deduction.
2.1.2.7. **Investments in Tier 1 Capital of controlled non-life financial corporations**

Investments in financial instruments of controlled (as defined in the *Insurance Companies Act*) non-life solvency regulated financial corporations\(^{36}\) are deducted from the tier of capital for which the instrument would qualify if it were issued by the insurer itself. Where an instrument issued by a controlled non-life financial corporation meets the criteria outlined in section 2.1.1.1 or 2.1.1.2, it is deducted from Gross Tier 1. If the instrument in which the insurer has invested does not meet the qualifying criteria for either Tier 1 or Tier 2, the instrument is deducted from Gross Tier 1.

The amount deducted is the carrying amount of the deconsolidated subsidiary reported as an investment using the equity method of accounting, as specified in section 1.3. The deduction of this amount therefore includes the goodwill, all other intangible assets, net DB pension plan assets, DTAs, encumbered assets, AOCI and all other net assets of the deconsolidated subsidiary, as the de-consolidation should reverse these amounts prior to their respective Gross Tier 1 deductions.

Where the insurer provides a facility such as a letter of credit or guarantee that is treated as capital\(^{37}\) by the controlled non-life financial corporation, the full amount of the facility is deducted from Gross Tier 1\(^{38}\).

A credit risk factor will not be applied to equity investments, letters of credit and guarantees or other facilities provided to controlled non-life financial corporations where these have been deducted from Available Capital. Where letters of credit are provided to controlled non-life financial corporations and are not deducted from Available Capital, they are treated like any other direct credit substitute in accordance with this guideline (refer to Chapters 3 and 4).

2.1.2.8. **Cash surrender value deficiencies calculated on an aggregate grouped basis**

Cash surrender value (CSV) deficiencies are calculated net of all reinsurance on an aggregate basis within groupings by product type. The deduction from Gross Tier 1 is the sum of the aggregate deficiencies (if positive) for each grouping of policies. All of the policies in an aggregated group must be within the same line of business (as defined in the LIFE return), must be contractually similar, and must eventually offer a meaningful cash surrender value. Policies that never pay CSVs may not be used to offset deficiencies in policies that do. The CSVs used in the calculation of deficiencies should be net of all surrender charges, market value adjustments and other deductions that an insurer could reasonably expect to apply in the event the policy were to be surrendered. The policy liabilities used in calculating CSV deficiencies include future

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\(^{36}\) Non-life solvency regulated financial corporations include those entities that are engaged in the business of banking, trust and loan business, property and casualty insurance business, the business of co-operative credit societies or that are primarily engaged in the business of dealing in securities, including portfolio management and investment counselling. Where the company cannot carry on the business directly or where application of the LICAT factors does not measure the risks adequately in the controlled non-life solvency regulated financial corporation, the deduction method is used.

\(^{37}\) That is, the facility is available for drawdown in the event of impairment of the non-life corporation's capital and is subordinated to the non-life financial corporation's customer obligations.

\(^{38}\) Although the facility has not been called upon, if it were drawn, the resources would not be available to cover capital requirements in the insurer.
income tax cash flows under valuation assumptions as required by the Canadian Institute of Actuaries Standards prior to any accounting adjustment for balance sheet presentation.

### 2.1.2.9. Negative reserves calculated on a policy-by-policy basis

Insurers are required to calculate negative reserves on a policy-by-policy basis net of all reinsurance. Policy-by-policy negative reserves are adjusted by a percentage factor and then reduced for amounts that may be recovered on surrender. The deduction from Gross Tier 1 or the amount included in Assets Required is the total amount, calculated policy-by-policy, of adjusted negative reserves net of a reduction of [45%] of amounts recoverable on surrender, with the net amount for each policy subject to a minimum of zero. Policy liabilities used in calculating policy-by-policy negative reserves include future income tax cash flows under valuation assumptions as required under CALM prior to any accounting adjustment for balance sheet presentation of deferred taxes.

Policy-by-policy negative reserves should be calculated for all products and lines of business, including group and accident and sickness business. The calculation should include:

1) the negative reserve for each certificate under group policies for which premiums or reserves are based on individual insured characteristics, such as group association or creditor insurance;

2) the excess, if positive, of the deferred acquisition costs for any policy over its termination or surrender charges; and

3) negative group refund provisions where recovery is not completely assured, calculated policy by policy.

The negative reserve for a policy may be adjusted by multiplying it by a factor of 70%, if it arises from either of the following:

a. active life reserves for Canadian individual health business, or

b. Canadian individual life business.

No adjustment is allowed for negative reserves relating to any other type of business. The adjusted negative reserve for a policy may then be further reduced to a minimum of zero by the sum of the following amounts recoverable on surrender:

1) the net commission chargeback for the policy;

2) the policy’s marginal insurance risk requirement; and

3) a specified amount if the policy is part of a yearly renewable term (YRT) reinsurance treaty.

However, the maximum total amount by which the deduction from Gross Tier 1 of adjusted policy-by-policy negative reserves for a Canadian insurer may be reduced for amounts recoverable on surrender is limited to 25% of:

1) Gross Tier 1; less
2) All deductions from Gross Tier 1 used to determine Net Tier 1 as specified in section 2.1.2, excluding negative reserves; less

3) Total adjusted policy-by-policy negative reserves calculated without any reduction for amounts recoverable on surrender.

For a foreign insurer, the maximum amount by which adjusted policy-by-policy negative reserves included in Assets Required may be reduced for amounts recoverable on surrender is limited to 25% of:

1) admitted assets vested in trust; plus
2) investment income due and accrued on admitted vested assets; less
3) the portion of Deductions/Adjustments (refer to section 12.6) that is subtracted directly in the determination of Assets Available (refer to section 12.3); less
4) Assets Required excluding negative reserves; less
5) total adjusted policy-by-policy negative reserves calculated without any reduction for amounts recoverable on surrender.

In order to use any amount recoverable on surrender to offset a policy’s adjusted negative reserve, the amount must be calculated for that policy alone. The following provides additional detail on the calculation of each amount.

2.1.2.9.1. Commission chargebacks

The net commission chargeback for a policy is defined as:

\[ 0.85 \times S \times C \]

where \( S \) is the factor used to adjust the policy negative reserve (either 70% or 100%), and \( C \) is the policy’s commission chargeback that the insurer could reasonably expect to recover in the event the policy were to lapse. The chargeback amount used should be based on the policy’s chargeback schedule, and should be calculated net of all ceded reinsurance allowances and commissions.

2.1.2.9.2. Marginal insurance risk requirements

The marginal insurance risk requirement for a policy is equal to the sum of the marginal policy requirements for each of the seven insurance risks as specified below. In determining the offset to a policy’s adjusted negative reserve, the policy’s marginal insurance risk requirement should be reduced by the amount of any credits that an insurer has taken on account of deposits placed by the policyholder (reference section 6.7). Each marginal policy requirement should be calculated net of all reinsurance. All marginal policy requirements for participating products should be multiplied by 30%, and all marginal policy requirements for adjustable products should be multiplied by 50%. The adjusted negative reserve for a policy may not be offset by any marginal insurance risk component if an insurer has taken a reduction in required capital on account of a reinsurance claims fluctuation reserve covering the policy.
For a policy within a specific geography, the marginal policy requirement for mortality risk is equal to:

\[ 0.425 \times \frac{r_{c_{vol}}^2 + 2 \times r_{c_{cat}} \times R_{c_{cat}} - r_{c_{cat}}^2}{\sqrt{R_{c_{vol}}^2 + R_{c_{cat}}^2}} + 0.925 \times (r_{c_{l}} + r_{c_{t}}) \]

where:

- \( r_{c_{vol}} \) is the mortality volatility risk component for the policy
- \( r_{c_{cat}} \) is the mortality catastrophe risk component for the policy
- \( R_{c_{vol}} \) is the mortality volatility risk component for all business in the policy’s geography
- \( R_{c_{cat}} \) is the mortality catastrophe risk component for all business in the policy’s geography
- \( r_{c_{l}} \) is the policy’s level component for mortality risk
- \( r_{c_{t}} \) is the policy’s trend component for mortality risk

The marginal policy requirement for all other insurance risks is equal to:

\[ 0.425 \times \frac{2 \times r_{c_{vol}} \times R_{c_{vol}} + 2 \times r_{c_{cat}} \times R_{c_{cat}} - r_{c_{vol}}^2 - r_{c_{cat}}^2}{\sqrt{R_{c_{vol}}^2 + R_{c_{cat}}^2}} + 0.925 \times (r_{c_{l}} + r_{c_{t}}) \]

where:

- \( r_{c_{vol}} \) is the volatility component of the particular insurance risk for the policy (multiplied by the statistical fluctuation factor of the policy’s geography if applicable)
- \( r_{c_{cat}} \) is the catastrophe component of the particular insurance risk for the policy
- \( R_{c_{vol}} \) is the volatility component of the particular insurance risk for all business in the policy’s geography
- \( R_{c_{cat}} \) is the catastrophe component of the particular insurance risk for all business in the geography
- \( r_{c_{l}} \) is the policy’s level component for the particular insurance risk, multiplied by the statistical fluctuation factor of the policy’s geography if applicable
- \( r_{c_{t}} \) is the policy’s trend component for the particular insurance risk

2.1.2.9.3. Policies assumed under YRT treaties

If a policy has been assumed under an eligible YRT reinsurance treaty (defined as a treaty that has fully guaranteed premiums and does not provide for profit sharing), the adjustment that may be used to reduce the policy’s negative reserve is:
\[ NR \times \min \left( \frac{A - B}{A}, 0.25 \right) \]

where:

- \( NR \) is the policy’s adjusted negative reserve;
- \( A \) is the total of adjusted negative reserves for all policies within the insurer’s eligible YRT reinsurance treaties calculated policy-by-policy; and
- \( B \) is the total of adjusted negative reserves for all of the insurer’s eligible YRT reinsurance treaties, calculated treaty by treaty.

2.1.2.10. Other items deducted from Gross Tier 1

Insurers are also required to deduct the following from Gross Tier 1:

1) aggregate positive policy liabilities ceded under arrangements defined to be unregistered reinsurance, less the amount of collateral and letters of credit applied toward these liabilities (refer to Chapter 10);
2) purchased options for which the insurer elects deduction under section 6.2.1.3.

2.1.3 Net Tier 1 and Tier 1

Net Tier 1 is defined as Gross Tier 1 less deductions from Gross Tier 1.

An insurer that does not have sufficient Gross Tier 2 Capital from which to make required deductions from Gross Tier 2 Capital must deduct the shortfall from Net Tier 1 Capital. Thus Tier 1 capital is defined as Net Tier 1 Capital less deductions from Gross Tier 2 Capital that are in excess of Gross Tier 2 Capital (refer to section 2.2).

2.2. Tier 2

2.2.1 Gross Tier 2

Gross Tier 2 is equal to the sum of the following:

1) Capital instruments that meet the qualifying criteria specified in section 2.2.1.1;
2) Instruments issued by consolidated subsidiaries of the insurer and held by third parties that meet the criteria for classification as Tier 2 as specified in section 2.2.1.1 and subject to section 2.2.1.4;
3) Tier 2 capital instruments issued prior to August 7, 2014 that meet the criteria specified in Appendix 2-B\(^{39}\); and
4) Tier 2 capital elements other than capital instruments.

\(^{39}\) These instruments may be subject to transitioning.
2.2.1.1 **Qualifying Criteria for Tier 2 Capital Instruments**

Instruments qualify as Tier 2 if all of the following criteria are met:

1) The instrument is issued and paid-in in cash or, with the prior approval of the Superintendent, in property.

2) The instrument is subordinated to policyholders and general creditors of the insurer.

3) The instrument is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis the insurer’s policyholders and/or general creditors.

4) Maturity:
   a. At issuance, the minimum original maturity is at least five years.
   b. Recognition in Available Capital in the remaining five years before maturity must be amortized on a straight line basis.
   c. There are no step-ups or other incentives to redeem.

5) The instrument may be callable at the initiative of the issuer only after a minimum of five years:
   a. To exercise a call option an insurer must receive the prior approval of the Superintendent; and
   b. An insurer must not do anything that creates an expectation that the call will be exercised; and
   c. An insurer must not exercise the call unless:
      i. It replaces the called instrument with capital of the same or better quality, including through an increase in retained earnings, and the replacement of this capital is done at conditions which are sustainable for the income capacity of the insurer; or
      ii. The insurer demonstrates that its capital position is well above the supervisory target capital requirements after the call option is exercised.

OSFI continues to explore the applicability of non-viability contingent capital (NVCC) to insurers. In the event insurers become subject to this requirement, the qualifying criteria for Tier 1 capital instruments, other than common shares, and Tier 2 capital instruments will be revised accordingly and further transitioning arrangements may be established for non-qualifying instruments.

A step-up is defined as a call option combined with a pre-set increase in the initial credit spread of the instrument at a future date over the initial dividend (or distribution) rate after taking into account any swap spread between the original reference index and the new reference index. Conversion from a fixed rate to a floating rate (or vice-versa) in combination with a call option without any increase in credit spread would not constitute a step-up.

An option to call the instrument after five years but prior to the start of the amortization period will not be viewed as an incentive to redeem as long as the insurer does not do anything that creates an expectation that the call will be exercised at this point.

Replacement issues can be concurrent with but not after the instrument is called.

For a definition of the Supervisory Target, refer to Guideline A-4 *Regulatory Capital and Internal Capital Targets*.
6) The investor must have no rights to accelerate the repayment of future scheduled principal or interest payments, except in bankruptcy, insolvency, wind-up or liquidation.

7) The instrument cannot have a credit sensitive dividend feature; that is, a dividend or coupon that is reset periodically based in whole or in part on the insurer’s credit standing.

8) Neither the insurer nor a related party over which the insurer exercises control or significant influence can have purchased the instrument, nor can the insurer directly or indirectly have funded the purchase of the instrument.

9) If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g., it is issued out of an SPV), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 2.

Tier 2 capital instruments must not contain restrictive covenants or default clauses that would allow the holder to trigger acceleration of repayment in circumstances other than the liquidation, insolvency, bankruptcy or winding-up of the issuer.

Purchase for cancellation of Tier 2 capital instruments is permitted at any time with the prior approval of the Superintendent. For further clarity, a purchase for cancellation does not constitute a call option as described in the above Tier 2 qualifying criteria.

Tax and regulatory event calls are permitted during an instrument’s life subject to the prior approval of the Superintendent and provided the insurer was not in a position to anticipate such an event at the time of issuance. Where an insurer elects to include a regulatory event call in an instrument, the regulatory event call date should be the same date as specified in a letter from the Superintendent to the Company on which the instrument will no longer be recognized in full as Available Capital of the insurer on a consolidated basis.

Where an amendment or variance of a Tier 2 instrument’s terms and conditions affects its recognition as Available Capital, such amendment or variance will only be permitted with the prior approval of the Superintendent.

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45 Insurers may use a broad index in which the issuing insurer is a reference entity as a reference rate; however, the reference rate should not exhibit significant correlation with the insurer’s credit standing. If an insurer plans to issue capital instruments where the margin is linked to a broad index in which the insurer is a reference entity, the insurer should ensure that the dividend/coupon is not credit-sensitive.

46 An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.

47 For greater certainty, the only assets the SPV may hold are intercompany instruments issued by the insurer or a related entity with terms and conditions that meet or exceed the Tier 2 qualifying criteria. Put differently, instruments issued to the SPV have to fully meet or exceed all of the eligibility criteria for Tier 2 capital as if the SPV itself was an end investor – i.e., the insurer cannot issue a senior debt instrument to an SPV and have the SPV issue qualifying capital instruments to third-party investors so as to receive recognition as Tier 2 capital.

48 Any modification of, addition to, or renewal or extension of an instrument issued to a related party is subject to the legislative requirement that transactions with a related party be at terms and conditions that are at least as
An insurer is permitted to “re-open” offerings of capital instruments to increase the principal amount of the original issuance subject to the following:

1) the insurer may not re-open an offering if the initial issue date for the offering was on or before August 7, 2014 and the offering does not meet the criteria in section 2.2.1.1; and

2) call options may only be exercised, with the prior approval of the Superintendent, on or after the fifth anniversary of the closing date of the latest re-opened tranche of securities.

Defeasance options may only be exercised on or after the fifth anniversary of the closing date with the prior approval of the Superintendent.

Debt obligations, as defined in the Insurance Companies Act, made by life insurers that do not qualify as Available Capital by virtue of their characteristics are subject to an interest rate risk charge (refer to section 5.1).

2.2.1.2 Tier 2 Capital Instruments Issued to a Parent

In addition to the qualifying criteria and minimum requirements specified in this Guideline, Tier 2 capital instruments issued by an insurer to a parent either directly or indirectly, can be included in Tier 2 subject to the insurer providing prior written notification of the intercompany issuance to OSFI's Capital Division together with the following:

1) a copy of the instrument’s term and conditions;

2) the intended classification of the instrument for Available Capital purposes;

3) the rationale for not issuing common shares in lieu of the subject capital instrument;

4) confirmation that the rate and terms of the instrument are at least as favourable to the insurer as market terms and conditions;

5) confirmation that the failure to make dividend or interest payments, as applicable, on the subject instrument would neither result in the parent, now or in the future, being unable to meet its own debt servicing obligations nor would it trigger cross-default clauses or credit events under the terms of any agreements or contracts of either the insurer or the parent.

2.2.1.3. Tier 2 Capital Instruments Issued out of Branches and Subsidiaries outside Canada

Debt instruments issued out of an insurer’s branches or subsidiaries outside Canada must be governed by Canadian law. The Superintendent may, however, waive this requirement where the insurer can demonstrate that an equivalent degree of subordination can be achieved as under Canadian law. Instruments issued prior to year-end 1994 are not subject to this requirement.

In addition to any other requirements prescribed in this Guideline, where an insurer wishes to include, in its consolidated available capital, a capital instrument issued out of a branch or a
subsidiary of the insurer outside Canada, it must provide OSFI’s Capital Division with the following documentation:

1) a copy of the instrument’s term and conditions;

2) certification from a senior executive of the insurer, together with the insurer’s supporting analysis, that confirms that the instrument meets the qualifying criteria for the tier of Available Capital in which the insurer intends to include the instrument on a consolidated basis; and

3) an undertaking whereby both the insurer and the subsidiary confirm that the instrument will not be redeemed, purchased for cancellation, or amended without the prior approval of the Superintendent. Such undertaking will not be required where the prior approval of the Superintendent is incorporated into the terms and conditions of the instrument.

2.2.1.4. Tier 2 Capital Instruments issued by Consolidated Subsidiaries to Third Parties

Tier 2 Capital Instruments (including those that generate a non-controlling interest) issued by a fully consolidated subsidiary of the insurer to a third party investor may receive limited recognition in the consolidated Tier 2 Capital of the parent insurer.

Tier 2-type capital instruments issued by a subsidiary to third party investors for the funding of the parent are included in Tier 2 capital if they meet the following criteria:

1) The terms and conditions of the issue, as well as the intercompany transfer, ensures that investors are placed in the same position as if the instrument were issued by the parent insurer;

2) The subsidiary uses the proceeds of the issue to purchase a similar instrument from the parent; and

3) The instrument held by third party investors is not effectively secured by other assets, such as cash, held by the subsidiary.

The amount of Tier 2-type capital instruments issued by a subsidiary to third party investors that do not meet the above criteria that may be included in the consolidated Available Capital of the parent insurer (i.e. the eligible amount), subject to materiality is equal to the lesser of:

a. The value of Tier 2-type instruments issued by the subsidiary;

b. The difference between the result of applying the limit formula calculated in section 2.1.1.5, and the amount of capital instruments included in Tier 1 capital that are issued by the subsidiary to third parties; and

c. 50% of the result of applying the limit formula.

Tier 2 Capital Instruments above that are included in the consolidated Available Capital of the parent insurer that meet the relevant criteria in Appendix 2-B of this Guideline but do not meet the relevant criteria specified in sections 2.2.1.1 to 2.2.1.4 may be subject to transitional measures in due course.
2.2.1.5.  *Tier 2 capital elements other than capital instruments*

Tier 2 capital elements other than capital instruments include:

1) all amounts deducted from Gross Tier 1 for negative reserves;

2) 75% of cash surrender value deficiencies deducted from Gross Tier 1;

3) 50% of the amount deducted from Gross Tier 1 (per section 2.1.2.4) on account of each net DB pension plan asset

4) the adjustment amount to amortize the impact in the current period on Available Capital on account of the net defined benefit pension plan liability (asset);

5) accumulated net after-tax fair value gains after transition to IFRS on investment properties that do not back policy liabilities under CALM;

6) share premium resulting from the issuance of capital instruments included in Tier 2 capital

For those insurers who made a one-time election to amortize the impact on Available Capital on account of the net DB pension plan liability (asset), the amounts subject to amortization in each period include the change, in each period, of the:

a. accumulated net defined benefit pension plan OCI remeasurements included in Gross Tier 1;

b. amount of the Pension Asset Deduction from Gross Tier 1 (section 2.1.2.4); and

c. Pension Asset Add-back in Tier 2.

The amount subject to amortization in each period is the sum of a, b and c above. The amortization will be made on a straight-line basis over the amortization period. The amortization period will be twelve quarters and will begin in the current quarter. The election will be irrevocable and the company will continue, in each quarter, to amortize the new impact on Available Capital in subsequent periods. The adjustment amount will be reflected in Tier 2.

2.2.2  Amortization of Tier 2 Capital Instruments

Tier 2 capital instruments are subject to straight-line amortization in the final five years prior to maturity. Hence, as these instruments approach maturity, such outstanding balances are to be amortized based on the following schedule:

<table>
<thead>
<tr>
<th>Years to Maturity</th>
<th>Included in Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 years or more</td>
<td>100%</td>
</tr>
<tr>
<td>4 years and less than 5 years</td>
<td>80%</td>
</tr>
<tr>
<td>3 years and less than 4 years</td>
<td>60%</td>
</tr>
</tbody>
</table>

49 Share premium that is not eligible for inclusion in Tier 1 will only be permitted to be included in Tier 2 if the shares giving rise to the share premium are permitted to be included in Tier 2.
2 years and less than 3 years  40%
1 year and less than 2 years  20%
Less than 1 year  0%

Amortization should be computed at the end of each fiscal quarter based on the "years to maturity" schedule (above). Thus amortization would begin during the first quarter that ends within five calendar years of maturity. For example, if an instrument matures on October 31, 2025, 20% amortization of the issue would occur on November 1, 2020, and be reflected in the December 31, 2020 LICAT Life Quarterly Return and LICAT Life Annual Supplement. An additional 20% amortization would be reflected in each subsequent December 31 return.

2.2.3. Deductions from Gross Tier 2

The items below are deducted from Gross Tier 2. A credit risk factor is not applied to items that are deducted from Gross Tier 2.

2.2.3.1 Investments in own Tier 2

An insurer’s investments in its own Tier 2 capital, whether held directly or indirectly, are deducted from Gross Tier 2 (unless already derecognized under IFRS).

In addition, any Tier 2 capital instrument that the insurer could be contractually obliged to purchase is deducted from Gross Tier 2.

2.2.3.2 Investments in Tier 2 Capital of controlled non-life financial corporations

Investments in financial instruments of controlled (as defined in the Insurance Companies Act) non-life solvency regulated financial corporations\textsuperscript{50} are deducted from the tier of capital for which the instrument would qualify if it were issued by the insurer itself. Where an instrument issued by a controlled non-life financial corporation meets the criteria outlined in section 2.2.1.1, it is deducted from Gross Tier 2. If the instrument in which the insurer has invested does not meet the qualifying criteria for Tier 2, the instrument is deducted from Gross Tier 1.

Where the insurer provides a facility such as a letter of credit or guarantee that is treated as capital\textsuperscript{51} by the controlled non-life financial corporation, the full amount of the facility is deducted from Gross Tier 2\textsuperscript{52}.

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\textsuperscript{50} Non-life solvency regulated financial corporations include those entities that are engaged in the business of banking, trust and loan business, property and casualty insurance business, the business of co-operative credit societies or that are primarily engaged in the business of dealing in securities, including portfolio management and investment counselling. Where the company cannot carry on the business directly or where application of the LICAT factors does not measure the risks adequately in the controlled non-life solvency regulated financial corporation, the deduction method is used.

\textsuperscript{51} That is, the facility is available for drawdown in the event of impairment of the non-life corporation's capital and is subordinated to the non-life corporation's customer obligations.

\textsuperscript{52} Although the facility has not been called upon, if it were drawn, the resources would not be available to cover capital requirements in the insurer.
A credit risk factor will not be applied to equity investments, letters of credit, and guarantees or other facilities provided to controlled non-life financial corporations where these have been deducted from Available Capital. Where letters of credit provided to controlled non-life financial corporations are not deducted from Available Capital, they are treated like any other direct credit substitute in accordance with this guideline (refer to Chapters 3 and 4).

2.2.3.3 Reciprocal cross holdings in Tier 2 capital of banking, financial and insurance entities

Reciprocal cross holdings in Tier 2 capital (e.g., Insurer A holds investments in Tier 2 instruments of Insurer B and, in return, Insurer B holds investments in Tier 2 instruments of Insurer A), whether arranged directly or indirectly, that are designed to artificially inflate the capital position of insurers are fully deducted from Gross Tier 2.

2.2.4. Tier 2

Tier 2 is defined as Gross Tier 2 less deductions from Gross Tier 2 set out in section 2.2.3. However, Tier 2 capital may not be lower than zero. If the total of all Gross Tier 2 deductions exceeds Gross Tier 2, the excess must be deducted from Net Tier 1 capital (section 2.1.3).

2.3. Capital Composition and Limitations

The following capital composition requirements and limitations apply to capital elements after all specified deductions and adjustments:

1. Common shareholders’ equity and policyholders’ equity (mutual companies) should be the predominant form of an insurer’s Tier 1 capital. As a result, the aggregate of the following should equal or exceed 75% of Net Tier 1 capital:
   a) Common shares that meet the criteria specified in section 2.1.1.1;
   b) Instruments issued by consolidated subsidiaries of the insurer and held by third parties that meet the criteria for classification as Common Shares as specified in section 2.1.1.1 and subject to section 2.1.1.5;
   c) Tier 1 capital instruments other than innovative instruments and non-cumulative perpetual preferred shares, issued prior to August 7, 2014 that meet the criteria specified in Appendix 2-B and Appendix 2-C\(^53\);
   d) Contributed Surplus:
      i. Share premium resulting from the issuance of Tier 1 capital instruments included within this limit;
      ii. Other contributed surplus, resulting from sources other than profits (e.g. members’ contributions and initial funds for mutual companies and other contributions by shareholders in excess of amounts allocated to share

\(^{53}\) These instruments may be subject to transitioning.
capital for joint stock companies) excluding any share premium resulting from the issuance of capital instruments included in Tier 2;

e) Adjusted Retained Earnings;
f) Adjusted Accumulated Other Comprehensive Income (AOCI);
g) Participating account (joint stock companies);
h) Non-participating account (mutual companies)

2. An insurer should have Net Tier 1 capital that equals or exceeds 40% of its Base Solvency Buffer.

3. An insurer’s Net Tier 2 capital (comprising capital elements net of amortization) shall not exceed 100% of Net Tier 1 capital.

2.4. **Transitional Arrangements**

[To be determined]
Appendix 2-A  Information Requirements for Capital Confirmations

Given the potential impact of the disqualification of a capital instrument, insurers are encouraged to seek confirmations of capital quality from OSFI prior to issuing instruments\(^{54}\). In conjunction with such requests, the institution is expected to provide the following information to the Capital Division.

1. An indicative term sheet specifying indicative dates, rates and amounts and summarizing key provisions should be provided in respect of all proposed instruments.

2. The draft and final terms and conditions of the proposed instrument supported by relevant documents (i.e., Prospectus, Offering Memorandum, Debt Agreement, Share Terms, etc.).

3. A copy of the institution’s current by-laws or other constating documents relevant to the capital to be issued as well as any material agreements, including shareholders’ agreements, which may affect the capital quality of the instrument.

4. Where applicable, for all debt instruments only:
   a) the draft and final Trust Indenture and supplemental indentures; and
   b) the terms of any guarantee relating to the instrument.

5. Where the terms of the instrument include a redemption option or similar feature upon a tax event, an external tax opinion confirming the availability of such deduction in respect of interest or distributions payable on the instrument for income tax purposes\(^{55}\).

6. An accounting opinion describing the proposed treatment and disclosure of the Tier 1 Capital Instrument Other than Common Shares) or the Tier 2 capital instrument on the institution’s financial statements\(^{56}\).

7. Where the initial interest or coupon rate payable on the instrument resets periodically or the basis of the interest rate changes from fixed to floating (or vice versa) at a pre-determined future date, calculations demonstrating that no incentive to redeem, or step-up, will arise upon the change in the initial rate. Where applicable, a step-up calculation should be provided according to the swap-spread methodology which confirms there is no step-up upon the change in interest rate and supported by screenshots of the applicable reference index rate(s).

8. Capital projections that demonstrate that the insurer will be in compliance with its supervisory target capital ratios as well as the capital composition requirements specified in section 2.3 at the end of the quarter in which the instrument is expected to be issued.

9. An assessment of the features of the proposed capital instrument against the minimum criteria for inclusion as a Tier 1 Capital Instrument Other than Common Shares or Tier 2 Capital Instrument Other than Common Shares.

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\(^{54}\) If an insurer fails to obtain a capital confirmation (or obtains a capital confirmation without disclosing all relevant material facts to OSFI), OSFI may, at its discretion and at any time determine that such capital does not comply with these principles and is to be excluded from an insurer’s Available Capital.

\(^{55}\) OSFI reserves the right to require a Canada Revenue Agency advance tax ruling to confirm such tax opinion if the tax consequences are subject to material uncertainty.

\(^{56}\) OSFI reserves the right to require such accounting opinion to be an external opinion of a firm acceptable to OSFI if the accounting consequences are subject to material uncertainty.
capital, as applicable, specified in this Guideline. For greater certainty, this assessment would only be required for an initial issuance or precedent and is not required for subsequent issuances provided the terms of the instrument are not materially altered.

10. A written attestation from a senior officer of the insurer confirming that the insurer has not provided financing to any person for the express purpose of investing in the proposed capital instrument.
Appendix 2-B Qualifying Criteria for Capital Instruments Issued Prior to August 7, 2014

Capital instruments issued prior to August 7, 2014 that do not meet the relevant criteria specified in sections 2.1.1.2 to 2.1.1.5 or 2.2.1.1 to 2.2.1.4 are assessed against the relevant criteria specified in this Appendix for inclusion in Available Capital. Capital instruments that meet the relevant criteria in this Appendix, but do not meet the relevant criteria specified in sections 2.1.1.2 to 2.1.1.5 or 2.1.2.1 to 2.1.2.3 may be subject to transitional measures in due course.

A. Tier 1

1. Preferred shares (Tier 1)

Tier 1 capital instruments are intended to be permanent. Where tier 1 preferred shares provide for redemption by the issuer after five years, with supervisory approval, the Office would not normally prevent such redemptions by healthy and viable companies when the instrument is or has been replaced by equal or higher quality capital including an increase in retained earnings, or if the company is downsizing. The redemption or purchase for cancellation of tier 1 instruments requires the prior approval of the Superintendent.

Preferred shares will be judged to qualify as tier 1 instruments based on whether they are, in form and in substance:

a. subordinated;
b. permanent; and
c. free of mandatory fixed charges.

1.1. Subordination

Preferred shares must be subordinated to policyholders and unsecured creditors of the company. If preferred shares are issued by a subsidiary or intermediate holding company for the funding of the company and are to qualify for capital at the consolidated entity (non-controlling interest), the terms and conditions of the issue, as well as the intercompany transfer, must ensure that investors are placed in the same position as if the instrument were issued by the company.

1.2. Permanence

To ensure that preferred shares are permanent in nature, the following features are not permitted:

a. retraction by the holder;
b. obligation for the issuer to redeem shares;
c. redemption within the first five years of issuance; and
d. any step-up\(^{57}\) representing a pre-set increase at a future date in the dividend (or distribution) rate based in whole or in part on the issuer’s credit rating or financial condition\(^{58}\).

Any conversion, other than to common shares of the issuer\(^{59}\), or redemption is subject to supervisory approval and:

1. redemption can only be for cash or the equivalent; and
2. conversion privileges cannot be structured to effectively provide either a redemption of or return on the original investment.

For example, an issue would not be considered non-cumulative if it had a conversion feature that compensates for undeclared dividends or provides a return of capital.

Preferred shares with dividends that are fixed for a period of time and then shift to a floating rate (“Fixed-Floaters”) may contain embedded step-ups. OSFI must be satisfied that dividend reset features do not impair the permanence of the shares, and that these features do not create an incentive to redeem. A dividend reset feature that results in a step-up from the initial rate signals intent to redeem. Accordingly, step-ups, at any level and any time, are not acceptable in a tier 1 preferred share instrument. To qualify for inclusion as Available Capital, applicants must demonstrate that a dividend reset feature does not give rise to a step-up of any amount, given the company’s credit quality at the original date of issue.

Fixed-Floaters that are determined to contain a step-up will be subject to the specific treatment that is established by OSFI with the issuing FRFI.\(^{60}\)

For purposes of determining the existence of a step-up, international standards employ the “swap spread” methodology outlined in Appendix 2-C. In situations where the index that is the basis for the reset rate differs from that of the initial rate, this methodology uses the public swap markets to enable a comparison of the two rates. FRFIs wishing to include a dividend reset mechanism in a preferred share instrument must demonstrate, using the swap spread methodology, that no embedded step-up exists. However, for this analysis to be conclusive, a public swap market should exist between the two reference rates. Without such a market, it will be difficult for a FRFI to demonstrate objectively to demonstrate to OSFI’s satisfaction that no

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\(^{57}\) An increase over the initial rate after taking into account any swap spread between the original reference index and the new reference index.

\(^{58}\) In keeping with this policy, a dividend-reset mechanism that does not specify a cap, consistent with the company’s credit quality at the original date of issue, is not acceptable because it raises the possibility that the dividend would be reset based on the future credit quality of the company. Any existing preferred shares containing such a feature and previously approved for inclusion in Tier 1 are grandfathered.

\(^{59}\) Qualifying preferred shares outstanding as of January 31, 2004 and accounted for as equity, prior to November 1, 2004, the effective date of CICA Handbook Section 3860 Financial Instruments – Disclosure and Presentation, will continue to be eligible for core tier 1 treatment for as long as they remain outstanding, even if they are accounted for as liabilities after the effective date of the change in accounting standards.

\(^{60}\) Effective May 2001 and up to June 2004, issues of preferred shares containing embedded step-ups at any level did not qualify for Tier 1 or Tier 2A and were considered for inclusion only in Tier 2B. Effective June 2004, qualifying preferred shares that have a moderate step-up may be included in Tier 2A capital, as detailed below.
step-up exists. In these circumstances, OSFI believes that only a public swap market between the two reference rates contained in the instrument provides certainty as to the intent of the dividend reset mechanism.

The only capital instruments that could qualify as tier 1 capital and contain a step-up feature are instruments that meet the requirements of rules for innovative instruments outlined in Appendix 2-C. In those limited circumstances, the instrument may have a moderate step-up only after 10 years.

1.3. Free of mandatory fixed charges

Preferred shares included in tier 1 capital are not permitted to offer the following features:

1. cumulative dividends;
2. dividends influenced by the credit standing of the institution;
3. compensation to preferred shareholders other than a dividend; or
4. sinking or purchase funds.

In addition, the non-declaration of a dividend shall not trigger restrictions on the issuer other than the need to seek approval of the holders of the preferred shares before paying dividends on other shares or before retiring other shares. Non-declaration of a dividend would not preclude the issuer from making the preferred shares voting or, with the prior approval of the Superintendent, making payment in common shares.

To conform with accepted practice, in the event of non-declaration of a dividend, approval of the holders of preferred shares may be sought before:

1. paying dividends on any shares ranking junior to the preferred shares (other than stock dividends in any shares ranking junior to the preferred shares); or
2. redeeming, purchasing or otherwise retiring any share ranking junior to the preferred shares (except out of the net cash proceeds of a substantially concurrent issue of shares ranking junior to the preferred shares); or
3. redeeming, purchasing or otherwise retiring less than all such preferred shares; or
4. except pursuant to any purchase obligation, sinking fund, retraction privilege or mandatory redemption provisions attached to any series of preferred shares, redeeming, purchasing or otherwise retiring any shares ranking on a parity with such preferred shares.

1.4. Examples of acceptable features

Outlined below are examples of certain preferred share features that may be acceptable in tier 1 capital instruments:

1. a simple call feature that allows the issuer to call the instrument provided the issue cannot be redeemed in the first five years and, after that, only with prior supervisory approval;
2. A dividend that floats at some fixed relationship to an index or the highest of several indices as long as the index or indices are linked to general market rates and not to the financial condition of the borrower;

3. A dividend rate that is fixed for a period of years and then shifts to a rate that floats over an index plus an additional amount tied to the increase in common share dividends if the index is not based on the institution’s financial condition and the increase is not automatic, not a step-up, nor of an exploding rate nature; and

4. Conversion of preferred shares to common shares where the minimum conversion value or the way it is to be calculated is established at the date of issue. Examples of conversion prices are: a specific dollar price; a ratio of common to preferred share prices; and a value related to the common share price at time of conversion.

1.5. Examples of unacceptable features

Examples of preferred share features that will not be acceptable in tier 1 capital are:

1. An exploding rate preferred share, where the dividend rate is fixed or floating for a period and then sharply increases to an uneconomically high level;

2. An auction rate preferred share or other dividend reset mechanism in which the dividend is reset periodically based, in whole or part, on the issuer’s credit rating or financial condition; and

3. A dividend reset mechanism that does not specify a cap, consistent with the institution’s credit quality at the original date of issue.

B. Tier 2

Tier 2 capital instruments must not contain restrictive covenants or default clauses that would allow the holder to trigger acceleration of repayment in circumstances other than the insolvency, bankruptcy or winding-up of the issuer. Further, the debt agreement must normally be subject to Canadian law. However, OSFI may waive this requirement, in whole or in part, provided the company can show that an equivalent degree of subordination can be achieved as under Canadian law. In all cases, the prior consent of OSFI must be obtained where law other than Canadian law will apply. Instruments issued prior to year-end 1994 are grandfathered. Tier 2 capital instruments with a purchase for cancellation clause will be deemed to mature on the date this clause becomes effective unless the purchase requires the prior approval of the Superintendent.

Tier 2 capital components are subject to straight-line amortization in the final five years prior to maturity or the effective dates governing holders’ retraction rights.

1. Hybrid capital instruments (Tier 2A)

Hybrid capital includes instruments that are essentially permanent in nature and that have certain characteristics of both equity and debt. Hybrid capital instruments must, at a minimum, meet the following criteria:

1. Are unsecured, subordinated to policyholder and creditor obligations and fully paid;
2. are not redeemable at the initiative of the holder;
3. may be redeemable by the issuer after an initial term of five years with the prior consent of the Superintendent of Financial Institutions;
4. are available to participate in losses without triggering a cessation of ongoing operations or the start of insolvency proceedings; and
5. allow service obligations to be deferred (as with cumulative preferred shares) where the profitability of the company would not support payment.

These instruments include:
   a. cumulative perpetual preferred shares;
   b. qualifying 99-year debentures; and
   c. qualifying non-controlling interest arising on consolidation from tier 2 hybrid capital instruments.

To qualify as tier 2A capital, preferred shares should have characteristics similar to those required for tier 1 capital with the exception that tier 2A preferred shares may be cumulative.\(^{61}\)

Hybrid capital instruments issued in conjunction with a repackaging arrangement that are deemed by the Superintendent to be an effective amortization are to be treated as limited life instruments subject to their conforming with the criteria for tier 2B instruments. Repackaging arrangements vary but normally involve above-market coupons and a step down in interest rates after a specified period. Economically, therefore, they may be regarded as involving disguised capital repayment. To qualify for tier 2A, capital should not have a limited life.

Perpetual\(^{62}\) debentures meeting the criteria for hybrid capital instruments specified above will be eligible for inclusion in tier 2A capital if they also:

1. are available to participate in losses while the issuer is still a going concern. Therefore, if the retained earnings (both par and non-par) of the issuer are negative, then the principal amount of the debt and unpaid interest must automatically convert to common or perpetual preferred shares\(^{63}\); 
2. must allow the issuer to defer principal and interest payments if the issuer does not report a net profit for the most recent combined four quarters and the issuer eliminates cash dividends on its common and preferred stock. Under no circumstances will the deferral of interest be allowed to compound;

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61 Effective June 2004, Tier 2A qualifying capital instruments, including preferred shares, may also include moderate step-ups, as described below.
62 Perpetual includes debentures with a 99-year term.
63 It may be acceptable for the principal amount of the debt, together with any unpaid interest, to be deemed for all purposes to have automatically converted to common shares or perpetual preferred shares immediately before the Superintendent takes control of the issuer or steps are initiated for the winding-up of the issuer so that the holder will no longer be a holder of tier 2A-qualifying debentures but a holder of common or preferred shares. OSFI will consider the acceptability of this alternative conversion trigger on a case-by-case basis in the context of a debenture’s other principal features.
3. must not contain provisions for any form of compensation in respect of any unpaid payments, except subject to prior approval of the Superintendent; and
4. are free from special restrictive covenants or default clauses that would allow the holder to trigger acceleration of repayment in circumstances other than insolvency.

Where hybrid instruments provide for redemption by the issuer after five years, with supervisory approval, OSFI would not normally prevent such redemptions by healthy and viable companies when the instrument is or has been replaced by equal or higher quality capital including an increase in retained earnings, or if the company is downsizing.

Preferred shares or perpetual subordinated debentures with moderate step-ups may be included in tier 2A capital, provided these instruments meet all of the other conditions for tier 2A treatment and subject to the following additional requirements:

1. step-up cannot result in an increase of more than 100 basis points over the initial rate;
2. step-up must be calculated using the “swap spread” methodology outlined in Appendix 2-C;
3. step-up cannot occur before 10 years from the date on which the capital is issued;
4. terms of the instrument must not provide for more than one step-up over the life of the instrument; and
5. the step-up cannot be combined with any other feature that causes an economic incentive to redeem.

2. Limited life instruments (tier 2B)

Limited life instruments must, at a minimum, meet the following criteria:

1. subordination to policyholders and other senior creditors;
2. an initial minimum term greater than five years; and
3. may be redeemable by the issuer in the first five years only with the prior consent of the Superintendent of Financial Institutions.

In contrast to hybrid instruments, limited life instruments are not permanent and include:

1. limited life redeemable preferred shares;
2. qualifying capital instruments issued in conjunction with a repackaging arrangement;
3. other debentures and subordinated debt; and
4. qualifying non-controlling interests arising on consolidation from tier 2 limited life instruments.

A capital instrument with a step-up feature that does not meet all of the stated Tier 2A conditions may be eligible for Tier 2B treatment, provided it meets the step-up conditions and all other conditions for Tier 2B treatment.

OSFI would not normally prevent such redemptions by healthy and viable companies when the instrument is or has been replaced by equal or higher quality capital, including an increase in retained earnings, or if the institution is downsizing.
Preferred shares with dividends that are fixed for a period of time and then shift to a floating rate (“Fixed-Floaters”) may contain embedded step-ups.

Subordinated debt or term preferred shares with embedded step-ups may be included in tier 2B capital, provided these instruments meet all of the other conditions for tier 2B treatment and subject to the following requirements:

1. step-up must be calculated using the “swap spread” methodology outlined in Appendix 2-C;
2. step-up cannot be combined with any other feature that causes an economic incentive to redeem;
3. terms of the instrument must not provide for more than one step-up over the life of the instrument;
4. instrument must not have a step-up of any amount in the first five years; and
5. capital instruments with step-ups greater than 100 basis points will be treated for amortization purposes as term debt that matures at the date the step-up comes into effect.

Limited life debt instruments issued to a parent company either directly or indirectly will be included in tier 2B capital only with the prior approval of the Superintendent. Before granting approval, the Superintendent will consider the rationale provided by the parent for not providing equity capital or not raising tier 2B capital from external sources. The Superintendent will also want to be assured that the interest rate is reasonable and that failure to meet debt servicing obligations on the tier 2B debt provided by the parent would not, either now or in the future, be likely to result in the parent company being unable to meet its own debt servicing obligations, and would not trigger cross-default clauses under the covenants of other borrowing agreements of either the institution or the parent.

Limitations apply to the amount of limited life instruments that may be included in tier 2B (see section 2.1.5).

Capital instruments issued in conjunction with a repackaging arrangement that are deemed by the Superintendent to be an effective amortization are to be treated as limited life instruments subject to their conforming with the criteria for tier 2B instruments.

3. Amortization of Tier 2 Capital Instruments

Tier 2 capital instruments are subject to straight-line amortization in the final five years prior to maturity or the effective dates governing holders’ retraction rights. Hence, as redeemable preferred shares and subordinated debentures of the company or non-controlling interest preferred shares and qualifying subsidiary debt instruments approach maturity, redemption or retraction, such outstanding balances are to be amortized based on the following criteria:
<table>
<thead>
<tr>
<th>Years to Maturity</th>
<th>Included in Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 years or more</td>
<td>100%</td>
</tr>
<tr>
<td>4 years and less than 5 years</td>
<td>80%</td>
</tr>
<tr>
<td>3 years and less than 4 years</td>
<td>60%</td>
</tr>
<tr>
<td>2 years and less than 3 years</td>
<td>40%</td>
</tr>
<tr>
<td>1 year and less than 2 years</td>
<td>20%</td>
</tr>
<tr>
<td>Less than 1 year</td>
<td>0%</td>
</tr>
</tbody>
</table>

Similarly for capital instruments that have sinking funds, amortization of the amount paid into the sinking fund should begin five years before it is made. This is required because the amount in the sinking fund is not subordinated to the rights of policyholders.

Amortization should begin five years before the date at which the debenture or share may be redeemed at the company's option. For example, for a 20-year debenture or share that can be redeemed at the company's option any time after the first ten years, amortization should begin after the fifth year. This rule does not apply when redemption requires the Superintendent's approval.

Where there is an option for the issuer to redeem an instrument subject to the Superintendent's approval, the instrument would be subject to straight-line amortization in the final five years to maturity.

Tier 2B capital instruments with step-ups greater than 100 basis points will be treated for amortization purposes as term debt that matures at the date the step-up comes into effect.

Amortization should be computed at the end of each fiscal quarter based on the "years to maturity" schedule (above). Thus amortization would begin during the first quarter that ends within five calendar years of maturity. For example, if an instrument matures on October 31, 2000, 20% amortization of the issue would occur on November 1, 1995, and be reflected in the December 31, 1995 MCCSR return. An additional 20% amortization would be reflected in each subsequent December 31 return.

C. Early Redemption of Capital Instruments

Redemption of a tier 1 preferred share or tier 2A hybrid instrument at the option of the issuer is not permitted within the first five years of issuance. There are, however, certain circumstances under which OSFI would consider redemption during this period. These circumstances are limited to:

1. Tax laws change, adversely affecting the tax advantage of the preferred shares/hybrid instrument;
2. OSFI's capital adequacy requirements change, such that the preferred shares/hybrid instrument could no longer be included in calculating the Available Capital of the company on a consolidated basis; or
3. A restructuring resulting from a major acquisition or merger where the instrument is immediately exchanged for a capital qualifying instrument of the continuing company with identical terms and conditions and capital attributes.

Superintendent approval is required for redemption at any time.

D. Related Guidance Notes and Advisories

Refer to the following OSFI additional guidance on the definition of capital.

<table>
<thead>
<tr>
<th>Guidance</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ruling 2005-01: Conversion of subordinated debt</td>
<td>2005</td>
</tr>
<tr>
<td>Advisory: Innovative Tier 1 and Other Capital Clarifications – Revised Version</td>
<td>December 2008</td>
</tr>
</tbody>
</table>
Appendix 2-C  Principles Governing Inclusion of Innovative Instruments in Tier 1 Capital

A. Application

The principles in this Appendix take effect immediately. Given the nature of the subject matter covered in this Appendix, OSFI will continue to review the principles in light of any issues arising from their application to specific transactions. We plan to revisit the Appendix as our experience develops. Subsequent amendments to the principles, if any, will not disqualify approvals granted under this Appendix.

For the purposes of this Appendix, “innovative instrument” means an instrument issued by a Special Purpose Vehicle (SPV), which is a consolidated non-operating entity whose primary purpose is to raise capital. A non-operating entity cannot have depositors or policyholders.

This Appendix applies to indirect issues done through an SPV. To qualify as capital, direct issues must meet the conditions set out in OSFI Guidelines Life Insurance Capital Adequacy Test or Capital Adequacy Requirements (CAR), as applicable. Note that step-ups are not permitted in directly issued Tier 1 instruments.

In this Appendix, FRFI means:

1. the operating federally regulated life insurance company that has policyholders (Life Company); or
2. the operating bank or the operating federally regulated trust or loan company that has depositors (DTI) and with whom the SPV is consolidated.

In this Appendix, an Asset-Based Structure is one where the assets of the SPV do not include an instrument issued by the FRFI. A Loan-Based Structure is one where the SPV’s primary asset is an instrument issued by the FRFI.

B. Limits on Innovative Instruments in Tier 1 Capital

Principle #1: OSFI expects FRFIs to meet capital requirements without undue reliance on innovative instruments. Common shareholders’ equity (i.e., common shares, retained earnings and participating account surplus, as applicable) should be the predominant form of a FRFI’s Tier 1 capital.

I(a): Innovative instruments must not, at the time of issuance, make up more than 15 per cent of a FRFI’s net Tier 1 capital. Any excess cannot be included in Available Capital.67

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66 All qualifying consolidated innovative tier 1 instruments outstanding as of June 30, 2003, and any in respect of which OSFI received a formal request for capital confirmation as of the same date and which was subsequently approved by OSFI, continue to receive innovative tier 1 regulatory capital treatment by OSFI, even if these were no longer consolidated as a result of AcG-15 Consolidation of Variable Interest Entities, when it became effective in November 2004.
If, at any time after issuance, a FRFI’s ratio of innovative instruments to net Tier 1 capital exceeds 15 per cent, the FRFI must immediately notify OSFI. The FRFI must also provide a plan, acceptable to OSFI, showing how the FRFI proposes to eliminate the excess quickly. A FRFI will generally be permitted to include such excesses in its Tier 1 capital until such time as the excess is eliminated in accordance with its plan.

1(b): Tier 1-qualifying preferred shares (combined with innovative instruments) must not, at the time of issuance, make up more than 40 per cent of a FRFI’s net Tier 1 capital. Any excess cannot be included in Available Capital.

Tier 1-qualifying preferred shares that were previously included in Tier 1 capital (i.e., they were within the 40% aggregate limit for Tier 1 instruments other than common shares as at issuance) but which subsequently exceed the 40% aggregate limit due to operating losses and/or the payment of normal dividends will be considered eligible for continued inclusion in Tier 1 capital.

A FRFI that wishes to include such excess preferred share amounts in Tier 1 capital must obtain OSFI’s prior confirmation that this treatment is acceptable. To obtain confirmation, the FRFI must demonstrate that operating losses and/or the payment of normal dividends created the excess amount. The FRFI must also provide a clear and supportable plan, acceptable to OSFI, outlining how it proposes to eliminate the excess quickly. This approach to the treatment of excess Tier 1-qualifying preferred share amounts is effective as at March 31, 2003.

1(c): A strongly capitalized FRFI should not have innovative instruments and perpetual non-cumulative preferred shares that, in aggregate, exceed 40% of its net Tier 1 capital. Tier 1-qualifying preferred shares issued in excess of this limit can be included in Tier 2 capital.

1(d): For the purposes of this principle, “net Tier 1 capital” means Tier 1 capital after deductions for goodwill etc., as set out in OSFI’s MCCSR or CAR Guideline, as applicable.

C. General Principles for Innovative Instruments

Innovative instruments may be included in Tier 1 capital (subject to the limits set out in Principle #1), provided they meet certain requirements. The following principles will govern their inclusion:

Principle #2: The nature of inter-company instruments issued by the FRFI in connection with the raising of Tier 1 capital by way of innovative

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67 Only those excesses arising after issuance and as a result of operating losses and/or the payment of normal dividends will normally be eligible for continued inclusion in Tier 1 capital.
instruments must not compromise the Tier 1 qualities of the innovative instrument.

2 (a): An SPV should not, at any time, hold assets that materially exceed the amount of the innovative instrument. For Asset-Based Structures, OSFI will consider the excess to be material if it exceeds 25 per cent of the innovative instrument(s) and, for Loan-Based Structures, the excess will be considered to be material if it exceeds 3 per cent of the innovative instrument(s). Amounts in excess of these thresholds require the Superintendent’s approval.

2 (b): The following minimum standards apply to inter-company instruments issued by the FRFI when raising Tier 1 capital by way of an innovative instrument:

1) Inter-company instruments must be permanent; they may contain a maturity date provided the term to maturity is at least 99 years.\(^68\) If, at maturity, the proceeds are not used to repay the innovative instrument, the SPV must reinvest the proceeds in assets acquired from the FRFI.

2) Failure to make payments or to meet covenants must not cause acceleration of repayment of the inter-company instrument.

3) The inter-company instrument must not be secured or covered by a guarantee or other arrangement that legally or economically results in a priority ahead of the claims of policyholders/depositors.

2 (c): Life Companies wishing to include an Asset-Based Structure in Tier 1 capital pursuant to this Appendix must satisfy OSFI that, after the assets have been transferred to the SPV, there will be sufficient cash flows available to support insurance contract liabilities within the FRFI and the valuation of the FRFI’s insurance contract liabilities will not be materially affected.

Principle #3: Innovative instruments must allow FRFIs to absorb losses within the FRFIs on an ongoing basis.

3 (a): Innovative instruments must enable the FRFIs to absorb losses without triggering the cessation of ongoing operations or the start of insolvency proceedings. The ability to absorb losses must be present well before there is any serious deterioration in the FRFI’s financial position.

3 (b): The method used to achieve loss absorption within the FRFI must be transparent and must not raise any uncertainty about the availability of capital for this purpose. Any of the following mechanisms would be acceptable, provided OSFI receives a high degree of assurance that they will function appropriately:

\(^{68}\) Qualifying inter-company instruments issued prior to December 2008 are required to have a maturity of at least 30 years.
1) Mandatory write-down of the innovative instrument.

2) Automatic conversion into Tier 1-qualifying preferred shares of the FRFI. Automatic conversion must occur, at a minimum, upon the occurrence of any of the following events (Loss Absorption Events):

a) an application for a winding-up order in respect of the FRFI pursuant to the *Winding-up and Restructuring Act (Canada)* is filed by the Attorney General of Canada or a winding-up order in respect of the FRFI pursuant to that Act is granted by a court; or

b) the Superintendent advises the FRFI in writing that the Superintendent has taken control of the FRFI or its assets pursuant to the *Insurance Companies Act, Bank Act or Trust & Loan Companies Act*, as applicable; or the Superintendent advises the FRFI in writing that the Superintendent is of the opinion that, in the case of a Life Company, it has a net Tier 1 Ratio of less than 75 per cent or a MCCSR Total Ratio of less than 120 per cent; or

c) in the case of a DTI, it has a Tier 1 capital ratio of less than 5.0 per cent or a Total Capital ratio of less than 8.0 per cent; or

d) the FRFI’s Board of Directors advises the Superintendent in writing that, in the case of a Life Company, the FRFI has a Tier 1 Ratio of less than 75 per cent or a MCCSR Total Ratio of less than 120 per cent, or, in the case of a DTI, the FRFI has a Tier 1 capital ratio of less than 5.0 per cent or a Total Capital ratio of less than 8.0 per cent; or

e) the Superintendent directs the FRFI, pursuant to the *Insurance Companies Act, Bank Act or Trust & Loan Companies Act*, as applicable, to increase its capital or provide additional liquidity and the FRFI elects to cause the exchange as a consequence of the issuance of such direction or the FRFI does not comply with such direction to the satisfaction of the Superintendent within the time specified.

If the Tier 1-qualifying preferred shares issued pursuant to an automatic conversion contain a feature allowing the holder to convert into common shares at future market values, such a feature must be structured to ensure that the investors would absorb losses. Accordingly, the right to convert must be structured to ensure that the holder cannot exercise the conversion right while a Loss Absorption Event is continuing.

The risk premium (over the risk-free rate) reflected in the dividend rate on the Tier 1-qualifying preferred shares issued pursuant to the automatic conversion must be established at the time the innovative instrument is issued and must not exceed the risk premium (over the risk-free rate) reflected in the dividend rate of

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69 The MCCSR Tier 1 and Total Ratios are calculated per section 2.1.6: \((\text{Adjusted net tier 1 capital} \div \text{Base Solvency Buffer}) \times 100\) and \(((\text{Adjusted net tier 1 capital} + \text{net tier 2 capital}) \div \text{Base Solvency Buffer}) \times 100\).
comparable shares as at that date (i.e., upon the original issuance of the innovative instrument).  

3) Another method that is consistent with Principle #4 and approved by the Superintendent.

**Principle #4: Innovative instruments must absorb losses in liquidation.**

4 (a): Innovative instruments must achieve, through conversion or other means (for example, a mechanism that ensures investors will receive distributions consistent with preferred shareholders of the FRFI), a priority after the claims of policyholders/depositors, other creditors and subordinated debt holders of the FRFI in a liquidation.

4 (b): Innovative instruments must not be secured or covered by a guarantee or other arrangement that legally or economically results in a claim ranking equal to or prior to the claims of policyholders/depositors, other creditors and subordinated debt holders of the FRFI in a liquidation.

**Principle #5: Innovative instruments must not contain any feature that may impair the permanence of the instrument.**

5 (a): For the purposes of this principle, a step-up is defined as a pre-set increase at a future date in the dividend (or distribution) rate to be paid on an innovative instrument. Moderate step-ups in innovative instruments are permitted only if the moderate step-up occurs at least 10 years after the issue date and if it results in an increase over the initial rate not exceeding the greater of:

(i) 100 basis points, less the swap spread between the initial index basis and the stepped-up index basis; and

(ii) 50 per cent of the initial credit spread, less the swap spread between the initial index basis and the stepped-up basis.

The terms of the innovative instrument should provide for no more than one rate step-up over the life of the instrument. The swap spread should be fixed as of the pricing date and should reflect the differential in pricing on that date between the initial reference security or rate and the stepped-up reference security or rate.

5 (b): A step-up feature cannot be combined with any other feature that creates an economic incentive to redeem.

5 (c): A redemption feature after an initial five-year period is acceptable in an innovative instrument on the condition that the redemption requires both the prior approval of the

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70 For Tier 1-qualifying preferred shares issued prior to December 2008, the dividend rate on the Tier 1-qualifying preferred shares issued pursuant to the automatic conversion must be established at the time the innovative instrument is issued and must not exceed the market rate for such shares as at that date.
Superintendent and the replacement of the innovative instrument with capital of the same or better quality, unless the Superintendent determines that the FRFI has capital that is more than adequate to cover its risks.

An innovative instrument may be redeemed during the initial five-year period, with the Superintendent's approval, upon the occurrence of tax or regulatory (including legislative) changes affecting one or more components of the transaction. It is highly unlikely that the Superintendent would approve redemption of an innovative instrument in the initial five-year period due to a tax reassessment.

The purchase for cancellation of an innovative instrument requires the prior approval of the Superintendent.

5 (d): Innovative instruments issued after December 2008 can include securities that mature in at least 99 years. However, these will be subject to straight-line amortization for regulatory capital purposes beginning 10 years prior to maturity. The instrument may contain the right of holders, at their option, to exchange their innovative instrument for Tier 1-qualifying preferred shares of the FRFI provided the dividend rate is established at the time the innovative instrument is issued and it does not exceed the market rate for such shares as at that date.

5 (e): An innovative instrument must not contain a feature allowing the holder to convert the innovative instrument directly into common shares of the FRFI or of other entities. Conversions into common shares are permitted only if the conversion occurs first into Tier 1-qualifying preferred shares of the FRFI which are then convertible into common shares of the FRFI or its OSFI-regulated holding company, and provided OSFI is satisfied that the innovative instrument is issued in a market where the conversion feature is widely accepted.

Structures permitting the indirect conversion of an innovative Tier 1 instrument into the common shares of an unregulated holding company may be submitted to OSFI for review and approval, provided the following conditions are met:

1. unregulated holding company has a material public common float and the FRFI does not;
2. unregulated holding company is the direct parent and controlling shareholder of the FRFI; and
3. unregulated holding company is a non-operating holding company.

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71 Innovative instruments issued prior to January 2009 must not contain a maturity date or other feature that requires the instrument to be paid in cash.

72 The intent is to allow the issuance of innovative Tier 1 instruments by a FRFI owned directly by a holding company with a material float of common shares listed and posted for trading on a recognized stock exchange (a “material public common float”) when the FRFI has no such float of its own.
OSFI reserves the right to require additional conditions or restrictions, consistent with the proposed regulatory capital treatment of an instrument, to address the particular nature of proposals presented for its consideration.

Principle #6: Innovative instruments must be free from mandatory fixed charges.

6 (a): The FRFI, through the SPV, must have discretion over the amount and timing of distributions. Rights to receive distributions must clearly be non-cumulative and must not provide for compensation in lieu of undeclared distributions. The FRFI must have full access to undeclared payments.

6 (b): Distributions may be paid only in cash.

6 (c): Distributions may not be reset based on the future credit standing of the FRFI.

Principle #7: Innovative instruments must be issued and fully paid-for in money, or, with the approval of the Superintendent, in property.

Principle #8: Innovative instruments, even if not issued as shares, may be included in Tier 1 capital.

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If, subsequent to the issuance of an innovative Tier 1 instrument that has a structure involving an unregulated holding company, material changes occur in the activities of that holding company or the nature of its relationship to the FRFI, the FRFI should seek OSFI’s confirmation that the original capital treatment of the instrument continues to apply. In those circumstances, OSFI reserves the right to reassess the quality of the instrument and, where appropriate, to introduce additional conditions or restrictions to maintain the original regulatory capital treatment of the instrument.

Effective December 2008, a qualifying innovative instrument is permitted to be “share cumulative” where, under specified circumstances to maintain cash resources in the FRFI and as a result of contractual obligations between the investors, the SPV and the FRFI, deferred cash coupons on the innovative instrument become payable in Tier 1-qualifying perpetual preferred shares of the FRFI, subject to the following requirements (in the situation where preferred shares are issued during a cash coupon deferral period, leaving aside any tax consequences related thereto, such issuance reallocates capital between retained earnings and preferred share capital and does not result in a net increase in the overall level of Tier 1 capital):

- Cash coupons on the innovative instrument can be deferred at any time, at the FRFI management’s complete discretion, with no limit on the duration of the deferral, apart from the maturity of the instrument.
- The preferred shares issued by the FRFI will initially be held in trust and will only be distributed to the holders of the innovative instrument to pay for deferred coupons once the cash coupons on the innovative instrument are resumed or when the innovative instruments are no longer outstanding (e.g., maturity of the innovative instrument, conversion of innovative instrument into preferred shares of the FRFI, etc.).
- The number of preferred shares to be distributed by the FRFI to effect payment in lieu of deferred cash coupons must be calculated by dividing the deferred cash coupon amount by the face amount of the preferred shares.
- The risk premium (over the risk-free rate) reflected in the dividend rate of such preferred shares must be established at the time the innovative instrument is issued and must not exceed the risk premium (over the risk-free rate) reflected in the dividend rate of comparable shares as at that date (i.e., upon original issuance of the innovative instrument).
Principle #9: The main features of an innovative instrument must be easily understood and publicly disclosed.

9 (a): For the purposes of this principle, OSFI will consider the main features of an innovative instrument to be easily understood where:

1) the legal (including tax) and regulatory risks arising out of the innovative instrument have been minimized to the satisfaction of the Superintendent. The likelihood of failing this test increases as the number of entities placed between the investors and the ultimate recipient of the proceeds increases, as the number of jurisdictions involved increases, and/or if the assets of the FRFI are transferred to an entity outside Canada; and

2) the manner by which the innovative instrument meets the Tier 1 capital requirements and the main features of the instrument are, in the opinion of the Superintendent, transparent to a reasonably sophisticated investor.

9 (b): The main features of innovative instruments, including those features designed to achieve Tier 1 capital status (for example, the triggers and mechanisms used to achieve loss absorption), must be publicly disclosed in the FRFI’s annual report to shareholders.

OSFI expects that FRFIs will, particularly for innovative instruments issued after July 1, 2008, provide prospectus-level disclosure at issuance to ensure the main features of the innovative instruments and the structure of the issue are transparent and easily understood by investors, including all relevant risk factors. Further, in the case of material changes, OSFI expects the FRFI will provide additional disclosure on a timely basis. In particular, the following information should be disclosed to investors in innovative instruments and to the shareholders of the FRFI issuing, directly or indirectly, the innovative instruments:

1) **Tier 1 treatment:** It should be explicitly stated that innovative instruments are structured with the intent of achieving Tier 1 regulatory capital treatment and, as such, have features of equity capital. It should be clearly stated that dividends on the innovative instruments will not be paid if dividends are not paid by the FRFI on its common and preferred shares. In addition, it should be disclosed that the innovative instruments contain certain features that will convert these instruments into preferred shares of the FRFI and thus, in the event of liquidation of the FRFI, holders of the innovative instruments issued by the SPV will rank as preferred shareholders of the FRFI.

2) **Trust assets (asset-based only):** FRFIs should, at issuance and on at least a quarterly basis thereafter, provide prospectus-level disclosure of any material information that will assist investors in understanding the risks of the underlying trust assets, including, to the extent relevant: a breakdown of the assets by type (i.e., residential mortgage, mortgage backed security, etc.), the geographic distribution of the assets, information on the creditworthiness of obligors and guarantors, a description of collateral and a description of the average maturities of the assets.
D. Grandfathering

Principle #10: For purposes of Principle #1, FRFIs exceeding the “25 per cent limit” as of the date of the release of this Appendix can continue to include the excess in Tier 1 capital if the excess also existed at July 30, 1999, but may only do so until July 30, 2004 unless otherwise permitted in writing by the Superintendent. Excesses created subsequent to July 30, 1999 are not grandfathered for purposes of Principle #1 unless otherwise permitted in writing by the Superintendent. All existing innovative instruments and Tier 1-qualifying preferred shares must continue to be included in the computation of a FRFI’s position relative to the 15 per cent and 25 per cent limits going forward.
Chapter 3  Credit Risk – On-Balance Sheet Items

Credit risk is the risk of loss arising from the potential default of parties having a financial obligation to the insurer. Required capital takes account of the risk of actual default as well the risk of an insurer incurring losses due to deterioration in an obligor’s creditworthiness. The financial obligations to which credit risk factors apply include loans, debt instruments, reinsurance assets and receivables, derivatives and amounts due from policyholders, agents and brokers.

Required capital for on-balance sheet assets is calculated by applying credit risk factors to the balance sheet values of these assets. The same factors apply to assets backing qualifying participating and adjustable products, as the credit for participating and adjustable products is calculated in aggregate for all risks. Collateral and other forms of credit risk mitigation may be used to reduce capital required for credit risk. A credit risk factor of zero is applied to assets deducted from Available Capital. Investment income due and accrued is reported with, and receives the same factor as, the asset to which it relates.

Additionally, the credit risk factor relating to certain types of asset risks is calculated using techniques that are different from applying the regular factors:

1) Required capital for asset backed securities is described in section 3.4;

2) Required capital for repurchase, reverse repurchase and securities lending agreements is described in section 3.5;

3) Assets backing index-linked products do not receive credit risk factors. They are instead considered as part of the correlation calculation described in section 5.5; and

4) Assets held in segregated funds by an insurer’s policyholders are not subject to the requirements of this chapter.\footnote{If an insurer’s balance sheet includes an unleveraged mutual fund entity reported on a consolidated basis and the investment in the entity is not deducted from Available Capital, the requirements of section 6.5 apply to the portion of assets where returns on those assets are retained for the insurer’s own account. The requirements of Chapter 3 and sections 6.2-6.4 do not apply to the portion of assets where the insurer can demonstrate, to the satisfaction of the Superintendent, (1) ownership by policyholders or outside investors and (2) contractual obligation to pass through all returns, provided that the insurer tracks and distinguishes the mutual fund units held for its own account from those held by policyholders and outside investors.}

The calculation of required capital for off-balance sheet items is described in Chapter 4.

3.1. Credit Risk Required Capital for On-balance Sheet Assets

For the purpose of calculating the credit risk charge, balance sheet assets are valued at their balance sheet carrying amounts. [Exceptions to this principle are under review].
3.1.1. Use of ratings

Many of the factors in this chapter depend on the rating assigned to an asset or an obligor. In order to use a factor that is based on a rating, an insurer must meet all of the conditions specified in this section. Insurers may recognize credit ratings from the following rating agencies:

- DBRS;
- Moody’s Investors Service;
- Standard and Poor’s (S&P); or
- Fitch Rating Services.

An insurer must choose the rating agencies it intends to rely on and then use their ratings consistently for each type of claim. Insurers may not selectively choose assessments provided by different rating agencies.

Any rating used to determine a factor must be publicly available, i.e., the rating must be published in an accessible form and included in the rating agency’s transition matrix. Ratings that are made available only to the parties to a transaction or to a limited number of parties do not satisfy this requirement.

If an insurer uses multiple rating agencies and there is only one assessment for a particular claim, that assessment is used to determine the required capital for the claim. If there are two assessments from the rating agencies used by an insurer and these assessments differ, the insurer should apply the credit risk factor corresponding to the lower of the two ratings. If there are three or more assessments for a claim, the insurer should exclude one of the ratings that corresponds to the lowest credit risk factor, and then use the rating that corresponds to the lowest credit risk factor of those that remain (i.e., the insurer should use the second-highest rating from those available, allowing for multiple occurrences of the highest rating).

Where an insurer holds a particular securities issue that carries one or more issue-specific assessments, the credit risk factor for the claim is based on these assessments. Where an insurer’s claim is not an investment in a specifically rated security, the following principles apply:

1) In circumstances where the issuer has a specific rating for an issued debt security, but the insurer’s claim is not an investment in this particular security, a rating of BBB- or better on the rated security may only be applied to the insurer’s unrated claim if this unrated claim ranks pari passu or senior to the rated claim in all respects. If not, the credit rating of the rated claim cannot be used and the insurer’s unrated claim must be treated as an unrated obligation.

2) In circumstances where the issuer has an issuer rating, this assessment typically applies to senior unsecured claims on that issuer. Consequently, only senior unrated claims on that issuer will benefit from an investment-grade (BBB- or better) issuer assessment; other unassessed claims on the issuer will be treated as unrated. If either the issuer or one of its issues has a rating of BB+ or lower, this equivalent rating should be used to determine the capital charge for an unrated claim on the issuer.
3) Short-term assessments are deemed to be issue specific. They can only be used to determine the credit risk factor applied to claims arising from the rated facility. They cannot be generalized to other short-term claims, and in no event can a short-term rating be used to support a capital charge for an unrated long-term claim.

4) Where the credit risk factor for an unrated exposure is based on the rating of an equivalent exposure to the issuer, foreign currency ratings must be used for exposures in foreign currency. Canadian currency ratings, if separate, are only to be used to determine the risk factor for claims denominated in Canadian currency.

The following additional conditions apply to the use of ratings:

1) External assessments for one entity within a corporate group may not be used to determine the credit risk factors for other entities within the same group.

2) No rating may be inferred for an unrated entity based on assets that the entity possesses.

3) In order to avoid the double counting of credit enhancement factors, insurers may not recognize credit risk mitigation under sections 3.2 and 3.3 if the credit enhancement has already been reflected in the issue-specific rating.

4) An insurer may not recognize a rating if the rating is at least partly based on unfunded support (e.g., guarantees, credit enhancement or liquidity facilities) provided by the insurer itself or one of its affiliates.

5) Any assessment used must take into account and reflect the entire amount of credit risk exposure an insurer has with regard to all payments owed to it. In particular, if an insurer is owed both principal and interest, the assessment must fully take into account and reflect the credit risk associated with repayment of both principal and interest.

Insurers may not use unsolicited ratings in determining the risk factor for an asset, except where the asset is a sovereign exposure and a solicited rating is not available.

### 3.1.2. Credit risk factors based on external ratings

The credit risk factors in the table below apply to rated credit exposures that meet the criteria set out in section 3.1.1. The exposures for which these factors may be used include bonds, loans, mortgages, guarantees, and off-balance sheet exposures. However, these factors may not be used for reinsurance exposures and asset-backed securities. The factors depend on the rating and effective maturity of the exposure.
For effective maturities of 1 to 10 years, the factor is determined using linear interpolation between the nearest effective maturities in the above table. For effective maturities greater than 10 years, the factors for 10-year maturity are used. For effective maturities less than 1 year, the factors for 1-year maturity are used.

For an instrument subject to a determined cash flow schedule, effective maturity is defined as:

$$\text{Effective Maturity (M)} = \frac{\sum_t t \times CF_t}{\sum_t CF_t}$$

where $CF_t$ denotes the cash flows (principal, interest payments and fees) contractually payable by the borrower in period $t$.

If an insurer is not in a position to calculate the effective maturity of the contracted payments as noted above, it may use the maximum remaining time (in years) that the borrower is permitted to take to fully discharge its contractual obligation (principal, interest, and fees) under the terms of the loan agreement as the effective maturity. Normally, this will correspond to the nominal maturity of the instrument.

For derivatives subject to a master netting agreement, the weighted average maturity of the transactions should be used when calculating the effective maturity. Further, the notional amount of each transaction should be used for weighting the maturity.

When an insurer has multiple exposures to an entity or a connected group\(^\text{77}\), it should aggregate the exposures within each rating grade before calculating the effective maturity for the exposures.

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\(^{76}\) Refer to Appendix 3-1 for a table showing equivalent ratings from DBRS, Moody’s, S&P and Fitch.

\(^{77}\) As defined in Guideline B-2.
3.1.3. **Short-term investments**

<table>
<thead>
<tr>
<th>Rating</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.3%</td>
<td>Demand deposits, checks, acceptances and similar obligations that are drawn on regulated deposit-taking institutions subject to the solvency requirements of the Basel Committee on Banking Supervision (BCBS) and that have an original maturity of less than three months</td>
</tr>
<tr>
<td>0.3%</td>
<td>Rated A-1, P-1, F1 or R-1</td>
</tr>
<tr>
<td>0.6%</td>
<td>Rated A-2, P-2, F2 or R-2</td>
</tr>
<tr>
<td>2.5%</td>
<td>Rated A-3, P-3, F3 or R-3</td>
</tr>
<tr>
<td>10%</td>
<td>All other ratings, including non-prime and B or C ratings</td>
</tr>
</tbody>
</table>

3.1.4. **Entities eligible for a 0% factor**

Bonds, notes and other obligations of the following entities are eligible for a 0% credit risk factor:

1. The Government of Canada;
2. Sovereigns rated AA- or better and their central banks, provided that the rating applies to the currency in which an obligation is issued;
3. Unrated sovereigns with a country risk classification of 0 or 1, as assigned by Export Credit Agencies participating in the “Arrangement on Officially Supported Export Credits”, for obligations denominated in the sovereign’s domestic currency;
4. Canadian provincial and territorial governments;
5. Agents of the Canadian Government or a Canadian provincial or territorial government whose debts are, by virtue of their enabling legislation, direct obligations of the Crown in right of such federal or provincial government;
6. The Bank for International Settlements;
7. The International Monetary Fund;
8. The European Community and the European Central Bank;
9. The following multilateral development banks:
   a. International Bank for Reconstruction and Development (IBRD);
   b. International Finance Corporation (IFC);
   c. Asian Development Bank (ADB);

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78 Sovereign obligations rated lower than AA- may not receive a factor of 0%, and are instead subject to the factor requirements in section 3.1.5.
79 The consensus country risk classification is available on the OECD’s web site (http://www.oecd.org) in the Export Credit Arrangement web page of the Trade Directorate.
d. African Development Bank (AfDB);
e. European Bank for Reconstruction and Development (EBRD);
f. Inter-American Development Bank (IADB);
g. European Investment Bank (EIB);
h. European Investment Fund (EIF);
i. Nordic Investment Bank (NIB);
j. Caribbean Development Bank (CDB);
k. Islamic Development Bank (IDB);
l. Council of Europe Development Bank (CEDB);
m. The International Finance Facility for Immunisation (IFFI);

10. Public sector entities in jurisdictions outside Canada where:
   a. The jurisdiction’s sovereign rating is AA- or better, and
   b. The national bank supervisor in the jurisdiction of origin permits banks under its supervision to use a risk weight of 0% for the public sector entity under the Basel Framework.

11. Qualifying central counterparties\(^80\) to derivatives and securities financing transactions.

### 3.1.5. Unrated claims

For unrated commercial paper and similar short-term facilities having an original maturity of less than one year, a credit risk factor corresponding to a rating of A-3, P-3, F3 or R-3 must be used, unless the issuer has a rated short-term facility outstanding with an assessment that warrants a capital charge of 10%. If an issuer has such a short-term facility outstanding, a credit risk factor of 10% must be used for all unrated debt claims on the issuer, whether long term or short term, unless recognized credit risk mitigation techniques (reference sections 3.2 and 3.3) are being used for such claims.

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\(^80\) A central counterparty (CCP) is an entity that interposes itself between counterparties to contracts traded within one or more financial markets, becoming the legal counterparty so that it is the buyer to every seller and the seller to every buyer. A qualifying central counterparty (QCCP) is an entity that is licensed to operate as a central counterparty (including a licence granted by way of confirming and exemption), and is permitted by the appropriate regulator/overseer to operate as such with respect to the products offered. This is subject to the provision that the CCP is based and prudentially supervised in a jurisdiction where the relevant regulator/overseer has established, and publicly indicated that it applies to the CCP on an on-going basis, domestic rules and regulations that are consistent with the CPSS-IOSCO Principles for Financial Market Infrastructures. In order to qualify for a 0% factor, the CCP must mitigate its own exposure to credit risk by requiring all participants in its arrangements to fully collateralize their obligations to the CCP on a daily basis. The 0% factor may not be used in respect of transactions that have been rejected by the CCP, nor in respect of equity investments, guarantee fund or default fund obligations an insurer may have to a CCP. Where the CCP is in a jurisdiction that does not have a CCP regulator applying the Principles to the CCP, OSFI may make the determination of whether the CCP meets this definition.
If it is not possible to infer a rating for a bond or loan using the rules in section 3.1.1, the risk factor to be used is 6%. This factor also applies to derivative contracts or other capital markets transactions for which a rating cannot be inferred.

3.1.6. Mortgages

An insurer may use a ratings-based factor from section 3.1.2 for a mortgage if the mortgage meets the criteria for use of a rating set out in section 3.1.1. For other mortgages the following factors apply:

<table>
<thead>
<tr>
<th>Factor</th>
<th>Mortgage Category</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>Mortgages that are guaranteed by Canada Mortgage and Housing Corporation (CMHC), or that are otherwise insured under the NHA or equivalent provincial mortgage insurance program</td>
</tr>
<tr>
<td>See below</td>
<td>Mortgages guaranteed by private sector mortgage insurers</td>
</tr>
<tr>
<td>2%</td>
<td>Qualifying residential mortgage loans and qualifying home equity lines of credit</td>
</tr>
<tr>
<td>6%</td>
<td>Commercial mortgage loans (office, retail stores, industrial, hotel, other)</td>
</tr>
<tr>
<td>6%</td>
<td>Non-qualifying residential mortgage loans, and non-qualifying home equity lines of credit</td>
</tr>
<tr>
<td>10%</td>
<td>Mortgages secured by undeveloped land (e.g., construction financing), other than land used for agricultural purposes or the production of minerals. A property recently constructed or renovated is considered as under construction until it is completed and at least 80% leased.</td>
</tr>
<tr>
<td>10%</td>
<td>The portion of a mortgage that is based on an increase in value occasioned by a change in use</td>
</tr>
<tr>
<td>18%</td>
<td>Impaired and restructured mortgages, net of write-downs and individual allowances</td>
</tr>
</tbody>
</table>

Where a mortgage is comprehensively insured by a private sector mortgage insurer that has a backstop guarantee provided by the Government of Canada (for example, a guarantee made pursuant to the Protection of Residential Mortgage or Hypothecary Insurance Act), insurers should recognize the risk-mitigating effect of the counter-guarantee by reporting the portion of the exposure that is covered by the Government of Canada backstop as if this portion were directly guaranteed by the Government of Canada. The remainder of the exposure is treated as an exposure to the mortgage guarantor in accordance with the rules set out in section 3.3.

Residential mortgage loans and home equity lines of credit must meet one of the following criteria in order to qualify for a 2% factor:

1. the loan or line of credit is secured by a first mortgage on an individual condominium residence or one- to four-unit residential dwelling, is made to a person(s) or guaranteed by a person(s), is not more than 90 days past due, and does not exceed a loan-to-value ratio of 80%; or

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81 Mortgage-backed securities, collateralized mortgage obligations and other asset backed securities are not subject to this section and are covered in section 3.4.
2. the loan or line of credit is a first or junior collateral mortgage on an individual condominium residence or one- to four-unit residential dwelling, is made to a person(s) or guaranteed by a person(s), and no party other than the insurer holds a senior or intervening lien on the property to which the collateral mortgage applies. Further, the loan or line of credit is no more than 90 days past due, and all of the mortgages held by the insurer and secured by the same property do not, collectively, exceed a loan-to-value ratio of 80%;

Investments in hotels, time-shares or similar shared properties do not qualify for a 2% factor.

3.1.7. Assets receivable and recoverable

<table>
<thead>
<tr>
<th>Factor</th>
<th>Assets Receivable and Recoverable</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.7%</td>
<td>Receivables under arrangements deemed to constitute registered reinsurance</td>
</tr>
<tr>
<td>0.7%</td>
<td>Reinsurance premiums due from federally regulated insurers and approved reinsurers</td>
</tr>
<tr>
<td>2.5%</td>
<td>Reinsurance assets arising from arrangements deemed to constitute registered reinsurance</td>
</tr>
<tr>
<td>5%</td>
<td>Receivables outstanding less than 60 days, including receivables arising from unregistered reinsurance</td>
</tr>
<tr>
<td>10%</td>
<td>Receivables outstanding 60 days or more, including receivables arising from unregistered reinsurance</td>
</tr>
</tbody>
</table>

Refer to section 10.2 for the definitions of registered and unregistered reinsurance. The exposure amount used to calculate the credit risk requirement for reinsurance assets arising from arrangements deemed to constitute registered reinsurance may be reduced by:

1. the funds held by the ceding insurer for the exclusive benefit of the ceding insurer (e.g. funds withheld reinsurance) to secure the payment to the ceding insurer by the reinsurer of the reinsurer's share of any loss or liability for which the reinsurer is liable under the reinsurance agreement; and

2. any other liabilities of the ceding insurer due to the reinsurer for which the ceding insurer has a legal and contractual right of setoff against the amount recoverable from the reinsurer.

Negative reinsurance assets may be offset by positive reinsurance assets for each reinsurer, and total reinsurance assets by reinsurer are floored at zero. Collateral and letters of credit posted by reinsurers under arrangements deemed to constitute registered reinsurance may be recognized provided the conditions outlined in sections 3.2 and 3.3 are met.
3.1.8. Other items

<table>
<thead>
<tr>
<th>Factor</th>
<th>Other Items</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>Cash held on the insurer’s own premises</td>
</tr>
<tr>
<td>0%</td>
<td>Unrealized gains and accrued receivables on forwards, swaps, purchased options and similar derivative contracts where they have been included in the off-balance sheet calculation</td>
</tr>
<tr>
<td>0%</td>
<td>Any assets deducted from Available Capital, including investments in controlled non-life financial corporations reported using the equity method of accounting per section 1.3, goodwill, intangible assets, and deferred tax assets</td>
</tr>
<tr>
<td>0%</td>
<td>Instalment premiums receivable (not yet due)</td>
</tr>
<tr>
<td>5%</td>
<td>Premiums outstanding less than 60 days, including instalment premiums receivable</td>
</tr>
<tr>
<td>10%</td>
<td>Premiums outstanding more than 60 days, including instalment premiums receivable</td>
</tr>
<tr>
<td>10%</td>
<td>Carrying value of miscellaneous items (e.g., agent's debit balances, furniture and fixtures, prepaid expenses)</td>
</tr>
<tr>
<td>10%</td>
<td>The amount of available refunds from defined benefit pension plan surplus assets included in Tier 1</td>
</tr>
<tr>
<td>10%</td>
<td>Instruments or investments that are not specifically identified in sections 3.1, 5.2, 5.3 or 5.4.</td>
</tr>
<tr>
<td>20%</td>
<td>Assets classified as held for sale (HFS)(^2)</td>
</tr>
<tr>
<td>25%</td>
<td>Deferred tax assets not deducted from Available Capital</td>
</tr>
</tbody>
</table>

\(^2\) An insurer may elect to use the 20% factor, or it may alternatively elect to use a look-through approach. If the insurer elects to use the 20% factor, the associated liabilities that are held for sale must be included in the determination of required capital. Under the look-through approach, assets held for sale are reclassified on the balance sheet according to their nature. For example, real estate held for sale may be reclassified as a real estate investment or a disposal group classified as held for sale may be re-consolidated. If this alternate method is elected, any write-down made as a result of re-measuring the assets at the lower of carrying amount and fair value less costs to sell should not be reversed upon reclassification or re-consolidation; the write-down should continue to be reflected in the retained earnings used to determine Available Capital. The write-down amount should be applied to the reclassified/re-consolidated assets in a manner consistent with the basis for the write-down of the HFS assets. If the insurer applies this alternate method for a disposal group, OSFI Lead Supervisor may request a pro-forma LICAT return that includes the impact of the sale. The pro-forma LICAT calculation should include all items affecting the results (e.g. the projected gain or loss on sale, and the projected impact of other related transactions and agreements that may occur in parallel) irrespective of whether they have been recognized at period-end. The insurer may also be requested to provide OSFI with an impact analysis identifying the significant drivers of the LICAT differences with and without the disposal group, including the impact of sale-related subsequent agreements and transactions.
3.1.9. **Leases**

3.1.9.1. **Lessee**

Where a life insurer is the lessee under an operating lease, no capital is required for the leased asset. However, under a finance lease, the capital requirement for the asset held on the balance sheet is based on the underlying property leased per section 5.3.

3.1.9.2. **Lessor**

A credit risk factor of 0% is applied to any lease that is a direct obligation of an entity listed in section 3.1.4 that is eligible for a 0% credit risk factor. A 0% factor may also be used for a lease that is guaranteed by such an entity if the guarantee meets the criteria for recognition under section 3.3. The 0% factor may not be used for leases where an insurer does not have direct recourse to an entity eligible for a 0% factor under the terms of the obligation, even if such an entity is the underlying lessee.

For finance leases, if the lease is secured only by equipment, a 6% credit risk factor applies. If the lease is also secured by the general credit of the lessee and the lease is rated or a rating for the lease can be inferred under section 3.1.1, the factor will be based on this rating. Any rating used must be applicable to the direct obligor of the instrument held by the insurer (or the direct guarantor, if recognition is permitted under section 3.3), which may be different from the underlying lessee. If no rating can be inferred, the credit risk factor is 6%.

3.1.10. **Impaired and restructured obligations**

The charges for impaired and restructured obligations in this section replace the charges that would otherwise apply to a performing asset. They are to be applied instead of (not in addition to) the charge that was required for the asset before it became impaired or was restructured.

A factor of 18% applies to the unsecured portion of any asset (i.e., the portion not secured by collateral or guarantees) that is impaired, has been restructured, or for which there is reasonable doubt about the timely collection of the full amount of principal or interest (including any asset that is contractually more than 90 days in arrears), and that does not carry an external rating from an agency listed in section 3.1.1. This factor is applied to the net carrying amount of the asset on the balance sheet, defined as the principal balance of the obligation net of write-downs and individual allowances. For the purpose of defining the secured portion of a past due obligation, eligible collateral and guarantees are the same as in sections 3.2 and 3.3.

An asset is considered to have been restructured when the insurer, for economic or legal reasons related to the obligor's financial difficulties, grants a concession that it would not otherwise have considered. The 18% factor will continue to apply to restructured obligations until cash flows have been collected for a period of at least one year in accordance with the terms of the restructuring.
3.1.11. Credit protection provided

If an insurer has guaranteed a debt security (e.g., through the sale of a credit derivative), it should hold the same amount of capital as if it held the security directly. Such exposures are reported as off-balance sheet instruments in the capital test.

Where an insurer provides credit protection on a securitisation tranche rated BBB- or higher via a first-to-default credit derivative on a basket of assets, required capital is determined as the notional amount of the derivative times the credit risk factor corresponding to the tranche’s rating, provided that this rating represents an assessment of the underlying tranche that does not take account of any credit protection provided by the insurer. If the underlying product does not have an external rating, the insurer may either 1) deduct the full notional amount of the derivative from available capital as a first loss position, or it may 2) calculate the required capital as the notional amount times the sum of the credit risk factors for each asset in the basket. In the case of a second-to-default credit derivative where the underlying product does not have an external rating and the insurer is using the second summation approach, the insurer may exclude the asset in the basket having the lowest credit risk factor.

3.2. Collateral

A collateralized transaction is one in which:

1. an insurer has a credit exposure or potential credit exposure; and 
2. that credit exposure or potential credit exposure is hedged in whole or in part by collateral posted by a counterparty or by a third party on behalf of the counterparty.

The following standards must be met before capital relief will be granted in respect of any form of collateral:

1. The effects of collateral may not be double counted. Therefore, insurers may not recognize collateral on claims for which an issue-specific rating is used that already reflects that collateral. All criteria in section 3.1.1 around the use of ratings apply to collateral.

2. All documentation used in collateralized transactions must be binding on all parties and legally enforceable in all relevant jurisdictions. Insurers must have conducted sufficient legal review to verify this and have a well-founded legal basis to reach this conclusion, and undertake such further review as necessary to ensure continuing enforceability.

3. The legal mechanism by which collateral is pledged or transferred must provide the insurer the right to liquidate or take legal possession of it in a timely manner in the event of the default, insolvency or bankruptcy (or one or more otherwise-defined credit events set out in the transaction documentation) of the counterparty (and, where applicable, of

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83 In this section, “counterparty” is used to denote a party to whom an insurer has an on- or off-balance sheet credit exposure or a potential credit exposure. That exposure may, for example, take the form of a loan of cash or securities (where the counterparty would traditionally be called the borrower), of securities posted as collateral, of a commitment, or of an exposure under an OTC derivatives contract.
the custodian holding the collateral). Furthermore, insurers must take all necessary steps to fulfil those requirements under the law applicable to the insurer’s interest in the collateral for obtaining and maintaining an enforceable security interest (e.g., by registering it with a registrar, or for exercising a right to net or set off in relation to title transfer collateral).

4. The credit quality of the counterparty and the value of the collateral must not have a material positive correlation. For example, securities issued by the counterparty or by any related group entity are ineligible.

5. Insurers must have clear and robust procedures for the timely liquidation of collateral to ensure that any legal conditions required for declaring the default of the counterparty and liquidating the collateral are observed, and that collateral can be liquidated promptly.

6. Where collateral is held by a custodian, insurers must take reasonable steps to ensure that the custodian segregates the collateral from its own assets.

Collateralized transactions are classified according to whether they are 1) policy loans, 2) capital markets transactions, or 3) other secured lending arrangements. The category of capital markets transactions includes repo-style transactions (e.g., repos and reverse repos, securities lending and borrowing) and other capital markets driven transactions (e.g., OTC derivatives and margin lending).

3.2.1. Policy loans

Loans for which insurance policies are provided as collateral will receive a 0% credit risk factor if all of the following conditions are met:

1. Both the loan and the policy provided as collateral are issued by and remain held by the insurer;
2. The term of the loan does not exceed the term of the policy provided as collateral;
3. The insurer has the legal right and intention of offset in the event the loan goes into default or the policy is cancelled;
4. Amounts owing under the loan, including any unpaid interest, are never greater than the proceeds available under the collateral; and
5. The policy will be surrendered if the loan balance exceeds the proceeds available under the collateral.

If any of these conditions are not met, a credit risk factor of 10% will be applied to the loan.

3.2.2. Eligible financial collateral

The following collateral instruments may be recognized for secured lending and capital markets transactions:

1. Debt securities rated by a recognized rating agency (section 3.1.1) where these securities are:
a. rated BB- or better and issued by an entity eligible for a 0% bond factor;

b. rated BBB- or better and issued by other entities (including banks, insurance companies, and securities firms); or

c. short-term and rated A-3/P-3 or better.

2. Debt securities not rated by a recognized rating agency where:

a. the securities are issued by a Canadian bank whose equity is listed on a recognized exchange; and

b. the original maturity of the securities is less than one year; and

c. the securities are classified as senior debt; and

d. all debt issues by the issuing bank having the same seniority as the securities and that have been rated by a recognized rating agency are rated at least BBB- or A-3/P-3.

3. Equities and convertible bonds that are included in a main index.


5. Mutual funds where:

a. a price for the units is publicly quoted daily; and

b. the mutual fund is limited to investing in the instruments listed above.

Additionally, the following collateral instruments may be recognized for capital markets transactions:

6. Equities and convertible bonds that are not included in a main index but that are listed on a recognized exchange, and mutual funds that include such equities and bonds.

For collateral to be recognized in a secured lending transaction, it must be pledged for at least the life of the loan. For collateral to be recognized in a capital markets transaction, it must be secured in a manner that precludes release of the collateral unless warranted by market movements, the transaction is settled, or the collateral is replaced by new collateral of equal or greater value.

3.2.3. Secured lending

Collateral received in secured lending must be re-valued on a mark-to-market basis at least every six months. The market value of collateral that is denominated in a currency different from that of the loan must be reduced by 30%. The portion of a loan that is collateralized by the market value of eligible financial collateral will receive the credit risk factor applicable to the collateral

84 However, the use of derivative instruments by a mutual fund solely to hedge investments listed as eligible financial collateral shall not prevent units in that mutual fund from being recognized as eligible financial collateral.
instrument, subject to a minimum of 0.375% with the exception noted below. The remainder of the loan will be assigned the risk factor appropriate to the counterparty.

A credit risk factor of 0% may be used for a secured lending transaction if:

1. the loan and the collateral are denominated in the same currency; and
2. the collateral consists entirely of securities eligible for a 0% credit risk factor; and
3. the market value of the collateral is at least 25% greater than the carrying value of the loan.

3.2.4. Capital markets transactions

3.2.4.1. Introduction

When taking collateral for a capital markets transaction, insurers must calculate an adjusted exposure amount to a counterparty for capital adequacy purposes in order to take account of the effects of that collateral. Using haircuts, insurers adjust both the amount of 1) the exposure to the counterparty and 2) the value of any collateral received in support of the counterparty’s obligations. Such adjustments are made to take into account possible future fluctuations in the value of the exposure or the collateral received\(^{85}\) resulting from market movements. This will produce volatility-adjusted amounts for both the exposure and the collateral. Unless either side of the transaction is in cash, the volatility-adjusted amount for the exposure will be higher than the exposure itself, and for the collateral it will be lower. Additionally, where the exposure and collateral are held in different currencies, an additional downwards adjustment must be made to the volatility-adjusted collateral amount to take account of possible future fluctuations in exchange rates.

Where the volatility-adjusted exposure amount is greater than the volatility-adjusted collateral amount (including any further adjustment for foreign exchange risk), required capital is calculated as the difference between the two multiplied by the credit risk factor appropriate to the counterparty.

Section 3.2.4.2 describes the size of the individual haircuts used. These haircuts depend on the type of instrument and the type of transaction. The haircut amounts are then scaled using a square root of time formula depending on the frequency of remargining. Section 3.2.4.3 sets out conditions under which insurers may use zero haircuts for certain types of repo-style transactions involving government bonds. Section 3.2.4.4 describes the treatment of master netting agreements.

3.2.4.2. Calculation of the capital requirement

For a collateralized capital markets transaction, the exposure amount after risk mitigation is calculated as follows:

\(^{85}\) The exposure amount may vary where, for example, securities are being lent.
\[ E^* = \max \left( 0, \left[ E \times (1 + H_e) - C \times (1 - H_c - H_{fx}) \right] \right) \]

where:

- \( E^* \) is the exposure value after risk mitigation
- \( E \) is the current value of the exposure
- \( H_e \) is the haircut appropriate to the exposure
- \( C \) is the current value of the collateral received
- \( H_c \) is the haircut appropriate to the collateral
- \( H_{fx} \) is the haircut appropriate for currency mismatch between the collateral and the exposure

The exposure amount after risk mitigation is multiplied by the credit risk factor appropriate to the counterparty to obtain the charge for the collateralized transaction.

When the collateral consists of a basket of assets, the haircut to be used on the basket is the average of the haircuts applicable to the assets in the basket, where the average is weighted according to the market values of the assets in the basket.

The following are the standard haircuts, expressed as percentages:

<table>
<thead>
<tr>
<th>Issue rating for debt securities</th>
<th>Residual Maturity</th>
<th>Securities eligible for a 0% credit risk factor</th>
<th>Other issuers</th>
<th>Securitizations</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA to AA-/A-1</td>
<td>\leq 1 year</td>
<td>0.5</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td></td>
<td>&gt; 1 year, \leq 3 years</td>
<td>2</td>
<td>3</td>
<td>8</td>
</tr>
<tr>
<td></td>
<td>&gt; 3 years, \leq 5 years</td>
<td>4</td>
<td>4</td>
<td>8</td>
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<td></td>
<td>&gt; 5 years, \leq 10 years</td>
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<td>6</td>
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<td></td>
<td>&gt; 10 years</td>
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<td>16</td>
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<tr>
<td>A+ to BBB-A-2/A-3/P-3</td>
<td>\leq 1 year</td>
<td>1</td>
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<td>Unrated bank debt securities</td>
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<td>&gt; 3 years, \leq 5 years</td>
<td>6</td>
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<tr>
<td></td>
<td>&gt; 5 years, \leq 10 years</td>
<td>6</td>
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<td>24</td>
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<td></td>
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<tr>
<td>BB+ to BB-</td>
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<td>Not eligible</td>
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<tr>
<td>Main index equities and convertible bonds, and gold</td>
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<tr>
<td>Other equities and convertible bonds listed on a recognized exchange</td>
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<tr>
<td>Mutual funds</td>
<td>Highest haircut applicable to any security in which the fund can invest</td>
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<td></td>
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</table>
The standard haircut for currency risk where the exposure and collateral are denominated in different currencies is 8%.

For transactions in which an insurer lends cash, the haircut applied to the exposure will be zero. For transactions in which an insurer lends non-eligible instruments (e.g., non-investment grade corporate debt securities), the haircut applied to the exposure will be the same as that applied to an equity that is traded on a recognized exchange but not part of a main index.

For collateralized OTC derivatives transactions, the $E^* \times (1 + H_x)$ term representing the volatility-adjusted exposure amount before risk mitigation, will be replaced by the exposure amount for the derivatives transaction calculated using the current exposure method as described in Chapter 10. This is either the positive replacement cost of the transaction plus the add-on for potential future exposure, or, for a series of contracts eligible for netting, the net replacement cost of the contracts plus $A_{Net}$ (see section 4.2.1 for definition). The haircut for currency risk will be applied when there is a mismatch between the collateral currency and the settlement currency, but no additional adjustments beyond a single haircut for currency risk will be required if there are more than two currencies involved in collateral, settlement and exposure measurement.

All of the standard haircuts listed above must be scaled by a square root of time factor according to the following formula:

$$H = S \times \sqrt{\frac{N + T - 1}{10}}$$

where:

- $H$ represents any of the haircuts used in calculating the exposure amount after risk mitigation;
- $S$ is the standard haircut specified above for the exposure or collateral;
- $N$ is the actual number of business days between remargining under the transaction; and
- $T$ is equal to 5 for repo-style transactions, and 10 for all other capital markets transactions.

3.2.4.3. Conditions for using zero haircuts

For repo-style transactions that satisfy the following conditions, and for which the counterparty is a core market participant as defined below, insurers may apply haircuts of zero to both the exposure and collateral:

1. Both the exposure and the collateral are cash or securities issued by the Government of Canada or a provincial or territorial government in Canada;

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86 An insurer may use a haircut of zero for cash received as collateral if the cash is held in Canada in the form of a deposit at one of the insurer’s banking subsidiaries.
2. Both the exposure and the collateral are denominated in the same currency;
3. Either the transaction is overnight or both the exposure and the collateral are marked to market daily and are subject to daily remargining;
4. Following a counterparty’s failure to remargin, the time that is required between the last mark to market before the failure to remargin and the liquidation\(^{87}\) of the collateral is considered to be no more than four business days;
5. The transaction is settled across a settlement system proven for that type of transaction;
6. The documentation covering the agreement is standard market documentation for repo-style transactions in the securities concerned;
7. The transaction is governed by documentation specifying that if the counterparty fails to satisfy an obligation to deliver cash or securities or to deliver margin or otherwise defaults, then the transaction is immediately terminable; and
8. Upon any default event, regardless of whether the counterparty is insolvent or bankrupt, the insurer has the unfettered, legally enforceable right to immediately seize and liquidate the collateral for its benefit.

Core market participants include the following entities:
1. Sovereigns, central banks and public sector entities;
2. Banks and securities firms;
3. Other financial companies (including insurance companies) rated AA- or better;
4. Regulated mutual funds that are subject to capital or leverage requirements;
5. Regulated pension funds; or
6. Recognized clearing organizations.

3.2.4.4. **Treatment of repo-style transactions covered under master netting agreements**

The effects of bilateral netting agreements covering repo-style transactions will be recognized on a counterparty-by-counterparty basis if the agreements are legally enforceable in each relevant jurisdiction upon the occurrence of an event of default and regardless of whether the counterparty is insolvent or bankrupt. In addition, netting agreements must:

1. provide the non-defaulting party the right to terminate and close out in a timely manner all transactions under the agreement upon an event of default, including in the event of insolvency or bankruptcy of the counterparty;
2. provide for the netting of gains and losses on transactions (including the value of any collateral) terminated and closed out under it so that a single net amount is owed by one party to the other;
3. allow for the prompt liquidation or setoff of collateral upon the event of default; and

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\(^{87}\) This does not require an insurer to always liquidate the collateral but rather to have the capability to do so within the given time frame.
4. be, together with the rights arising from the provisions required above, legally enforceable in each relevant jurisdiction upon the occurrence of an event of default and regardless of the counterparty’s insolvency or bankruptcy.

For repo-style transactions included within a master netting agreement, the exposure amount after risk mitigation will be calculated as follows:

\[ E^* = \max \left( 0, \left[ \sum E - \sum C + \sum (E_s \times H_s) + \sum (E_{fx} \times H_{fx}) \right] \right) \]

where:
- \( E^* \) is the exposure value after risk mitigation;
- \( E \) is the current value of the exposure;
- \( C \) is the current value of the collateral received;
- \( E_s \) is the absolute value of the net position in each security covered under the agreement;
- \( H_s \) is the haircut appropriate to \( E_s \);
- \( E_{fx} \) is the absolute value of the net position in each currency under the agreement that is different from the settlement currency; and
- \( H_{fx} \) is the haircut appropriate for currency mismatch.

All other rules regarding the calculation of haircuts in section 3.2.4.2 equivalently apply for insurers using bilateral netting agreements for repo-style transactions.

3.3. Guarantees and credit derivatives

Where guarantees\(^88\) or credit derivatives are direct, explicit, irrevocable and unconditional, and insurers fulfil certain minimum operational conditions relating to risk management processes, they are allowed to take account of such credit protection in calculating capital requirements. A substitution approach is used: the protected portion of a counterparty exposure is assigned the credit risk factor of the guarantor or protection provider, while the uncovered portion retains the credit risk factor of the underlying counterparty. Thus, only guarantees issued by or protection provided by entities with a lower risk factor than the counterparty will lead to reduced capital requirements. A range of guarantors and protection providers is recognized.

3.3.1. Operational requirements common to guarantees and credit derivatives

The effects of credit protection may not be double counted. Therefore, no capital recognition will be given to credit protection on claims for which an issue-specific rating is used that already

\(^88\) Letters of credit for which an insurer is the beneficiary are included within the definition of guarantees, and receive the same capital treatment.
reflects that protection. All criteria in section 3.1.1 around the use of ratings remain applicable to guarantees and credit derivatives.

The following conditions must be satisfied in order for a guarantee (counter-guarantee) or credit derivative to be recognized in calculating required capital:

1. It represents a direct claim on the protection provider and is explicitly referenced to a specific exposure or a pool of exposures, so that the extent of the cover is clearly defined and incontrovertible;

2. Other than non-payment by a protection purchaser of money due in respect of the credit protection contract, it is irrevocable; there must be no clause in the contract that allows the protection provider to unilaterally cancel the credit cover or that increases the effective cost of cover as a result of deteriorating credit quality in the hedged exposure\(^{89}\);

3. It is unconditional; there is no clause in the protection contract outside the direct control of the insurer that could prevent the protection provider from being obliged to pay out in a timely manner in the event that the original counterparty fails to make the payment(s) due; and

4. All documentation used for documenting guarantees and credit derivatives is binding on all parties and legally enforceable in all relevant jurisdictions. Insurers must have conducted sufficient legal review, documented in a legal opinion supporting this conclusion, to establish this and undertake such further review as necessary to ensure continuing enforceability\(^{90}\).

### 3.3.2. Additional operational requirements for guarantees

The following conditions must be satisfied in order for a guarantee to be recognized:

a) On the qualifying default/non-payment of the counterparty, the insurer may in a timely manner pursue the guarantor for any monies outstanding under the documentation governing the transaction. The guarantor may make one lump sum payment of all monies under such documentation to the insurer, or the guarantor may assume the future payment obligations of the counterparty covered by the guarantee. The insurer must have the right to receive any such payments from the guarantor without first having to take legal action in order to pursue the counterparty for payment;

b) The guarantee is an explicitly documented obligation assumed by the guarantor; and

c) Except as noted in the following sentence, the guarantee covers all types of payments the underlying obligor is expected to make under the documentation governing the transaction, for example notional amount, margin payments, etc. Where a guarantee covers payment of principal only, interest and other uncovered payments will be treated as an unsecured amount in accordance with section 3.3.5.

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\(^{89}\) The irrevocability condition does not require that the credit protection and the exposure be maturity matched. However, it does require that the maturity agreed \textit{ex ante} cannot be reduced \textit{ex post} by the protection provider.

\(^{90}\) The documented legal opinion must be available for review by OSFI, upon request.
3.3.3. Additional operational requirements for credit derivatives

The following conditions must be satisfied in order for a credit derivative contract to be recognized:

a) The credit events specified by the contracting parties must, at a minimum, cover:

1) failure to pay the amounts due under terms of the underlying obligation that are in effect at the time of such failure (with a grace period that is closely in line with the grace period in the underlying obligation);

2) bankruptcy, insolvency or inability of the obligor to pay its debts, or its failure or admission in writing of its inability generally to pay its debts as they become due, and analogous events; and

3) restructuring of the underlying obligation involving forgiveness or postponement of principal, interest or fees that results in a credit loss event (i.e., charge-off, specific provision or other similar debit to the profit and loss account).

b) If the credit derivative covers obligations that do not include the underlying obligation, section g) below governs whether the asset mismatch is permissible.

c) The credit derivative shall not terminate prior to expiration of any grace period required for a default on the underlying obligation to occur as a result of a failure to pay.

d) Credit derivatives allowing for cash settlement are recognized for capital purposes insofar as a robust valuation process is in place in order to estimate loss reliably. There must be a clearly specified period for obtaining post-credit event valuations of the underlying obligation. If the reference obligation specified in the credit derivative for purposes of cash settlement is different than the underlying obligation, section g) below governs whether the asset mismatch is permissible.

e) If the protection purchaser’s right/ability to transfer the underlying obligation to the protection provider is required for settlement, the terms of the underlying obligation must provide that any required consent to such transfer may not be unreasonably withheld.

f) The identity of the parties responsible for determining whether a credit event has occurred must be clearly defined. This determination must not be the sole responsibility of the protection seller. The protection buyer must have the right/ability to inform the protection provider of the occurrence of a credit event.

g) A mismatch between the underlying obligation and the reference obligation under the credit derivative (i.e., the obligation used for purposes of determining cash settlement value or the deliverable obligation) is permissible if (1) the reference obligation ranks pari passu with or is junior to the underlying obligation, and (2) the underlying obligation and reference obligation share the same obligor (i.e., the same legal entity) and legally enforceable cross-default or cross-acceleration clauses are in place.

h) A mismatch between the underlying obligation and the obligation used for purposes of determining whether a credit event has occurred is permissible if (1) the latter obligation ranks pari passu with or is junior to the underlying obligation, and (2) the underlying obligation and reference obligation share the same obligor (i.e., the same legal entity) and legally enforceable cross-default or cross-acceleration clauses are in place.
Only credit default swaps and total return swaps that provide credit protection equivalent to guarantees will be eligible for recognition. Where an insurer buys credit protection through a total return swap and records the net payments received on the swap as net income, but does not record offsetting deterioration in the value of the asset that is protected (either through reductions in fair value or by increasing provisions), the credit protection will not be recognized.

Other types of credit derivatives are not eligible for recognition.

3.3.4. Eligible guarantors and protection providers

Insurers may recognize credit protection given by the following entities:

1) entities eligible for a 0% credit risk factor under section 3.1.4;
2) externally rated public sector entities, banks and securities firms with a lower credit risk factor than that of the counterparty; and
3) other entities that currently are externally rated BBB- or better, and that were externally rated A- or better at the time the credit protection was provided. This includes credit protection provided by parent, subsidiary and affiliate companies of an obligor when they have a lower credit risk factor than that of the obligor.

However, an insurer may not recognize a guarantee or credit protection on an exposure to a third party when the guarantee or credit protection is provided by a related party (parent, subsidiary or affiliate) of the insurer. This treatment follows the principle that guarantors within a corporate group are not a substitute for capital.

3.3.5. Capital treatment

The protected portion of a counterparty exposure is assigned the capital factor of the protection provider. The uncovered portion of the exposure is assigned the factor of the underlying counterparty.

Where the amount guaranteed, or against which credit protection is held, is less than the amount of the exposure, and the secured and unsecured portions are of equal seniority (i.e., the insurer and the guarantor share losses on a pro-rata basis), capital relief will be afforded on a proportional basis, so that the protected portion of the exposure will receive the treatment applicable to eligible guarantees and credit derivatives, and the remainder will be treated as unsecured. Where an insurer transfers a portion of the risk of an exposure in one or more tranches to a protection seller or sellers and retains some level of risk, and the risk transferred and the risk retained are of different seniority, insurers may obtain credit protection for the senior tranches (e.g., second-loss position) or the junior tranches (e.g., first-loss position). In this case, the rules as set out in Guideline B-5: Asset Securitization will apply.

Materiality thresholds on payments below which no payment is made in the event of loss are equivalent to retained first-loss positions, and must be deducted from Available Capital/Margin as a first loss position under section 2.1.2.10.
3.3.6. Currency mismatches

Where the credit protection is denominated in a currency different from that in which the exposure is denominated, the amount of the exposure deemed to be protected is 70% of the nominal amount of the credit protection, converted at current exchange rates.

3.3.7. Maturity mismatches

A maturity mismatch occurs when the residual maturity of the credit protection is less than that of the underlying exposure. If there is a maturity mismatch and the credit protection has an original maturity shorter than one year, the protection may not be recognized. As a result, the maturity of protection for exposures with original maturities less than one year must be matched to be recognized. Additionally, credit protection with a residual maturity of three months or less may not be recognized if there is a maturity mismatch. Credit protection will be partially recognized in other cases where there is a maturity mismatch.

The maturity of the underlying exposure and the maturity of the credit protection should both be measured conservatively. The effective maturity of the underlying exposure is measured as the longest possible remaining time before the counterparty is scheduled to fulfil its obligation, taking into account any applicable grace period. For the credit protection, embedded options that may reduce the term of the protection will be taken into account so that the shortest possible effective maturity is used. Where a call is at the discretion of the protection seller, the maturity will always be at the first call date. If the call is at the discretion of the insurer buying protection but the terms of the arrangement at origination contain a positive incentive for the insurer to call the transaction before contractual maturity, the remaining time to the first call date will be deemed to be the effective maturity. For example, where there is a step-up cost in conjunction with a call feature or where the effective cost of cover increases over time even if credit quality remains the same or improves, the effective maturity will be the remaining time to the first call.

When there is a maturity mismatch, the following adjustment will be applied:

$$P_a = P \times \frac{t - 0.25}{T - 0.25}$$

where:
- $P_a$ is the value of the credit protection adjusted for maturity mismatch;
- $P$ is the nominal amount of the credit protection, adjusted for currency mismatch if applicable;
- $T$ is the lower of 5 or the residual maturity of the exposure expressed in years; and
- $t$ is the lower of $T$ or the residual maturity of the credit protection arrangement expressed in years.
3.3.8. Sovereign counter-guarantees

Some claims may be covered by a guarantee that is indirectly counter-guaranteed by a sovereign. Such claims may be treated as covered by a sovereign guarantee provided that:

1) the sovereign providing the counter-guarantee is eligible for a 0% credit risk factor;
2) the sovereign counter-guarantee covers all credit risk elements of the claim;
3) both the original guarantee and the counter-guarantee meet all the operational requirements for guarantees, except that the counter-guarantee need not be direct and explicit to the original claim; and
4) the cover is robust, and there is no historical evidence suggesting that the coverage of the counter-guarantee is less than effectively equivalent to that of a direct sovereign guarantee.

3.3.9. Public sector entities in competition

Insurers may not recognize guarantees made by public sector entities, including provincial and territorial governments in Canada that would disadvantage private sector competition. Insurers will look to the host (sovereign) government to confirm whether a public sector entity is in competition with the private sector.

3.3.10. Other items related to the treatment of credit risk mitigation

In the case where an insurer has multiple types of mitigators covering a single exposure (e.g., both collateral and a guarantee partially cover an exposure), the insurer will be required to subdivide the exposure into portions covered by each type of mitigator (e.g., portion covered by collateral, portion covered by guarantee) and the required capital for each portion must be calculated separately. When credit protection provided by a single protection provider has differing maturities, they must be subdivided into separate protection as well.

There are cases where an insurer obtains credit protection for a basket of reference names and where the first default among the reference names triggers the credit protection and the credit event also terminates the contract. In this case, the insurer may recognize credit protection for the asset within the basket having the lowest capital charge, but only if the notional amount of the asset is less than or equal to the notional amount of the credit derivative. In the case where the second default among the assets within the basket triggers the credit protection, the insurer obtaining credit protection through such a product will only be able to recognize credit protection on the asset in the basket having the lowest capital charge if first-to-default protection has also been obtained, or if one of the assets within the basket has already defaulted.
3.4. **Asset backed securities**

The category of asset backed securities encompasses all securitizations, including collateralized mortgage obligations and mortgage backed securities. For exposures that arise as a result of asset securitization transactions, insurers should refer to Guideline B-5: *Asset Securitization*\(^1\) to determine whether there are functions provided (e.g. credit enhancement or liquidity facilities) that require capital for credit risk or a deduction from Available Capital.

3.4.1. **NHA mortgage-backed securities**

NHA mortgage-backed securities that are guaranteed by CMHC receive a factor of 0% to recognize the fact that obligations incurred by CMHC are legal obligations of the Government of Canada.

3.4.2. **Pass-through type mortgage-backed securities**

Mortgage-backed securities that are of pass-through type and are effectively a direct holding of the underlying mortgages receive the capital charge of the underlying mortgages provided that all of the following conditions are met:

1. the underlying mortgage pool contains only mortgages that were fully performing when the mortgage-backed security was created;
2. the securities absorb their pro rata share of any losses incurred;
3. a special-purpose vehicle has been established for securitization and administration of the pooled mortgage loans;
4. the underlying mortgages are assigned to an independent third party for the benefit of the investors in the securities who will then own the underlying mortgages;
5. the arrangements for the special-purpose vehicle and trustee provide that the following obligations are observed:
   a. if a mortgage administrator or mortgage servicer is employed to carry out administration functions, the vehicle and trustee must monitor the performance of the administrator or servicer;
   b. the vehicle and/or trustee must provide detailed and regular information on structure and performance of the pooled mortgage loans;
   c. the vehicle and trustee must be legally separate from the originator of the pooled mortgage loans;
   d. the vehicle and trustee must be responsible for any damage or loss to investors created by their own or their servicer's mismanagement of the pooled mortgages;

\(^1\) Guideline B-5 should be read in conjunction with any current Advisories concerning securitization (e.g., the October 2008 Advisory, “Securitization – Expected Practices”).
e. the trustee must have a first-priority security interest on the underlying mortgages on behalf of the securities holders;

f. the agreement must provide for the trustee to take clearly specified steps in cases when a mortgagor defaults;

g. the holder of the security must have a pro rata share in the underlying mortgages or the vehicle that issues the security must only have liabilities related to issuing the mortgage-backed security;

h. the cash flows of the underlying mortgages must meet the cash flow requirements of the security without undue reliance on any reinvestment income; and

i. the vehicle or trustee may invest cash flows pending distribution to investors only in short-term money market instruments (without any material reinvestment risk) or in new fully performing mortgage loans.

Pass-through mortgage-backed securities that do not meet all of the above conditions receive a factor of 12%. Stripped mortgage-backed securities or different classes of securities (senior/junior debt, residual tranches) that bear more than their pro-rata share of losses receive a 12% factor. Mortgage-backed securities that are issued in tranches are subject to the capital treatment described in Guideline B-5: Asset Securitization.

Where the underlying pool of assets contains mortgages having different capital charges, the charge for the security is the highest charge associated with the pool of assets. Where the underlying pool contains mortgages that have become impaired, that portion of the instrument should be treated as a past due investment in accordance with section 3.1.10.

3.4.3 Other asset-backed securities

The capital requirements for all other asset backed securities are based on their external ratings. For asset-backed securities (other than resecuritizations) rated BBB- or higher, the capital requirement is the same as the requirement specified in section 3.1.2 for a bond having the same rating and maturity as the asset-backed security. If an asset-backed security is rated BB- to BB+, an insurer may recognize the rating only if it is a third-party investor in the security, as opposed to being an originator of the security. The credit risk factor for an asset-backed security (other than a resecuritization) rated BB- to BB+ in which a company is a third-party investor is 300% of the requirement for a bond rated BB- to BB+ having the same maturity as the security.

The credit risk factors for short-term asset-backed securities (other than resecuritizations) rated A-3/F3/P-3/R-3 or higher are the same as those in section 3.1.3 for short-term obligations having the same rating.

The credit risk factor for any resecuritization rated BBB- or higher, or A-3/F3/P-3/R-3 or higher, is 200% of the risk factor applicable to an asset-backed security having the same rating and maturity as the resecuritization.

The credit risk factor for any asset-backed security that is not mentioned above (including unrated securities) is 60%.
Refer to Guideline B-5: *Asset Securitization* for additional capital requirements that may arise from securitization exposures.

### 3.5. Repurchase, reverse repurchase and securities lending agreements

A securities repurchase is an agreement whereby a transferor agrees to sell securities at a specified price and repurchase the securities on a specified date and at a specified price. Since the transaction is regarded as a financing for accounting purposes, the securities remain on the balance sheet. Given that these securities are temporarily assigned to another party, the credit risk factor associated with this exposure is the higher of:

- a. the factor for the securities to be repurchased; or
- b. the factor for an exposure to the counterparty to the transaction, recognizing any eligible collateral (reference section 3.2).

A reverse repurchase agreement is the opposite of a repurchase agreement, and involves the purchase and subsequent resale of a security. Reverse repos are treated as collateralised loans, reflecting the economic reality of the transaction. The risk is therefore measured as an exposure to the counterparty. If the asset temporarily acquired is a security that qualifies as eligible collateral per section 3.2, the exposure amount may be reduced accordingly.

In securities lending, insurers can act as a principal to the transaction by lending their own securities, or as an agent by lending securities on behalf of their clients. When an insurer lends its own securities, required capital is the higher of:

- a. the required capital for the instruments lent; or
- b. the required capital for an exposure to the borrower of the securities. The exposure to the borrower may be reduced if the insurer holds eligible collateral (section 3.2). Where the insurer lends securities through an agent and receives an explicit guarantee of the return of the securities, the insurer may treat the agent as the borrower, subject to the conditions in section 3.3.

When an insurer, acting as agent, lends securities on behalf of a client and guarantees that the securities lent will be returned or the insurer will reimburse the client for the current market value, the insurer must calculate the required capital as if it were the principal to the transaction. The required capital is that for an exposure to the borrower of the securities, where the exposure amount may be reduced if the insurer holds eligible collateral (reference section 3.2).

The methodologies described above do not apply to repurchases or loans of securities backing an insurer’s index-linked products, as defined in section 5.5. If an insurer enters into a repurchase or loan agreement involving such assets, the capital charge is equal to the charge for the exposure to the counterparty or borrower (taking account of qualifying collateral), plus the charge applicable under section 5.5.
# Appendix 3-1

## Long-term rating

<table>
<thead>
<tr>
<th>Rating</th>
<th>DBRS</th>
<th>Moody’s</th>
<th>S&amp;P</th>
<th>Fitch</th>
</tr>
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<tbody>
<tr>
<td>AAA</td>
<td>AAA</td>
<td>Aaa</td>
<td>AAA</td>
<td>AAA</td>
</tr>
<tr>
<td>AA</td>
<td>AA(high) to AA(low)</td>
<td>Aa1 to Aa3</td>
<td>AA+ to AA-</td>
<td>AA+ to AA-</td>
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<tr>
<td>A</td>
<td>A(high) to A(low)</td>
<td>A1 to A3</td>
<td>A+ to A-</td>
<td>A+ to A-</td>
</tr>
<tr>
<td>BBB</td>
<td>BBB(high) to BBB(low)</td>
<td>Baa1 to Baa3</td>
<td>BBB+ to BBB-</td>
<td>BBB+ to BBB-</td>
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<tr>
<td>BB</td>
<td>BB(high) to BB(low)</td>
<td>Ba1 to Ba3</td>
<td>BB+ to BB-</td>
<td>BB+ to BB-</td>
</tr>
<tr>
<td>B</td>
<td>B(high) to B(low)</td>
<td>B1 to B3</td>
<td>B+ to B-</td>
<td>B+ to B-</td>
</tr>
<tr>
<td>Other</td>
<td>CCC or lower</td>
<td>Below B3</td>
<td>Below B-</td>
<td>Below B-</td>
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</tbody>
</table>

## Short-term rating

<table>
<thead>
<tr>
<th>Rating</th>
<th>DBRS</th>
<th>Moody’s</th>
<th>S&amp;P</th>
<th>Fitch</th>
</tr>
</thead>
<tbody>
<tr>
<td>A-1/P-1</td>
<td>R-1(high) to R-1(low)</td>
<td>P-1</td>
<td>A-1+, A-1</td>
<td>F1+, F1</td>
</tr>
<tr>
<td>A-2/P-2</td>
<td>R-2(high) to R-2(low)</td>
<td>P-2</td>
<td>A-2</td>
<td>F2</td>
</tr>
<tr>
<td>A-3/P-3</td>
<td>R-3</td>
<td>P-3</td>
<td>A-3</td>
<td>F3</td>
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<tr>
<td>Others</td>
<td>Below R-3</td>
<td>NP</td>
<td>All short-term ratings below A-3</td>
<td>Below F3</td>
</tr>
</tbody>
</table>

Others
Chapter 4  Credit Risk - Off-Balance Sheet Activities

The term “off-balance sheet activities”, as used in this guideline, encompasses derivatives, guarantees, commitments, and similar contractual arrangements whose full notional principal amount may not necessarily be reflected on the balance sheet. Such instruments are subject to a capital charge under this section irrespective of whether they have been recorded on the balance sheet at fair value.

The major risk to insurers associated with off-balance sheet activities is the default of the counterparty to a transaction (i.e., counterparty credit risk). The face amount of an off-balance sheet instrument does not always reflect the exposure to the credit risk in the instrument. Credit equivalent amounts are used to determine the potential credit exposure of off-balance sheet instruments. The process for determining the credit equivalent amounts of derivative instruments is covered in sections 4.1 and 4.2. For off-balance sheet activities not covered in sections 4.1 and 4.2, to approximate the potential credit exposure, the face amount of the instrument must be multiplied by a credit conversion factor to derive a credit equivalent amount (refer to sections 4.3 and 4.4). The resulting credit equivalent amounts are then assigned the credit risk factor appropriate to the counterparty (refer to section 3.1) or, if relevant, the factor for the collateral (refer to section 3.2) or the guarantor (refer to section 3.3).

Insurers should also refer to OSFI’s Guideline B-5: Asset Securitization, which outlines the regulatory framework for asset securitization transactions, including transactions that give rise to off-balance sheet exposures.

4.1. Over-the-counter derivatives contracts

The treatment of forwards, swaps, purchased options and similar derivatives contracts is given specific consideration because insurers may not be exposed to credit risk on the full face value of their contracts (notional principal amount), but only to the potential cost of replacing the cash flow (on contracts showing a positive value) if the counterparty defaults. The credit equivalent amounts are calculated using the current exposure method and are assigned the asset default factor appropriate to the counterparty. Per section 3.1.4, derivatives transactions with qualifying central counterparties receive an asset default factor of 0%.

The add-on applied in calculating the credit equivalent amount depends on the maturity of the contract and on the volatility of the rates and prices underlying that type of instrument. Options purchased over the counter are included with the same conversion factors as other instruments.

A. Interest rate contracts include:
   1. single currency interest rate swaps;
   2. basis swaps;
   3. forward rate agreements and products with similar characteristics;
   4. interest rate futures; and
   5. interest rate options purchased.
B. Exchange rate contracts include:
   1. gold contracts\(^{92}\);
   2. cross-currency swaps;
   3. cross-currency interest rate swaps;
   4. forward foreign exchange contracts;
   5. currency futures; and
   6. currency options purchased.

C. Equity contracts include:
   1. futures;
   2. forwards;
   3. swaps;
   4. purchased options; and
   5. similar derivative contracts based on both individual equities as well as on equity indices.

D. Precious metals (e.g., silver, platinum, palladium) contracts, except gold contracts, include:
   1. futures;
   2. forwards;
   3. swaps;
   4. purchased options; and
   5. similar contracts based on precious metals.

E. Contracts on other commodities include:
   1. futures;
   2. forwards;
   3. swaps;
   4. purchased options;
   5. similar derivatives contracts based on energy contracts, agricultural contracts, base metals (e.g., aluminum, copper, zinc); and
   6. other non-precious metal commodity contract.

An insurer should calculate the credit equivalent amount of these contracts using the current exposure method. Under this method, the insurer adds:

1) the total replacement cost (obtained by "marking to market") of all its contracts with positive value; and

\(^{92}\) Gold contracts are treated the same as exchange rate contracts for the purpose of calculating credit risk.
2) an amount for potential future credit exposure (or "add-on"). This is calculated by multiplying the notional principal amounts by the following factors:

<table>
<thead>
<tr>
<th>Residual Maturity</th>
<th>Interest Rate</th>
<th>Exchange Rate and Gold</th>
<th>Equity</th>
<th>Precious Metals Except Gold</th>
<th>Other Commodities</th>
</tr>
</thead>
<tbody>
<tr>
<td>One year or less</td>
<td>0.0%</td>
<td>1.0%</td>
<td>6.0%</td>
<td>7.0%</td>
<td>10.0%</td>
</tr>
<tr>
<td>Over one year to five years</td>
<td>0.5%</td>
<td>5.0%</td>
<td>8.0%</td>
<td>7.0%</td>
<td>12.0%</td>
</tr>
<tr>
<td>Over five years</td>
<td>1.5%</td>
<td>7.5%</td>
<td>10.0%</td>
<td>8.0%</td>
<td>15.0%</td>
</tr>
</tbody>
</table>

Additional considerations:

1) For contracts with multiple exchanges of principal, the factors are multiplied by the number of remaining payments in the contract.

2) For contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset so that the market value of the contract is zero on these specified dates, the residual maturity is considered to be the time until the next reset date. In the case of interest rate contracts with remaining maturities of more than one year and that meet these criteria, the add-on factor is subject to a floor of 0.5%.

3) Contracts not covered by any of the columns of this matrix are to be treated as "other commodities".

4) No add-on factor should be calculated for single currency floating/floating interest rate swaps; the credit exposure on these contracts is evaluated solely on the basis of their mark-to-market value.

5) The add-ons are based on effective rather than stated notional amounts. In the event that the stated notional amount is leveraged or enhanced by the structure of the transaction, insurers should use the actual or effective notional amount when determining potential future exposure. For example, a stated notional amount of $1 million with payments calculated at two times LIBOR has an effective notional amount of $2 million.

6) Add-ons for potential future credit exposure are to be calculated for all over the counter (OTC) contracts (with the exception of single currency floating/floating interest rate swaps), regardless of whether the replacement cost is positive or negative.

7) No add-on for potential future exposure is required for credit derivatives. The credit equivalent amount for a credit derivative is equal to the greater of its mark-to-market value or zero.
4.2. Netting of derivative contracts

4.2.1. Conditions for netting

Insurers may net contracts that are subject to novation or any other legally valid form of netting. Novation refers to a written bilateral contract between two counterparties under which any obligation to each other to deliver a given currency on a given date is automatically amalgamated with all other obligations for the same currency and value date, legally substituting one single amount for the previous gross obligations.

Insurers who wish to net transactions under either novation or another form of bilateral netting will need to satisfy OSFI that the following conditions are met:

1) The insurer has executed a written bilateral netting contract or agreement with each counterparty that creates a single legal obligation covering all included bilateral transactions subject to netting. The result of such an arrangement is that the insurer only has one obligation for payment or one claim to receive funds based on the net sum of the positive and negative mark-to-market values of all the transactions with that counterparty in the event that counterparty fails to perform due to default, bankruptcy, liquidation or similar circumstances.

2) The insurer has written and reasoned legal opinions that, in the event of any legal challenge, the relevant courts or administrative authorities would find the exposure under the netting agreement to be the net amount under the laws of all relevant jurisdictions. In reaching this conclusion, legal opinions must address the validity and enforceability of the entire netting agreement under its terms.
   a. The laws of “all relevant jurisdictions” are: a) the law of the jurisdictions where the counterparties are incorporated and, if the foreign branch of a counterparty is involved, the laws of the jurisdiction in which the branch is located; b) the law governing the individual transactions; and c) the law governing any contracts or agreements required to effect netting.
   b. A legal opinion must be generally recognized as such by the legal community in the firm’s home country or by a memorandum of law that addresses all relevant issues in a reasoned manner.

3) The insurer has internal procedures to verify that, prior to recognizing a transaction as being subject to netting for capital purposes, the transaction is covered by legal opinions that meet the above criteria.

4) The insurer has procedures in place to update legal opinions as necessary to ensure continuing enforceability of the netting arrangements in light of possible changes in relevant law.

5) The insurer maintains all required documentation and makes it available to OSFI upon request.

Any contract containing a walkaway clause will not be eligible to qualify for netting for the purpose of calculating capital requirements. A walkaway clause is a provision within the
contract that permits a non-defaulting counterparty to make only limited payments, or no payments, to the defaulter.

4.2.2. Calculation of exposure

Credit exposure on bilaterally netted forwards, swaps, purchased options and similar derivatives transactions is calculated as the sum of the net mark-to-market replacement cost, if positive, plus a potential future credit exposure (an “add-on”) based on the notional principal of the individual underlying contracts. However, for purposes of calculating potential future credit exposure of contracts subject to legally enforceable netting agreements in which notional principal is equivalent to cash flows, notional principal is defined as the net receipts falling due on each value date in each currency.

These contracts are treated as a single contract because offsetting contracts in the same currency maturing on the same date will have lower replacement cost as well as lower potential future credit exposure. For multilateral netting schemes, current exposure (i.e., replacement cost) is a function of the loss allocation rules of the clearing house.

The calculation of the gross add-ons is based on the legal cash flow obligations in all currencies. This is calculated by netting all receivable and payable amounts in the same currency for each value date. The netted cash flow obligations are converted to the reporting currency using the current forward rates for each value date. Once converted the amounts receivable for the value date are added together and the gross add-on is calculated by multiplying the receivable amount by the appropriate add-on factor.

The potential future credit exposure for netted transactions ($A_{Net}$) is equal to the sum of:

(i) 40% of the add-on as presently calculated ($A_{Gross}$); and

(ii) 60% of $A_{Gross}$ multiplied by NPR, where NPR is the level of net replacement cost divided by the level of positive replacement cost for transactions subject to legally enforceable netting agreements.

The calculation of NPR can be made on a counterparty-by-counterparty basis or on an aggregate basis for all transactions subject to legally enforceable netting agreements. On a counterparty-by-counterparty basis a unique NPR is calculated for each counterparty. On an aggregate basis, one NPR is calculated and applied to all counterparties.

Steps for determining the credit equivalent amount of netted contracts

1) For each counterparty subject to bilateral netting, determine the add-ons and replacement costs of each transaction. A worksheet similar to that set out below could be used for this purpose:

93 $A_{Gross}$ equals the sum of the potential future credit exposures (i.e., notional principal amount of each transaction times the appropriate add-on factors from section 4.1) for all transactions subject to legally enforceable netting agreements.
Counterparty

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Notional Principal Amount</th>
<th>X</th>
<th>Add-on Factor (ref. 4.1)</th>
<th>Potential Future Credit Exposure</th>
<th>Positive Replacement Cost</th>
<th>Negative Replacement Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>etc.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td>$A_{gross}$</td>
<td>$R^+$</td>
<td>$R^-$</td>
</tr>
</tbody>
</table>

2) Calculate the net replacement cost for each counterparty.
   This is equal to the greater of:
   a. zero; or
   b. the sum of the positive and negative replacement costs ($R^+ + R^-$).

Negative replacement costs for one counterparty cannot be used to offset positive replacement costs for another counterparty.

3) Calculate the NPR.

For companies using the counterparty by counterparty basis, the NPR is the net replacement cost (from step 2) divided by the positive replacement cost (amount $R^+$ calculated in step 1).

For companies using the aggregate basis, the NPR is the sum of the net replacement costs of all counterparties subject to bilateral netting divided by the sum of the positive replacement costs for all counterparties subject to bilateral netting.

A simple example of calculating the NPR ratio is set out below:

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Counterparty 1</th>
<th>Counterparty 2</th>
<th>Counterparty 3</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Notional amount</td>
<td>Mark to Market value</td>
<td>Notional amount</td>
</tr>
<tr>
<td>Transaction 1</td>
<td>100</td>
<td>10</td>
<td>50</td>
</tr>
<tr>
<td>Transaction 2</td>
<td>100</td>
<td>-5</td>
<td>50</td>
</tr>
<tr>
<td>Positive replacement cost ($R^-$)</td>
<td>10</td>
<td>10</td>
<td>1</td>
</tr>
<tr>
<td>Net replacement cost (NR)</td>
<td>5</td>
<td>10</td>
<td>0</td>
</tr>
<tr>
<td>NPR (per counterparty)</td>
<td>0.5</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>NPR (aggregate)</td>
<td>$\frac{\sum NR}{\sum R^-} = 15/21 = 0.71$</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
4) Calculate $A_{Net}$.

$A_{Net}$ must be calculated for each counterparty subject to bilateral netting; however, the NPR applied will depend on whether the insurer is using the counterparty by counterparty basis or the aggregate basis. The insurer must choose which basis it will use and then use it consistently for all netted transactions.

$A_{Net}$ is given by:

$$
A_{Net} = \begin{cases} 
(0.4 \times A_{gross}) + (0.6 \times NPR \times A_{gross}) & \text{for netted contracts where the net replacement cost is } > 0 \\
0.4 \times A_{gross} & \text{for netted contracts where the net replacement cost is } = 0 
\end{cases}
$$

5) Calculate the credit equivalent amount for each counterparty by adding the net replacement cost (step 2) and $A_{Net}$ (step 4). Aggregate the counterparties by the factors appropriate to each type of counterparty and enter the total credit equivalent amount on the appropriate page of the LICAT Quarterly Return or LICAT Annual Supplement.

Note: Contracts may be subject to netting among different types of derivative instruments (e.g., interest rate, foreign exchange, equity, etc.). If this is the case, allocate the net replacement cost to the types of derivative instrument by pro-rating the net replacement cost among those instrument types which have a gross positive replacement cost.

Example of netting calculation for potential future credit exposure with contracts subject to novation

Assume an institution has 6 contracts with the same counterparty and has a legally enforceable netting agreement with that counterparty:

<table>
<thead>
<tr>
<th>Contract</th>
<th>Notional Principal Amount</th>
<th>Marked to Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>10</td>
<td>1</td>
</tr>
<tr>
<td>B</td>
<td>20</td>
<td>-2</td>
</tr>
<tr>
<td>C</td>
<td>10</td>
<td>-1</td>
</tr>
<tr>
<td>D</td>
<td>40</td>
<td>4</td>
</tr>
<tr>
<td>E</td>
<td>30</td>
<td>3</td>
</tr>
<tr>
<td>F</td>
<td>20</td>
<td>-2</td>
</tr>
</tbody>
</table>
Contracts A and B are subject to novation, as are contracts C and D. Under novation, the two contracts are replaced by one new contract. Therefore, to calculate the capital requirements, the institution would replace contracts A and B for contract A+ and contracts C and D for contract C+, netting the notional amounts and calculating a new marked to market amount.

<table>
<thead>
<tr>
<th>Contract</th>
<th>Notional Principal Amount</th>
<th>Marked to Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>A+</td>
<td>10</td>
<td>-1</td>
</tr>
<tr>
<td>C+</td>
<td>30</td>
<td>3</td>
</tr>
<tr>
<td>E</td>
<td>30</td>
<td>3</td>
</tr>
<tr>
<td>F</td>
<td>20</td>
<td>-2</td>
</tr>
</tbody>
</table>

Assume the add-on factor for all contracts is 5%. The potential future credit exposure is calculated for each contract. $A_{Gross}$ is the sum of the potential future credit exposures:

<table>
<thead>
<tr>
<th>Contract</th>
<th>Notional Principal Amount</th>
<th>Add-on Factor (5%)</th>
<th>Potential Credit Exposure</th>
<th>Positive Replacement Cost</th>
<th>Negative Replacement Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>A+</td>
<td>10</td>
<td>.05</td>
<td>0.5</td>
<td>0</td>
<td>-1</td>
</tr>
<tr>
<td>C+</td>
<td>30</td>
<td>.05</td>
<td>1.5</td>
<td>3</td>
<td>0</td>
</tr>
<tr>
<td>E</td>
<td>30</td>
<td>.05</td>
<td>1.5</td>
<td>3</td>
<td>0</td>
</tr>
<tr>
<td>F</td>
<td>20</td>
<td>.05</td>
<td>1.0</td>
<td>0</td>
<td>-2</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>4.5</td>
<td></td>
<td>6</td>
<td>-3</td>
</tr>
</tbody>
</table>

The net replacement cost is $(6 - 3 =) 3$; the greater of zero or the sum of the positive and negative replacement costs.

The NPR is $(3 / 6 =) 0.5$; the net replacement cost divided by the positive replacement cost.

$A_{Net}$ is then $((0.4*4.5) + (0.6*0.5*4.5) =) 3.15$.

The credit equivalent amount is $(3 + 3.15 =) 6.15$; the net replacement cost plus $A_{Net}$.

4.3. Off-balance sheet instruments other than derivatives

The definitions in this section apply to off-balance sheet exposures other than derivatives included in section 4.1.

4.3.1. Direct credit substitutes (100% conversion factor)

Direct credit substitutes include guarantees or equivalent instruments backing financial claims. With a direct credit substitute, the risk of loss to the insurer is directly dependent on the creditworthiness of the counterparty.
Examples of direct credit substitutes include:

1) guarantees given on behalf of customers to stand behind the financial obligations of the customer and to satisfy these obligations should the customer fail to do so; for example, guarantees of:
   a. payment for existing indebtedness for services,
   b. payment with respect to a purchase agreement,
   c. lease, loan or mortgage payments,
   d. payment of uncertified cheques,
   e. remittance of (sales) tax to the government,
   f. payment of existing indebtedness for merchandise purchased,
   g. payment of an unfunded pension liability, and
   h. financial obligations undertaken through reinsurance;
      i. standby letters of credit or other equivalent irrevocable obligations, serving as financial guarantees, such as letters of credit supporting the issue of commercial paper;
      ii. risk participations in bankers' acceptances and financial letters of credit. Risk participations constitute a guarantee by the participating institutions such that, if there is a default by the underlying obligor, they will indemnify the creditor for the full principal and interest attributable to them;
      iii. securities lending transactions, where an insurer acting as an agent lends securities on behalf of a client and is liable for any failure to recover the securities lent.

4.3.2. Repurchase and reverse repurchase agreements (100% conversion factor)

A repurchase agreement is a transaction that involves the sale of a security or other asset with the simultaneous commitment by the seller that after a stated period of time, the seller will repurchase the asset from the original buyer at a predetermined price. A reverse repurchase agreement consists of the purchase of a security or other asset with the simultaneous commitment by the buyer that after a stated period of time, the buyer will resell the asset to the original seller at a predetermined price. In any circumstance where these transactions are not reported on-balance sheet, they should be reported as an off-balance sheet exposure with a 100% credit conversion factor.

4.3.3. Forward asset purchases\(^9^4\) (100% conversion factor)

A commitment to purchase a loan, security or other asset at a specified future date, usually on prearranged terms.

\(^9^4\) This does not include a spot transaction that is contracted to settle within the normal settlement period.
4.3.4. **Forward-forward deposits (100% conversion factor)**

An agreement between two parties whereby one will pay and the other will receive an agreed rate of interest on a deposit to be placed by one party with the other at some predetermined date in the future. Such agreements are distinct from futures and forward rate agreements in that, with forward-forwards, the deposit is actually placed.

4.3.5. **Partly paid shares and securities (100% conversion factor)**

The unpaid portion of transactions where only a part of the issue price or notional face value of a security purchased has been subscribed and the issuer may call for the outstanding balance (or a further instalment), either on a date predetermined at the time of issue or at an unspecified future date.

4.3.6. **Transaction-related contingencies (50% conversion factor)**

Transaction-related contingencies relate to the ongoing business activities of a counterparty, where the risk of loss to the insurer depends on the likelihood of a future event that is independent of the creditworthiness of the counterparty. Essentially, transaction-related contingencies are guarantees that support particular performance of non-financial or commercial contracts or undertakings rather than supporting customers' general financial obligations. Performance-related guarantees specifically exclude items relating to non-performance of financial obligations.

Performance-related and non-financial guarantees include items such as:

1) performance bonds, warranties and indemnities, and performance standby letters of credit. These represent obligations backing the performance of non-financial or commercial contracts or undertakings and can include arrangements backing:
   a. subcontractors' and suppliers' performance,
   b. labour and material contracts,
   c. delivery of merchandise, bids or tender bonds,
   d. guarantees of repayment of deposits or prepayments in cases of non-performance;

4.3.7 **Trade-related contingencies (20% conversion factor)**

These include short-term self-liquidating trade-related items such as commercial and documentary letters of credit issued by the insurer that are, or are to be, collateralized by the underlying shipment.

Letters of credit issued on behalf of a counterparty back to back with letters of credit of which the counterparty is a beneficiary ("back-to-back" letters) should be reported as documentary letters of credit.
Letters of credit advised by the insurer for which the insurer is acting as an agent should not be considered a risk asset.

4.4. Commitments

Commitments are arrangements that obligate an insurer, at a client's request, to:

1) extend credit in the form of loans or participations in loans, lease financing receivables, mortgages, overdrafts, acceptances, letters of credit, guarantees or loan substitutes; or

2) purchase loans, securities, or other assets.

Normally, commitments involve a written contract or agreement and some form of consideration, such as a commitment fee.

Note issuance facilities (NIFs) and revolving underwriting facilities (RUFs) are arrangements whereby a borrower may issue short-term notes, typically three to six months in maturity, up to a prescribed limit over an extended period of time, commonly by means of repeated offerings to a tender panel. If at any time the notes are not sold by the tender at an acceptable price, an underwriter (or group of underwriters) undertakes to buy them at a prescribed price.

Commitments exclude policy loans, i.e., part of a policy's cash value that has not been taken in the form of a policy loan.

4.4.1. Maturity

Insurers should use original maturity (as defined below) to report commitments.

4.4.1.1. Original maturity

The maturity of a commitment should be measured from the date when the commitment was accepted by the customer, regardless of whether the commitment is revocable or irrevocable, conditional or unconditional, until the earliest date on which:

a. the commitment is scheduled to expire; or

b. the insurer can, at its option, unconditionally cancel the commitment.

A material adverse change clause is not considered to give sufficient protection for a commitment to be considered unconditionally cancellable.

Where the insurer commits to granting a facility at a future date (a forward commitment), the original maturity of the commitment is to be measured from the date the commitment is accepted until the final date that drawdowns are permitted.

4.4.1.2. Renegotiations of a commitment

If both parties agree, a commitment may be renegotiated before its term expires. If the renegotiation process involves a credit assessment of the customer consistent with the insurer's credit standards, and provides the insurer with the total discretion to renew or extend the
commitment and to change any other terms and conditions of the commitment, then on the date of acceptance by the customer of the revised terms and conditions, the original commitment may be deemed to have matured and a new commitment begun. If new terms are not reached, the original commitment will remain in force until its original maturity date. This process must be clearly documented.

In syndicated and participated transactions, a participating insurer must be able to exercise its renegotiation rights independent of the other syndicate members.

Where these conditions are not met, the original start date of the commitment must be used to determine maturity.

4.4.2. **Credit conversion factors**

The credit conversion factor applied to a commitment is dependent on its maturity. Longer maturity commitments are considered to be of higher risk because there is a longer period between credit reviews and less opportunity to withdraw the commitment if the credit quality of the drawer deteriorates.

Conversion factors apply to commitments as set out below.

*50% conversion factor*

a. Commitments and forward commitments with an original maturity of over one year;

b. NIFs and RUFs;

c. The undrawn portion of a commitment to provide a loan that will be drawn down in a number of tranches, some less than and some over one year.

*20% conversion factor*

a. Commitments and forward commitments with an original maturity of one year and under.

*0% conversion factor*

a. Commitments that are unconditionally cancellable at any time by the insurer without notice or that effectively provide for automatic cancellation due to deterioration in the borrower’s creditworthiness. This implies that the insurer conducts a review of the facility at least annually, thus giving it an opportunity to take note of any perceived deterioration in credit quality. Retail commitments are unconditionally cancellable if the terms permit the insurer to cancel them fully and this is allowable under consumer protection and related legislation.
4.4.3. **Specific types of commitments**

4.4.3.1. **Undated/open-ended commitments**
A 0% credit conversion factor is applied to undated or open-ended commitments, such as unused credit card lines, personal lines of credit, and overdraft protection for personal chequing accounts that are unconditionally cancellable at any time.

4.4.3.2. **Evergreen commitments**
Open-ended commitments that are cancellable by the insurer at any time subject to a notice period do not constitute unconditionally cancellable commitments and are converted at 50%. Long-term commitments must be cancellable without notice to be eligible for the 0% conversion factor.

4.4.3.3. **Commitments drawn down in a number of tranches**
A 50% credit conversion factor is applied to a commitment to provide a loan (or purchase an asset) to be drawn down in a number of related tranches, some one year and under and some over one year. In these cases, the ability to renegotiate the terms of later tranches should be regarded as immaterial. For example, such commitments may be provided for development projects from which the insurer may find it difficult to withdraw without jeopardizing its investment.

Where the facility involves unrelated tranches, and where conversions are permitted between the over- and under-one-year tranches (i.e., where the borrower may make ongoing selections as to how much of the commitment is under one year and how much is over), then the entire commitment should be converted at 50%.

Where the facility involves unrelated tranches with no conversion between the over- and under-one-year tranches, then each tranche may be converted separately, depending on its maturity.

4.4.3.4. **Commitments for fluctuating amounts**
For commitments that vary in amount over the life of the commitment, such as the financing of a business subject to seasonal variation in cash flow, the conversion factor should apply to the maximum unutilized amount that can be drawn under the remaining period of the facility.

4.4.3.5. **Commitment to provide a loan with a maturity of over one year**
A commitment to provide a loan that has a maturity of over one year but that must be drawn down within a period of less than one year may be treated as an under-one-year instrument, as long as any undrawn portion of the facility is automatically cancelled at the end of the drawdown period.

However, if through any combination of options or drawdowns, repayments and re-drawdowns, etc., the client can access a line of credit past one year, with no opportunity for the insurer to unconditionally cancel the commitment within one year, the commitment shall be converted at 50%.
4.4.3.6.  *Commitments for off-balance sheet transactions*

Where there is a commitment to provide an off-balance sheet item, companies are to apply the lower of the two applicable credit conversion factors.
Chapter 5  Market Risk

Market risk arises from potential changes in rates or prices in various markets such as those for bonds, foreign currency, equities and commodities. Exposure to this risk stems from investment and other business activities that create on- and off-balance sheet positions. Market risk in the LICAT includes interest rate, equity, real estate, and currency risks. Liability risks for segregated fund guarantees are covered separately in Chapter 7.

5.1  Interest rate risk

Interest rate risk is the risk of economic loss resulting from market changes in interest rates. The most significant aspect of this risk is the net effect of potential changes in interest rates on the values of interest-sensitive assets and liabilities whose cash flows may be mismatched.

A projected cash flow methodology is used to measure the economic impact of sudden interest rate shocks. Required capital for interest rate risk is calculated as the maximum loss under four different prescribed stress scenarios. For each scenario, the loss is defined as the decrease in the insurer’s net position after revaluing asset and liability cash flows by changing the discount rates from those of the base scenario to those of the stress scenario. The net position used to measure the loss in each scenario is equal to the difference between the discounted present values of assets (including assets backing capital or surplus) and liabilities. Required capital for interest rate risk is calculated for each geography.

5.1.1  Combined required capital for Canadian and US operations

Where insurers have operations in both Canada and the US, required capital for Canadian and US operations is calculated on a combined basis. The combined required capital for Canadian and US operations is calculated using the stress scenario that produces the highest total loss in the two countries. Scenario losses are calculated assuming that gains in one country do not offset losses in the other. Consequently, if the required capital for either country is negative under a scenario, the required capital for that country is set to zero for the purpose of calculating the total capital requirement for that scenario.

5.1.2  Base scenario discount rates

For the base scenario, the discount rates are risk-free interest rates plus a spread, with the sum grading to an ultimate interest rate (UIR) plus an ultimate spread. Base scenario discount rates are prescribed for Canada, the United States, the United Kingdom, Europe (other than the United Kingdom) and Japan. The base scenario discount rates for all other currencies are the same as for the United States.

Risk-free interest rates are based on the following:

- Canada – the spot rates for Government of Canada bonds;
- The United States – the spot rates for applicable United States treasuries;
- The United Kingdom – the spot rates for United Kingdom sovereign benchmark bonds;
- Europe (other than the United Kingdom) – the spot rates for Government of Germany bonds; and
- Japan – the spot rates for Government of Japan bonds.

The UIR for Canada, the United States, and the United Kingdom is a spot rate of 4.5%. The UIRs for Europe (other than the United Kingdom) and Japan are 2.8% and 1.0%, respectively.

The risk-free spot interest rates used in the base scenario are determined as follows:

1) For cash flows from day 0 to year 20, the interest rate is the published risk-free spot rate;
2) For cash flows from years 20 to 70, the interest rate is linearly interpolated between the 20-year spot discount rate and the UIR;
3) For cash flows beyond 70 years, the interest rate is the UIR.

The spread is defined as follows:

1) For the first year, the spread is 90% of the 1-year market average spread;
2) Between year 1 and year 10, the spread grades linearly from 90% of the 1-year market average spread to 90% of the 10-year market average spread;
3) Between year 10 and year 20, the spread grades linearly from 90% of the 10-year market average spread to 90% of the 20-year market average spread;
4) Between year 20 and year 70, the spread grades linearly from 90% of the 20-year market average spread to an ultimate spread of 80 basis points;
5) Beyond 70 years, the spread is 80 basis points.

The 1-year market average spread is determined using 1-year market spreads at the valuation date based on [index to be determined] for 1-3 year bonds. USD spreads are used for Canada, the United States and the United Kingdom, EUR spreads are used for Europe (other than the United Kingdom), and for Japan the spreads are scaled to the USD spreads using the ratio of the Japan UIR to the United States UIR. The 10-year and 20-year market average spreads are determined similarly using 7-10 year spreads and 15-year spreads, respectively, in place of 1-3 year spreads.

5.1.3 Stress scenarios

The present value of all contractual asset and liability cash flows is determined under four prescribed stress scenarios by discounting them to time zero using stressed discount rates. The stress scenario used to determine required capital is the one that produces the lowest net present value (i.e. the difference between the present values of assets and liabilities) for the cash flows. The required capital stress scenario may vary depending on the location of the risk.

For each stress scenario, the annualized stressed discount rates are calculated as follows:
1) For discount rates prior to year 20, the base scenario discount rates are adjusted by calculating the:
   a. adjustment to the 90-day discount rate (T),
   b. adjustment to the 20-year discount rate (B), and
   c. adjustments for all periods in between by applying linear interpolation to the coefficients used to calculate the two adjustments (T) and (B) above.

2) Between years 20 and 70, stressed discount rates are determined by linearly interpolating between the adjusted 20-year discount rate and the adjusted ultimate discount rate, determined in the next step.

3) Beyond 70 years, an adjustment (L) is added to the ultimate discount rate.

The four stress scenarios are described below, relative to the base scenario:

1) Decreased short term interest rate (after shock T2), decreased long term interest rate (after shock B2) and decreased UIR (after shock L2)
2) Increased short term interest rate (after shock S1), decreased long term interest rate (after shock C2) and lower UIR (after shock L2)
3) Increased short term interest rate (after shock T1), increased long term interest rate (after shock B1) and increased UIR (after shock L1)
4) Decreased short term interest rate (after shock S2), increased long term interest rate (after shock C1) and increased UIR (after shock L1)

The interest rate shocks (T1, T2, S1, S2, B1, B2, C1 and C2) to be used are the following linear functions of the square roots of the current risk-free interest rates \( r \), where \( r \) is expressed as a decimal (for example five percent corresponds to \( r \) of 0.05). Base and stress scenario interest rates are not floored at zero, and no adjustments are made if an interest rate is negative.

If the current 90-day risk-free interest rate is \( r_{0.25} \), then:

\[
\begin{align*}
T1 & \text{ is } 0.139 \sqrt{\max(r_{0.25},0.005)} + 0.0049 \\
T2 & \text{ is } 0.139 \sqrt{\max(r_{0.25},0.005)} - 0.0049 \\
S1 & \text{ is } 0.111 \sqrt{\max(r_{0.25},0.005)} + 0.0039 \\
S2 & \text{ is } 0.111 \sqrt{\max(r_{0.25},0.005)} - 0.0039
\end{align*}
\]

If the current 20-year risk-free interest rate is \( r_{20} \), then:

\[
\begin{align*}
B1 & \text{ is } 0.102 \sqrt{\max(r_{20},0.005)} + 0.0028 \\
B2 & \text{ is } 0.102 \sqrt{\max(r_{20},0.005)} - 0.0028
\end{align*}
\]
C1 is $-0.007 \sqrt{\max(r_{20},0.005)} + 0.0023$

C2 is $-0.007 \sqrt{\max(r_{20},0.005)} - 0.0023$

If the risk-free interest rate for term $t$ is equal to $r$, where $t$ is between 90 days and 20 years, then the changes interpolated for the time $t$ rate under the four test scenarios, which in all cases are added to the base rates, are:

i) $-(0.139468 - 0.001873t) \sqrt{\max(r,0.005)} + (0.00492658 - 0.00010633t)$

ii) $(0.112699 - 0.005997t) \sqrt{\max(r,0.005)} + (0.00394084 - 0.00008336t)$

iii) $(0.139468 - 0.001873t) \sqrt{\max(r,0.005)} + (0.00492658 - 0.00010633t)$

iv) $-(0.112699 - 0.005997t) \sqrt{\max(r,0.005)} + (0.00394084 - 0.00008336t)$

For shocks applied to the UIR:

L1 is +60 basis points for Canada, the United States and the United Kingdom, +40 basis points for Europe (other than the United Kingdom) and +30 basis points for Japan

L2 is -60 basis points for Canada, the United States, and the United Kingdom, -40 basis points for Europe (other than the United Kingdom) and -30 basis points for Japan

5.1.4 Projection of cash flows

Cash flows are determined at the reporting date, and are projected net of all reinsurance (i.e. all reinsurance assets are excluded from asset cash flows and all ceded insurance liabilities are excluded from liability cash flows)\(^{95}\). Liability cash flows should incorporate insurance MfADs projected under CALM. When interest rates are stressed, projected asset and liability cash flows (except for participating, adjustable and index-linked pass-through liability cash flows) that are interest sensitive should be changed to be consistent with the interest rate scenario.

For participating, adjustable, index-linked risk pass through (RPT) and non-interest sensitive products, the same cash flows are used for all interest scenarios. Cash flows for participating products should be based on Best Estimate Assumptions with the addition of insurance risk MfADs. Adjustments to cash flows should not be made for anticipated reductions or increases in dividends that may result from increases or decreases in interest rates under each scenario. A reduction in required capital for the potential risk-mitigating effect of dividend reductions is calculated separately for participating products (refer to Chapter 9).

\(^{95}\) Liabilities corresponding to business ceded under funds withheld arrangements are excluded from liability cash flows, but liabilities due to reinsurers under funds withheld arrangements are included in liability cash flows.
The following table summarizes the cash flows to use for interest rate risk by product:

<table>
<thead>
<tr>
<th></th>
<th>Base Scenario</th>
<th>Stress Scenarios</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Non-Participating Liabilities</strong></td>
<td>Cash flows based on Best Estimate Assumptions plus insurance risk MfADs</td>
<td>Same as base scenario, without adjustments for index-linked RPT and adjustable products</td>
</tr>
<tr>
<td>(non-interest sensitive)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Cash flows adjusted for minimum interest guarantees in each scenario</td>
</tr>
<tr>
<td><strong>Non-Participating Liabilities</strong></td>
<td>Cash flows based on Best Estimate Assumptions plus insurance risk MfADs, with interest rates assumed equal to implied forward rates under the CALM base scenario</td>
<td></td>
</tr>
<tr>
<td>(interest sensitive)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Participating Liabilities</strong></td>
<td>Cash flows based on Best Estimate Assumptions plus insurance risk MfADs</td>
<td>Same as base scenario, no dividend adjustment</td>
</tr>
<tr>
<td><strong>Assets</strong></td>
<td>Contractual cash flows net of investment expenses</td>
<td>Interest-sensitive cash flows adjusted for each scenario</td>
</tr>
</tbody>
</table>

The treatment for specific asset and liability cash flows is described next.

**5.1.4.1 Assets having fixed cash flows**

A fixed cash flow is one that is contractually guaranteed for a definite amount, and not contingent on future market prices or interest rates. A cash flow is considered contractually guaranteed if it is payable regardless of the condition of the obligor (for example, it is not contingent on the obligor meeting its target level of profitability), and if failure to pay the guaranteed cash flow would be considered an event of default. For assets having fixed cash flows, insurers should project the same cash flows as those used in the balance sheet valuation. These cash flows should be projected net of investment expenses and accounting provisions for credit losses. No reinvestment of the asset cash flows should be assumed.

**5.1.4.2 CALM MfADs and accounting loss provisions**

Cash flows should be projected without reflecting the impact of CALM C-1 MfADs, or of balance sheet loss provisions reported under IFRS 9. That is, asset cash flows should not be reduced by any amount on account of C-1 MfADs and IFRS 9 loss provisions, and liability cash flows should not be increased by any amount on account of these MfADs and provisions.

Liability cash flows should be projected reflecting the impact of CALM insurance risk MfADs. That is, all insurance assumptions used to project liability cash flows should be set equal to the best estimate assumption plus the CALM insurance risk MfAD.

All cash flows should be projected without reflecting the impact of CALM C-3 provisions.

**5.1.4.3 Participating liability dividends**

The dividend cash flows used in the base scenario are different from those projected under CALM. The dividend cash flows projected under the base scenario should be restated using the following procedure:
1) Make a level adjustment to the dividend scale to convert it from CALM best estimate returns to those of the base scenario.

2) Apply this adjustment throughout the whole projection period by replacing current portfolio yields with base scenario forward rates, and then re-project the participating portfolio management target (e.g. target par surplus level, target time zero par liability, etc.).

3) Adjust dividends and repeat step 2 until the par portfolio management target is the same, under base scenario forward rates, as it was originally using the company’s own earned rates.

The dividend cash flows projected for the base scenario remain unchanged under all of the stress scenarios.

5.1.4.4 Callable and floating rate bonds and notes

The cash flows associated with a fixed-coupon callable bond should be projected to its next call date if its market value is above par, and to its latest maturity date if its market value is below par. The market value of a floating rate bond or note should be reported as a time zero cash flow.

5.1.4.5 Real estate

For real estate, fixed cash flows on leases in force should be included in the period in which they are contractually expected to be received. No contract or lease renewals should be assumed. Prepaid rent is excluded from the present value of lease cash flows. Cash flows from lease agreements with a rent-free period followed by a rent-paying period are included in the present value of lease cash flows. Insurers should include as a time zero cash flow the balance sheet value of the real estate less the present value of fixed cash flows calculated using base scenario discount rates. Where no fixed cash flows are projected, the real estate’s entire balance sheet value should be included as a cash flow at time zero. The cash flow amount at time zero remains the same under all interest rate scenarios.

5.1.4.6 Preferred shares and innovative instruments

For preferred shares and innovative instruments that do not constitute substantial investments, expected dividends up to the first call or redemption date should be treated as fixed cash flows, with the redemption proceeds treated as a cash flow on the redemption date. Insurers should include as a time zero cash flow the balance sheet value of the investment less the present value of the fixed cash flows calculated using base scenario discount rates. For investments that are currently redeemable, the entire balance sheet value is treated as a cash flow at time zero. The cash flow amount at time zero remains the same under all interest rate scenarios.

5.1.4.7 Non-fixed income investments

Non-fixed income (NFI) investments include any assets\(^\text{96}\) that do not have contractually guaranteed cash flows. Examples of such assets include equities and infrastructure investments

\(^{96}\) Including assets replicated synthetically (reference section 5.2.1)
without contractually fixed cash flows. However, real estate, preferred shares and innovative instruments are excluded from the definition of NFI investments as they are treated separately within the interest rate risk requirement.

In order to approximate the non-interest sensitive component of NFI investment’s dividend stream, 33% of the investment’s value is projected as cash flows occurring beyond time zero, while the remaining 67% of the investment’s value is projected as a time zero cash flow. At all integer times \( t \geq 1 \), a cash flow of:

\[
\frac{4.1 \times 0.89^t}{D_t} \% 
\]

of the investment’s value is projected as a cash flow occurring at time \( t \), where \( D_t \) is the base scenario discount factor from time \( t \) to time zero.

5.1.4.8 Pooled funds – index-linked risk pass-through products

If the index-linked product risk component is used (see section 5.5), liability cash flows should match asset cash flows in each scenario. However, minimum interest rate guarantees must be reflected if they are higher than the asset cash flows.

If the index-linked product risk component is not used, the liability cash flows should be the same as those used in the balance sheet valuation. If minimum interest guarantees do not apply, the account value should be included as a cash flow at time zero. Cash flows from the portion of investment management fees used to cover investment expenses and other administration costs should be included in both asset and liability cash flows.

5.1.4.9 Pooled funds – products without direct risk pass-through

Where the account value of a policy is linked to a bond fund but does not vary directly with the fund’s value, the cash flows of the fund should be projected so that the value of the fund changes appropriately with the change in interest rates under each scenario. For mutual and pooled funds that hold assets without fixed cash flows (e.g., equities and real estate), insurers should include the balance sheet value of the fund as a cash flow at time zero.

5.1.4.10 Securitized assets

For securitized assets whose cash flows are fixed, insurers should project the underlying fixed cash flows. For securitized assets whose cash flows are not fixed, the balance sheet value should be projected as a cash flow at time zero.

5.1.4.11 Capital instruments issued by the insurer

Obligations that the insurer has issued itself and that qualify for recognition in available capital under Chapter 2 (e.g. preferred shares, subordinated debt) should be excluded from the projection of liability cash flows.

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97 For hedged equity positions receiving credit under section 5.2.2, the delta equivalent value of the hedged position should be used as the investment value.
5.1.4.12 Interest rate swaps

For an interest rate swap, a nominal cash flow should be added to the asset or liability cash flows at the term of the fixed-rate portion of the swap, and an offsetting amount should be added to cash flows at time zero. The reported offset may be positive or negative, and may be either an asset or a liability. However, any reported nominal cash flows should be such that when the interest rate scenarios are applied, the change in the net present value of the nominal cash flows is equal to the change in the market value of the swap. If a swap is tied to a specific investment, the swap may be netted against the investment’s reported interest cash flows.

The shocked risk-free interest rate curve is used to determine the floating asset or liability cash flows. The contractual rate is used to determine the fixed asset or liability cash flows. All cash flows are discounted using the same scenario discount rates. If an insurer’s model used for valuation in its financial statements is able to project the floating portion of the swap accurately, then asset cash flows may be updated for each stressed interest rate scenario. However, no portion of the swap spread may be added to the discount rates in any scenario.

5.1.4.13 Other interest rate derivatives

Interest rate derivatives other than swaps should be included as an asset or liability cash flow at time zero in all scenarios. In each scenario, the time zero cash flow for the derivative is equal to the derivative’s fair value under the scenario’s interest rates. Stressed fair values should be calculated assuming no change in underlying interest rate volatility.

5.1.4.14 Reverse mortgages and collateral loans

Cash flows for reverse mortgages and collateral loans with fixed interest rates are projected using Best Estimate Assumptions, including mortality assumptions. If the assets have variable interest rates then they are shown as time zero cash flows. If an insurer’s model used for valuation in its financial statements is able to project variable interest assets accurately then asset cash flows are updated in each interest rate scenario.

5.1.4.15 Policy loans

Cash flows for policy loans with interest rates that are fixed or subject to guaranteed maximums should be projected using mortality and lapse assumptions that are consistent with those used in the valuation of the related policies. Policy loan amounts for variable rate policy loans that are not subject to guaranteed maximums should be projected as time zero cash flows.

5.1.4.16 Future income taxes

Projected cash flows should include cash flows arising from investment income taxes and tax timing differences that are projected under CALM. No other income tax cash flows should be included in the projection.

5.1.4.17 Dynamic assumptions tied to interest rates

If an insurer uses dynamic assumptions (e.g. for lapses) that vary with interest rates to project insurance cash flows under CALM, the liability cash flows projected in the interest rate base
scenario and stress scenarios should reflect these assumptions (i.e. the assumptions that are set dynamically should vary in each interest rate scenario to be consistent with the scenario).

5.1.4.18 Cash flows tied to inflation

Cash flows projected for expenses, and for benefit payments that are subject to cost-of-living adjustments should reflect the impact of inflation assumptions that vary consistently with each scenario. Inflation rates should bear the same relation to risk-free interest rates as assumed under the CALM valuation. For example, if an insurer generates inflation rates dynamically under CALM, the same generator should be used to derive inflation rates in the base scenario and stress scenarios that are consistent with these scenarios.

5.1.4.19 Deposit liabilities

The balance sheet value of deposit-type liabilities that are classified as investment contracts in the financial statements should be treated as a time zero cash flow.

5.1.4.20 Universal life

For most products, only contractual cash flows are projected and reinvestments are not assumed. Universal life (UL) is an exception as the contract continues after the end of any interest guarantee period inside the investment account. It is therefore necessary to use a reinvestment assumption to generate a credited rate that is used to project best estimate cash flows for premiums, policy charges and benefits and expenses.

Insurers should use base scenario discount rates (reference section 5.1.2) for discounting UL cash flows. However, the credited rate should vary based on the type of crediting rate methodology used:

a) For UL products with credited rates tied to the return of the general account, the credited rate should be based on the spreads of company’s asset mix supporting the specific UL liabilities.

b) For UL products with credited rates tied to new money rates, the credited rate should be based on the spreads described in section 5.2.1.

c) For UL investment accounts with equity-based returns, the credited rate is the CALM credited rate minus the CALM discount rate plus the spreads described in section 5.2.1.

The above reinvestment assumptions and credited rates should vary appropriately with the scenario that is being tested, including the base scenario. When credited rates and product cash flows depend on the bond market rate, liability cash flows should be projected in a manner consistent with CALM, but with investment returns assumed to equal LICAT forward rates.

Where the universal life contract has minimum interest guarantees, the effect of these guarantees must be reflected in the scenario that is being tested.

If the performance of a universal life contract inside-account benefit is tied to the performance of specific assets and these assets are held by the insurer, then the cash flows on these assets and liabilities should be included with the cash flows of other index-linked RPT products (refer to
section 5.5). If matching assets are not held, then the cash flows should be projected using assumptions that are consistent with those used in the balance sheet valuation and then adjusted for the scenario being tested.

No adjustments are made to the universal life cash flows for anticipated changes in lapse rates and expense charges with the change in discount rates in each scenario. A component for these changes is included as part of required capital for insurance risk.

### 5.2 Equity risk

Equity risk is the risk of economic loss due to potential changes in the prices of equity investments and their derivatives. This includes both the systematic and specific components of equity price fluctuation.

#### 5.2.1 Common equity

Required capital for all investments classified as common equities (including equity index securities, managed equity portfolios, income trusts, limited partnerships, and interests in joint ventures) is calculated by applying a factor to the market value of the investment. The base factor is 35% for equities in developed markets, and 45% for equities in other markets. The base factor is increased by 5 percentage points (i.e. to 40% or 50%) if:

- a. the equities are not listed on a recognized public exchange (e.g. private equity), and/or
- b. the insurer’s ownership interest in the equities constitutes a substantial investment without control.

<table>
<thead>
<tr>
<th>Common Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>35%</td>
</tr>
<tr>
<td>Developed markets, listed and non-substantial</td>
</tr>
<tr>
<td>40%</td>
</tr>
<tr>
<td>Developed markets, non-listed or substantial</td>
</tr>
<tr>
<td>45%</td>
</tr>
<tr>
<td>Other markets, listed and non-substantial</td>
</tr>
<tr>
<td>50%</td>
</tr>
<tr>
<td>Other markets, non-listed or substantial</td>
</tr>
</tbody>
</table>

If an increased factor is used for an equity holding that is a substantial investment, the amount to which the factor is applied should be net of the amount of associated goodwill and intangible assets deducted from Gross Tier 1 capital in section 2.1.2.1.

Developed markets include countries listed as developed markets by at least two of the five following data providers: Dow Jones & Company, FTSE Group, MSCI Inc., Russell Investments and Standard and Poor’s.

Substantial investments in mutual fund entities that do not leverage their equity by borrowing in debt markets, and that do not otherwise leverage their investments, do not receive equity risk.

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98 As defined in Section 10 of the Insurance Companies Act.
factors for substantial investments. Instead, a capital charge on the assets of the mutual fund entity will apply based on the requirements of section 5.4. For example, the factors for substantial investments do not apply where the insurer has made a substantial investment in a mutual fund as part of a structured transaction that passes through the unaltered returns (i.e., no guarantee of performance) on the substantial investment to the mutual fund holder.

The treatment of offsetting long and short positions in identical or closely correlated equities is described in section 5.2.2.

5.2.2 Preferred shares

Required capital for preferred shares depends on their ratings, and is calculated by applying the factors shown in the table below to their market values:

<table>
<thead>
<tr>
<th>Preferred Shares</th>
<th>3%</th>
<th>AAA, AA, Pfd-1 or P-1</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>5%</td>
<td>A, Pfd-2 or P-2</td>
</tr>
<tr>
<td></td>
<td>10%</td>
<td>BBB, Pfd-3 or P-3</td>
</tr>
<tr>
<td></td>
<td>20%</td>
<td>BB, Pfd-4 or P-4</td>
</tr>
<tr>
<td>Common equity risk factor</td>
<td>B or lower, Pfd-5 or P-5 and unrated</td>
<td></td>
</tr>
</tbody>
</table>

The factors for preferred shares apply to all investments in non-common share capital instruments (including subordinated debt) issued by domestic or foreign financial institutions that qualify as capital according to the solvency standards of the financial institution’s home jurisdiction.

5.2.3 Assets replicated synthetically and derivatives

This section describes required capital for transactions that increase an insurer’s exposure to market risk and for which the full notional amount of the transaction may not be reported on the balance sheet, such as transactions undertaken through derivatives. Insurers are required to report the entire exposure amount in the OSFI 86/87 and to calculate required capital for the full underlying risk assumed for these transactions irrespective of whether they are recognized or how they are reported on the balance sheet.

No additional capital is required under this section for hedges of index-linked liabilities that have been taken into account in the correlation factor calculation under section 5.5, nor for purchased put options that clearly serve to hedge an insurer’s segregated fund guarantee risk. For hedges of segregated fund guarantees undertaken as part of an OSFI-approved hedging program, OSFI will determine at the time of approval the extent to which the hedges may be exempted from the requirements of this section.

Where an insurer has entered into transactions (including short equity positions) that:

1) are intended to hedge the insurer’s segregated fund guarantee risk;
2) are not applied as offsets or hedges against other positions of the insurer to reduce required capital; and

3) have not been undertaken as part of an OSFI-approved hedging program.

Required capital for the hedges may be reduced to a minimum of zero if the insurer is able to demonstrate, to the satisfaction of the Superintendent, that losses on the hedges under particular scenarios would be offset by decreases in its segregated fund guarantee liabilities. Insurers should contact OSFI for details on the calculation for determining the capital requirement for these hedges.

The requirements in this section are distinct from the requirements for counterparty credit risk arising from off-balance sheet transactions. Transactions referenced in this section remain subject to the requirements for potential replacement cost as described in section 3.1 and Chapter 4.

5.2.3.1 Short positions in equities

Required capital for a short position in any equity security or index that does not wholly or partially offset a long equity position is the same as that for a long position of the same magnitude. Positions eligible for offset recognition and the corresponding treatment are described in section 5.2.2.

5.2.3.2 Future, forwards and swaps

Required capital for a futures or forward position in any security or index is the same as that for the equivalent spot position, and is reported in the OSFI 86/87 as if the position were current. Required capital for a swap is the same as that for the series of future or forward transactions that replicates the swap.

Example A: An insurer has entered into a futures contract to purchase equity securities on a future date. The insurer reports an equity exposure in an amount equal to the total current market value of the equities underlying the futures contract.

Example B: An insurer has entered into a one-year swap during which it will pay the total return (coupons and capital gains) on a 10-year Government bond, and receive the return on a notional index of equities that was worth $100M at the time of inception. The index of equities is currently worth $110M. The insurer reports an equity risk exposure of $110M for the long position in the index, and a liability exposure in interest rate risk calculation for the short position in the bond.

5.2.3.3 Options on equities

The following describes the methodology used to determine the required capital for both equity options that have been purchased and options that have been sold. This methodology may not be applied to equity options embedded in products sold to policyholders. The market risk required capital for policies containing an equity option component is calculated using the methodologies for index-linked RPT products (refer to section 5.5) or segregated fund guarantees (refer to Chapter 7), as appropriate.
Required capital for an option (or a combination of options in exactly the same underlying equity) is determined by constructing a two-dimensional matrix of changes in the value of the option position under various market scenarios, using the same valuation model that is used for the financial statements. The first dimension of the matrix requires an insurer to evaluate the price of the option position over a range within the corresponding equity risk charge above and below the current value of the underlying stock or index, with at least seven observations (including the current observation) used to divide the range into equally spaced intervals. The second dimension of the matrix entails a change in the volatility of the underlying stock or index equal to ±25% of its current volatility. Required capital for the option position is then equal to the largest decline in value calculated in the matrix. The application of this method and the precise manner in which the analysis is undertaken must be documented and made available to OSFI upon request.

As an alternative to constructing a scenario matrix for a purchased option, an insurer may deduct 100% of the carrying amount of the option from its Tier 1 Available Capital.

**Example:** An insurer has sold a call option on a publicly listed Canadian stock, with the stock currently having a market value of $100 and volatility of 20%. The first dimension of the matrix ranges from $65 to $135, divided into six intervals of $11.66 each, and the second dimension assumes that volatility stays at 20%, increases to 25% (= 20% + 25% of 20%) or decreases to 15% (=20% - 25% of 20%). If the change in the value of the insurer’s option position under the various market scenarios is as below, then the required capital for the option is $25.83.

<table>
<thead>
<tr>
<th>Gain (loss) due to change in option value</th>
<th>Stock Price</th>
<th>$65.00</th>
<th>$76.66</th>
<th>$88.33</th>
<th>$100.00</th>
<th>$111.66</th>
<th>$123.33</th>
<th>$135.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Volatility 15%</td>
<td>$10.36</td>
<td>$9.65</td>
<td>$7.11</td>
<td>$1.86</td>
<td>($5.78)</td>
<td>($14.85)</td>
<td>($24.54)</td>
<td></td>
</tr>
<tr>
<td>(current) 20%</td>
<td>$10.01</td>
<td>$8.59</td>
<td>$5.36</td>
<td>$0</td>
<td>($7.21)</td>
<td>($15.72)</td>
<td>($24.99)</td>
<td></td>
</tr>
<tr>
<td>25%</td>
<td>$9.37</td>
<td>$7.31</td>
<td>$3.58</td>
<td>($1.89)</td>
<td>($8.85)</td>
<td>($16.96)</td>
<td>($25.83)</td>
<td></td>
</tr>
</tbody>
</table>

### 5.2.3.4 Equity-linked notes

The balance sheet carrying amount of an equity- or index-linked note is decomposed into the sum of a fixed-income amount, equivalent to the present value of the minimum guaranteed payments under the note, and an amount representing the value of the option embedded within the note. The fixed-income portion of the note is classified as a debt exposure subject to a credit risk charge based on the rating and maturity of the note, and the residual amount is treated as an equity option.

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99 Insurers must demonstrate an understanding of the details of the valuation model used to construct the scenario matrix, and must objectively review and test the model on an ongoing basis, to the satisfaction of OSFI. Market prices, volatilities and other inputs to the valuation model must be subject to review by an objective and qualified person that is not close to or otherwise involved in the transactions or have related decision making authority. An insurer that does not apply the matrix method to the satisfaction of the Superintendent is required to deduct 100% of the carrying amount of the purchased option from its Tier 1 Available Capital.
**Example:** An insurer purchases an A-rated equity-linked note from a Canadian bank for $10,000. The note promises to pay, in two years, the $10,000 purchase price of the note plus the purchase price times 65.7% of the percentage appreciation (if positive) of the S&P 500 over the term of the note. The insurer uses the Black-Scholes option valuation model for financial reporting purposes. The implied volatility of the stock index is 25%, the yield curve is flat, the annual risk-free rate is 5%, and the issuing bank’s annual borrowing rate is 6.5%. The total required capital for this note is ($88.17 + $1,118.92 + $17.09) = $1,224.18, the sum of the following three separate charges:

1) **Bond component:** The value of the fixed-income component of the note is $10,000/(1.065)^2 = $8,816.59. The credit risk component, based on the note’s two-year term and A rating, is 1% of this amount, or $88.17.

2) **Option component:** The value of the call option embedded within the note, taking into account the credit risk of the issuer, is the residual amount, namely $1,183.41. In the option scenario table, the greatest loss will occur if the value of the index declines by 35% at the same time as the index volatility declines to 18.75%, in which case the value of the option will decline by $1,118.92; this is the required capital for the option.

3) **Counterparty credit risk (per Chapter 4):** The exposure amount for the option is calculated under the current exposure method as:

   Positive mark-to-market + Factor × Notional
   
   = $1,183.41 + 8% × $6,570
   
   = $1,709.01

   Since the note has an A rating, the capital charge is 1% of the current exposure amount, or $17.09.

   5.2.3.5 **Convertible bonds**

Required capital for a convertible bond is equal to the credit risk required capital for the bond’s fixed-income component, plus the equity option requirement for the bond’s embedded warrant. Required capital for the fixed-income component is equal to the bond’s credit risk factor (based on its rating and maturity) multiplied by the present value of the minimum guaranteed payments under the bond. The required capital for the embedded warrant is calculated using the scenario table method (refer to section 5.2.1.3) for options on equities, where the gains and losses are based either on the change in value of the bond’s warrant component (if the valuation methodology assigns an explicit value to this component) or the change in value of the whole bond.

As a simplification, an insurer may classify the entire balance sheet value of the convertible bond as an equity exposure and calculate required capital for the bond by applying the market risk factor for equities to the bond’s value.
5.2.4 Recognition of equity hedges

5.2.4.1 Offsetting long and short positions in equities

Equity positions backing indexed-linked policyholder liabilities for which a factor is calculated under section 5.5 may not be recognized as an offset to any other positions. Offsetting hedges of an equity position may only be recognized if the party providing the hedge is an eligible guarantor as defined in section 3.3.4.

Identical reference assets

Long and short positions in exactly the same underlying equity security or index may be considered to be offsetting so that an insurer is required to hold required capital only for the net position.

Closely correlated reference assets

Where the underlying securities or indices in a long and short position are not exactly the same but are closely correlated (e.g., a broad stock index and a large capitalization sub-index), insurers should calculate the required capital factor for the combined position using the correlation factor methodology described in section 5.5.2. If an insurer has not held a short position over the entire period covered in the correlation factor calculation, but the security or index underlying the short position has quotations that have been published at least weekly for at least the past two years, the insurer may perform the calculation as if it had held the short position over the entire period. However, returns for actively managed short positions may not be inferred for periods in which the positions were not actually held, and mutual funds that are actively managed externally may not be recognized as an offsetting short position in an inexact hedging relationship.

5.2.4.2 Recognition of equity option hedges

Option hedges of an equity holding may only be recognized if the party providing the hedge is an eligible guarantor as defined in section 3.3.4. Option hedges of segregated fund guarantee risk may not be recognized in the segregated fund guarantee capital requirement without explicit approval from OSFI. The form and amount of any such recognition will be specified by OSFI at the time of approval. Option hedges of segregated fund guarantee risk that receive recognition in the segregated fund guarantee required capital cannot be applied towards other equity risks.

Identical reference assets

If an option’s reference asset is exactly the same as that underlying an equity position held, an insurer may exclude the equity holding in calculating required capital for its equity exposures and instead consider the combined change in value of the equity position with the option in constructing the scenario table (reference section 5.2.1.3).

Closely correlated reference assets

If an option’s reference asset is not exactly the same as that underlying an equity position, but is closely correlated with the equity, then the factor for offsetting long and short positions in the
option’s reference asset and the asset underlying the equity position is calculated as described in section 5.2.2.1. An insurer may then exclude the equity holding from its required capital for equity exposures and instead calculate the combined change in value of the equity position with the option in a scenario table (refer to section 5.2.1.3). However, the movement in the option’s reference asset under each scenario must be assumed to be higher or lower (whichever produces a lower value for the option position) than the movement of the equity, by an amount equal to the required capital for directly offsetting positions. No additional adjustments need be made to the assumed changes in asset volatilities under the scenarios to account for asset mismatch.

Example: An insurer has a long position in a main equity index in a developed market, and also owns a call option and a put option on different indices that are closely correlated with the main index. The highest factor F over the previous four quarters between the reference index of the call option and the main index, calculated per section 5.5.2, is 3%, and the highest factor F calculated over the previous four quarters between the reference index of the put option and the main index is 1%. The insurer therefore constructs a scenario table in which the price of the main index ranges from 35% below to 35% above its current value, while the index underlying the call option ranges from 38% below to 32% above its current value, and the index underlying the put option ranges from 34% below to 36% above its current value. In the scenarios in the center column of the table, the main index will remain at its current value, while the index underlying the call option will be 3% lower than currently and the index underlying the put option will be 1% higher than currently.

5.3 Real estate risk

Real estate market risk is the risk of economic loss due to changes in the amount and timing of cash flows from investments in real estate.

The carrying amount of investment property is divided into two components: leases in force and the residual value of the property. For leases in force, required capital is calculated for interest rate risk (section 5.1) and for credit risk (section 3.1.9.2) using the cash flows as defined in section 5.1.4.3. The residual value of investment property is defined as its fair value at the reporting date net of the present value of the fixed cash flows that are contractually expected to be received as determined in 5.1.4.3, including prepaid rent cash flows. Required capital is calculated by applying a factor of 30% to the residual value of the investment property.

For owner-occupied property, oil and gas properties, timberland, agricultural properties, and all other property, plant and equipment not having contractually guaranteed cash flows, required capital is calculated as the difference, if positive, between balance sheet value at the reporting date and 70% of the property’s fair value at the reporting date. If the fair value of such a property is not available then required capital is 30% of the property’s book value. Required capital is determined on a property-by-property basis.

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100 If an insurer is leasing a portion of owner-occupied property to an external party, it may treat the lease in the same manner as a lease in force on an investment property.
5.4 Mutual funds

The factor for investments in unleveraged mutual funds\textsuperscript{75}, exchange traded funds, segregated funds and real estate investment trusts is a weighted average of factors for assets that the fund is permitted to invest in. The weights and factors are calculated assuming that the fund first invests in the asset class attracting the highest capital requirement, to the maximum extent permitted in its prospectus or Annual Information Form (where more current). It is then assumed that the fund continues allocating investments to asset classes in declining order of capital charge, to the maximum extent permitted, until a total allocation of 100% is reached. The factor for the mutual fund is then the sum of the products of the weights and risk factors for the assumed investment allocation.

In the absence of specific limits to asset classes or if the fund is in violation of the limits stated in the prospectus, the entire fund is subject to the highest risk charge applicable to any security that the fund holds or is permitted to invest in.

The factor for any fund that employs leverage\textsuperscript{101} is 35%.

5.5 Index-linked products risk

5.5.1 Scope of application

The credit risk factors in section 3.1 and market risk charges in sections 5.1 to 5.4 do not apply to assets backing index-linked products. All assets backing index-linked products must be segmented and included in the index-linked reporting form, and receive factors based on the historical correlation between weekly asset and liability returns in section 5.5.2.

The correlation factor calculation may be used for index-linked products, such as universal life policies, having the following characteristics:

1) Both assets and liabilities for these contracts are held in the general fund of the life insurer;

2) The policyholder is promised a particular return in the contract, based on an index, possibly subject to a floor. The following are examples of such returns:
   a. The same return as a specified public index. This includes, but is not limited to a public stock index, a bond index, or an index maintained by a financial institution.
   b. The same return as is earned by one of the insurer’s segregated funds or mutual funds.
   c. The same return as is earned by another company’s mutual funds; and

3) The insurer may invest in assets that are not the same as those that constitute the indices.

\textsuperscript{101} Leveraged funds are those that issue debt/preferred shares, or that use financial derivatives to amplify returns. Funds that employ an insignificant amount of leverage may be excluded from this definition.
The following conditions must be adhered to:

1) All supporting assets must be segmented into asset subgroups;
2) A separate asset subgroup must be maintained for each index referred to in the products;
3) The returns (on a market basis) of each asset subgroup must be tracked; and
4) Any transfers into or out of the asset subgroup must be at market value.

5.5.2. Required capital

The factor $F$ applicable to a particular subgroup of assets is given by:

$$F = 20 \times (C - B + B \times \sqrt{2 - 2A})$$

where:

- $A$ is the historical correlation between the returns credited to the policyholder funds and the returns on the subgroup’s assets;
- $B$ is the minimum of [standard deviation of asset returns, standard deviation of returns credited to policyholder funds]; and
- $C$ is the maximum of [standard deviation of asset returns, standard deviation of returns credited to policyholder funds].

Note that a factor must be calculated for each asset subgroup.

The historical correlations and standard deviations must be calculated on a weekly basis, covering the previous 52-week period. The returns on asset subgroups must be measured as the increase in their market values net of policyholder cash flows.

The factor $F$ for the previous 52 weeks is required to be calculated each quarter. The charge is then equal to the highest of the four factors calculated over the previous four quarters. This factor is applied to the fair value at quarter-end of the assets in the asset subgroup.

Instead of using policyholder funds in the calculations, an insurer may use cash surrender values or policy liabilities to measure the correlation. The basis used must be consistently applied in all periods.

Credit and market risk factors must be applied to:

1) Assets backing index-linked products that are not segmented into asset subgroups;
2) Assets backing index-linked products for which $F$ cannot be calculated; and
3) Newly formed funds for the first three quarters. (Combined with the requirement to use the highest capital factor of the last four quarters’ calculations, this implies that the requirement for newly formed funds will be that of the underlying assets for the first 18 months.)
As a simplification, insurers may choose to apply a 35% factor to the assets listed above.

When a synthetic index investment strategy is used, there is some credit risk that is not borne directly by policyholders. This may include credit risk associated with fixed income securities and counterparty risk associated with derivatives that are purchased under the synthetic strategy. Insurers must hold credit risk required capital for these risks in addition to the index-linked requirements of this section.

For index-linked insurance policies that have a minimum death benefit guarantee, the appropriate requirement for segregated fund mortality guarantees must be applied. This requirement may be obtained using the methodology described in Chapter 7.

5.6 Currency risk

Currency risk is the risk of economic loss due to changes in the amount and timing of cash flows arising from changes in currency exchange rates. Two steps are required to calculate required capital for currency risk. The first is to measure the exposure in each currency position. The second is to calculate the required capital for the portfolio of positions in different currencies. In summary, the required capital is 30% of the greater of the sum of (i) the net open long positions or (ii) the net open short positions in each currency, plus the net open position in gold, whatever the sign\textsuperscript{102}. A charge is then added for currency volatility, if applicable.

5.6.1 Measuring the exposure in a single currency

The net open position for each individual currency (and gold) is calculated by summing:

1) the net spot position, defined as all asset items less all liability items denominated in the currency under consideration, including accrued interest and accrued expenses but excluding provisions for currency risk held within insurance contract liabilities;

2) the net forward position (i.e., all net amounts under forward foreign exchange transactions, including currency futures and the principal on currency swaps);

3) guarantees (and similar instruments) that are certain to be called and are likely to be irrecoverable;

4) net future income/expenses not yet accrued but already fully hedged by the insurer (see 5.6.5);

5) an offsetting short position of up to [200%] of required capital for assets and liabilities denominated in the currency under consideration. The percentage amount may be selected by the insurer and may vary by currency. Required capital for business denominated in a specific currency should be calculated by aggregating the requirements for credit risk, market risk (excluding currency risk) and insurance risk arising from

\textsuperscript{102} Gold is treated as a foreign exchange position rather than a commodity because its volatility is more in line with foreign currencies.
assets and liabilities in the currency, taking into account all credits for within-risk diversification, between-risk diversification, and participating and adjustable products applicable to these requirements (see chapters 9 and 11); and

6) any other item representing a profit or loss in foreign currencies.

The following structural positions and related hedges are excluded from the calculation of net open currency positions:

1) Assets backing surplus that are fully deducted from the insurer’s Available Capital (e.g., goodwill);

2) Any position entered into in relation to the net investment of a capital nature in a foreign operation, the accounting consequence of which is to reduce or eliminate what is otherwise a change in the foreign currency translation adjustment; and

3) Asset and liability positions corresponding to investments in foreign operations that are fully deducted from an insurer’s Available Capital (reference section 2.1.2).

5.6.2. Treatment of options

If an insurer has purchased or sold options on a foreign currency, it must perform the scenario table calculation described in section 5.2.1.3, where the changes in value measured are those of the net open position in the currency and the options combined, and where the range of values used for the currency in the table is 30% above and below its current value instead of 35%. The magnitude of the net open position in the currency after adjusting for options is then equal to 3.33 times the largest decline in value that occurs in the middle row of the table. If this decline occurs in a column where the value of the currency decreases then the position is treated as a long position, and if the decline occurs in a column where the value of the currency increases then the position is treated as a short position.

If the largest decline in the entire scenario table is greater than the largest decline in the middle row, then the difference represents the required capital for volatility in the foreign currency, and this amount is added to the capital requirement for currency risk.

5.6.3. Treatment of immaterial operations

Currency risk is assessed on a consolidated basis. It may be technically impractical in the case of immaterial operations to include some currency positions. In such cases, the internal limit in each currency may be used as a proxy for the positions, provided there is adequate ex post monitoring of actual positions complying with such limits. In these circumstances, the limits are added, regardless of sign, to the net open position in each currency.

5.6.4. Measurement of forward currency positions

Forward currency positions are valued at current spot market exchange rates. It is not appropriate to use forward exchange rates since they partly reflect current interest rate differentials. Insurers that base their normal management accounting on net present values are expected to use the net
present values of each position, discounted using current interest rates and translated at current spot rates, for measuring their forward currency and gold positions.

5.6.5. Accrued and unearned interest, income and expenses

Accrued interest, accrued income and accrued expenses are treated as a position if they are subject to currency fluctuations. Unearned but expected future interest, income or expenses may be included, provided the amounts are certain and have been fully hedged by forward foreign exchange contracts. Insurers must be consistent in their treatment of unearned interest, income and expenses and must have written policies covering the treatment. The selection of positions that are only beneficial to reducing the overall position is not permitted.

5.6.6. Calculating required capital for the portfolio

The nominal amount (or net present value) of the net open position in each foreign currency (and gold) is converted at spot rates into Canadian dollars. Required capital is 30% of the overall net open position, calculated as the sum of:

a. the greater of the sum of the net open short positions (absolute values) or the sum of the net open long position less offsets; and

b. the net open position in gold, whether long or short (i.e., regardless of sign).

Required capital is increased by the total of the volatility risk charges for each foreign currency, if any, to arrive at the final required capital.

5.6.7. Example

An insurer has the following net currency positions. These open positions have been converted at spot rates into Canadian dollars, where (+) signifies an asset position and (-) signifies a liability position.

<table>
<thead>
<tr>
<th>YEN</th>
<th>EUR</th>
<th>GB£</th>
<th>CHF</th>
<th>US$</th>
<th>GOLD</th>
</tr>
</thead>
<tbody>
<tr>
<td>+50</td>
<td>+100</td>
<td>+150</td>
<td>-20</td>
<td>-180</td>
<td>-35</td>
</tr>
<tr>
<td>+300</td>
<td></td>
<td></td>
<td>-200</td>
<td></td>
<td>-35</td>
</tr>
</tbody>
</table>

In this example, the insurer has three currencies in which it has long positions, these being the Japanese Yen, the Euro and the British Pound, and two currencies in which it has a short position, the Swiss Franc and the U.S. Dollar. The middle line of the above chart shows the net open positions in each of the currencies. The sum of the long positions is +300 and the sum of the short positions is -200.

The foreign exchange requirement is calculated using the higher of the summed absolute values of either the net long or short positions, and the absolute value for the position in gold. The factor used is 30%. In this example, the total long position (300) would be added to the gold position (35) to give an aggregate position of 335. The aggregated amount multiplied by 30% results in a capital charge of $100.50.
5.6.8. **Unregistered reinsurance**

A separate component calculation must be performed for each group of liabilities ceded to an unregistered reinsurer that is backed by a distinct pool of assets, where the defining characteristic of a pool is that any asset in the pool is available to pay any of the corresponding liabilities. Each calculation should take into consideration the ceded liabilities, the assets supporting them, and deposits placed by the reinsurer to cover the required capital for the ceded liabilities if the deposits are in a currency different from the currency in which the ceded liabilities are payable to policyholders. If some of the assets supporting the liabilities ceded to an unregistered reinsurer are held by the ceding insurer (e.g., funds withheld), the insurer’s corresponding liability is treated as an asset in the calculation of the open positions for the ceded business.

Excess deposits placed by an unregistered reinsurer within a pool of supporting assets may be used to reduce the required capital for foreign exchange risk for the corresponding ceded business to a minimum of zero, subject to the conditions in section 10.6. Any requirements not covered by excess deposits must be added to the ceding insurer’s own requirement.

5.6.9. **Foreign exchange de minimus criteria**

An insurer doing negligible business in foreign currency, and that does not take foreign exchange positions within its own investment portfolio, may be exempted from the requirement for currency risk provided that:

1) Its foreign currency business, defined as the greater of the sum of its gross long positions and the sum of its gross short positions in all foreign currencies, does not exceed 100% of total Available Capital; and

2) Its overall net open foreign exchange position does not exceed 2% of total Available Capital.
Chapter 6  Insurance Risk

Insurance risk is the risk of loss arising from the obligation to pay out benefits and expenses on insurance policies and annuities in excess of expected amounts. Insurance risk includes:

1) Mortality risk on life insurance;
2) Longevity risk on annuities;
3) Morbidity risk on disability, critical illness (CI), long term care (LTC) and accident & sickness (A&S) insurance;
4) Lapse and policyholder behaviour risk, and
5) Expense risk.

Required capital for insurance risk covers the risk that realized insurance experience may be worse than Best Estimate Assumptions (reference section 1.4.4). Required capital considers adverse experience arising from:

i) misestimation of the level of Best Estimate Assumptions (level risk);
ii) misestimation of the future trend of Best Estimate Assumptions (trend risk);
iii) volatility risk due to random fluctuations, and
iv) catastrophe risk due to a one-time, large-scale event.

A projected cash flow methodology that measures the economic impact of a one-time or multi-year shock to best-estimate mortality, morbidity, lapse and expense rate assumptions is used to determine the required capital for insurance risk. Components of required capital are calculated for each of level, trend, volatility and catastrophe risk components of each insurance risk. Required capital for each component is calculated as the difference between the present value of best-estimate cash flows and the present value of shocked cash flows. The components are calculated at the policy level, summed by product and added across products by risk component and geography.

Unless otherwise indicated, the four risk components for each type of insurance risk are aggregated as the square root of the sum of the squares of the volatility and catastrophe risk components, plus the level and trend risk components:

$$RC = \sqrt{RC_{vol}^2 + RC_{cat}^2 + RC_{level} + RC_{trend}}$$

where:

- $RC$ is total required capital for the insurance risk
- $RC_{vol}$ is the required capital component for volatility risk
- $RC_{cat}$ is the required capital component for catastrophe risk
- $RC_{level}$ is the required capital component for level risk
- $RC_{trend}$ is the required capital component for trend risk
Required capital is calculated by geography, and is floored at zero at the geography level.

Aggregation of the insurance risk components is specified in Chapter 11. Risks are aggregated separately for non-participating business, and for blocks of participating business (reference Chapter 9). Each risk is aggregated across entities within the same geography, with each geography treated as if it were a consolidated entity.

The methodologies specified in this chapter are not used for segregated fund guarantee products. Instead, the insurance risk requirements for such products are approximated as 200% of the sum of their PfADs for mortality, morbidity and longevity risk.

6.1. Projection of insurance liability cash flows

Cash flows used to determine required capital for insurance risk are calculated using Best Estimate Assumptions per section 1.4.4. Best estimate and shocked cash flows are projected for the terms of the liabilities by geography. Best estimate cash flows do not include CALM margins for adverse deviation (MfADs). All best estimate and shocked cash flows are net of registered reinsurance (refer to Chapter 10) and may reflect future assumed recaptures as long as all the features of the recapture are appropriately reflected\(^\text{103}\). For the purpose of calculating the insurance risk components, best estimate and shocked cash flows are discounted at prescribed rates that depend on where the business was originally sold (rather than the currency in which the liability is denominated). The spot discount rates are level, and are:

- 5.3% for Canada, the United States and the United Kingdom,
- 3.6% for Europe excluding the United Kingdom,
- 1.8% for Japan, and
- 5.3% for all other geographies.

In calculating required capital, group business that is individually underwritten is treated as individual business. Group liability cash flows may be projected up to or beyond the term of the liability. An insurer may project group cash flows (other than for claim liabilities) up to the term of the premium rate guarantee period (typically the renewal date) consistent with the CALM valuation, or else it may opt to project the cash flows for a full year and use a reduced factor. In instances where the remaining term of the liability is less than 1 year and the active life liability cash flows for group policies are projected for a full year, a 75\% factor is applied to the death benefit amounts used to determine mortality volatility risk in section 6.2, and to the projected cash flows used to determine the requirements for all other mortality and morbidity risks in sections 6.2 and 6.4.

\(^{103}\) Cash flows include those corresponding to liabilities assumed under modified coinsurance arrangements, and exclude those corresponding to business ceded under registered modified coinsurance arrangements.
6.2. Mortality risk

Mortality risk is the risk associated with the variability in liability cash flows due to the incidence of death. Level and trend risk components are calculated for all individual life and individually underwritten group life insurance products that are exposed to mortality risk. Volatility and catastrophe risk components are calculated for all individual and group life insurance products that are exposed to mortality risk. Mortality risk required capital is calculated for accidental death and dismemberment products and any mortality exposure supported by the general account. However, mortality risk required capital is not calculated for products without mortality risk such as waiver of premium, critical illness and deferred annuities.

Required capital for mortality risk is calculated for each geography using the following formula:

\[ RC_{mortality} = \sqrt{RC_{vol}^2 + RC_{cat}^2 + RC_{level} + RC_{trend}} \]

A diversification credit is given for level and trend components between individually underwritten life supported and individually underwritten death supported business (reference section 11.1.2).

All cash flow projections, benefit amounts and reserve amounts used to determine required capital for mortality risk are calculated net of all reinsurance that is deemed to constitute registered reinsurance under section 10.2.

The net amount at risk for a policy or set of products, for both directly written business and business acquired through reinsurance, refers to the total net face amount of all of the included policies minus the total net reserve for the included policies, where both the face amount and the reserve are net of registered reinsurance.

For purposes of mortality risk required capital, basic death benefits include supplementary term coverage, participating coverage arising out of dividends (paid-up additions and term additions), and increasing death benefits associated with universal life policies (i.e., policies where the death benefit is the face amount plus funds invested).

6.2.1. Designation of life and death supported business

Required capital for mortality risk is calculated separately for life supported and death supported business. All individual life and individually underwritten group life insurance products with mortality risk are designated as either life supported or death supported for aggregation purposes.

The insurer should group its policies into portfolios with similar products and characteristics and then determine if each individual portfolio is life supported or death supported. Level and trend risk components must be combined for this calculation.

The present value of cash flows for each portfolio is calculated using a -15% mortality level shock applied to the best estimate assumption for the mortality rate and a +75% mortality trend.
shock applied to the best estimate assumption for mortality improvement, discounted at the rates specified in section 6.1. The result of this calculation is compared to the present value of best estimate cash flows using the same discount rates. If the present value of the shocked cash flows is greater than the present value of the best estimate cash flows, the portfolio is designated as death supported business; otherwise, the portfolio is designated as life supported.

6.2.2. **Level risk**

A level risk component is calculated for all individual life and individually underwritten group life products that are exposed to mortality risk.

The mortality level risk component is the difference between the present value of shocked cash flows and the present value of best estimate cash flows, determined separately for life and death supported business.

In order to avoid double counting with mortality volatility risk, the level risk component is reduced by the component related to the increase in the Best Estimate Assumption for mortality rate in the first year following the reporting date. Required capital for the first year is calculated as the difference between the present value of best estimate cash flows with a level shock in the first year only, and the present value of best estimate cash flows.

6.2.2.1  *Life supported business*

The level risk shock for life supported business is a permanent increase to the Best Estimate Assumptions for mortality rate at each age. The increased mortality rates are calculated as:

\[(1 + \text{Factor}) \times \text{Best Estimate Mortality Rate}\]

where Factor is the lesser of:

a. 10% plus 35% of the ratio of the calculated individual life volatility component to the following year’s net expected claims; or

b. 25%.

The ratio in a) above is the same for all individual life insurance products within a single geography.

As an approximation, insurers may elect to use a one-year lag when calculating the ratio of the individual life volatility risk component to the following year’s expected claims. That is, for current year-end reporting requirements, companies may use the ratio calculated using the prior year’s volatility risk component and expected claims.

6.2.2.2  *Death supported business*

The level risk shock for death supported business is a permanent 15% decrease in best estimate mortality rates for each age and policy for all policy durations (i.e., -15% for all years).
6.2.3.  Trend risk

A trend risk component is calculated for all individual life and individually underwritten group life products that are exposed to mortality risk. The trend risk component is the difference between the present value of the shocked cash flows and the present value of best estimate cash flows for all years, determined separately for life and death supported business.

6.2.3.1  Life supported business

The trend risk shock for life supported business is a permanent 75% decrease to the Best Estimate Assumption for mortality improvement for 25 years, followed by no mortality improvement (i.e., a 100% decrease) thereafter.

6.2.3.2  Death supported business

The trend risk shock for death supported business is a permanent 75% increase in the Best Estimate Assumption for mortality improvement for all policy durations.

6.2.4.  Volatility risk

A volatility risk component is calculated for all individual and group life insurance products that are exposed to mortality risk. It is calculated in aggregate (i.e., life and death supported products) by geography across all products.

The volatility risk component is:

\[
\sqrt{\frac{1}{2} \sum_{\text{Basic Death}} R_C^2} + \sqrt{\frac{1}{2} \sum_{\text{AD&D}} R_C^2}
\]

where the sums are taken over all sets of basic death and AD&D products respectively, and \( R_C \) is the volatility risk required capital component for the set of products. The formula for \( R_C \) is given by:

\[
2.7 \times A \times \frac{E}{F}
\]

where:

- \( A \) is the standard deviation of the upcoming year’s projected net death claims for the set (including claims projected to occur after the term of the liability for group policies), defined by:

\[
A = \sqrt{\sum q(1-q)b^2}
\]

where:

- \( q \) is a particular policy’s Best Estimate Assumption for mortality; and
- \( b \) is the death benefit for the policy, net of registered reinsurance.

The sum is taken over all policies. The calculation is based on claims at the policy level, rather than claims per life insured. Multiple policies on the same life may be
treated as separate policies, but distinct coverages of the same life under a single policy must be aggregated. If this aggregation is not done due to systems limitations, the impact should still be approximated and accounted for in the mortality volatility risk requirement.

- $E$ is the total net amount at risk for all policies in the set; and
- $F$ is the total net face amount for all policies in the set.

When there is insufficient data available to calculate $A$ for a set of products and the standard deviation of the net death benefit amounts for all policies or (for group products) certificates in the set is known, factor $A$ for the set should be approximated as:

$$A \approx \sqrt{\frac{C \times \sum b^2}{F}}$$

where:

- $C$ is the projected value of the upcoming year’s total net death claims for all policies in the set (including claims projected to occur after policy renewal dates);
- The sum is taken over all policies or (for group products) certificates in the set, and $b$ is the net death benefit amount for the policy or certificate; and
- $F$ is the total net face amount for all policies in the set.

When there is insufficient data available to calculate $A$ for a set of products and the standard deviation of the net death benefit amounts is not known, the insurer may approximate factor $A$ for the set using a comparable set of its own products for which it is able to calculate the volatility component exactly. For the set whose volatility component is being approximated, $A$ may be approximated as:

$$A \approx \frac{A_c \times \sqrt{N_c}}{C_c} \times \sqrt{C} \times \sqrt{\max\left(\frac{F \times C}{n \times N}\right)}$$

where:

- $A_c$ is the exact factor $A$ calculated for the comparison set;
- $N_c$ and $N$ are the total numbers of deaths projected to occur over the upcoming year for all policies in the comparison set and all policies in the set for which $A$ is being approximated, respectively;
- $C_c$ and $C$ are the projected values of the upcoming year’s total net death claims for all policies in the comparison set and all policies in the set for which $A$ is being approximated, respectively;
- $F$ is the total net face amount for the policies in the set for which $A$ is being approximated; and
- $n$ is the total number of lives covered under the policies in the set for which $A$ is being approximated.

The use of the above approximation is subject to the following conditions:

1) There is no basis from which to conclude that the dispersion of the distribution of net death benefit amounts, as measured by the ratio of the standard deviation to the mean, of the comparison set may with material likelihood be lower than that of the set for which $A$ is being approximated. It may not be appropriate to base the approximation on an insurer’s entire book of products of the same type. An insurer’s Appointed Actuary must be able to explain, to the satisfaction of OSFI, why using the approximation based on the comparison set produces appropriate results.

2) Insurers must use comparison sets of individual products to approximate factors for sets of individual products, and comparison sets of group products to approximate factors for sets of group products. Insurers may use sets of basic death products to approximate factors for sets of AD&D products, but may not use sets of AD&D products to approximate factors for sets of basic death products.

3) For any particular set of products used as a comparison set, the number of covered lives in the comparison set must be greater than or equal to the total number of covered lives summed over all sets for which factors are approximated based on the comparison set.

4) If this approximation is used for sets of individual basic death products, the sets in aggregate must not be material relative to the insurer’s entire book of business.

For sets of products consisting entirely of traditional employer-sponsored group policies, insurers may use the above approximation without reliance on a set of comparable products with the comparison set factor $A_c \times \sqrt{N_c / C_c}$ replaced by 1.75 in the approximation. The factor of 1.75 may be used to approximate $A$ for a set only if each group policy in the set requires employees to remain actively working for the plan sponsor in order to continue coverage. In particular, such a set may not contain debtor, association, mass mailing or dependent coverages.

When there is insufficient data available to calculate $A$ for a set of products and the standard deviation of the net death benefit amounts is not known, companies may also approximate factor $A$ for the set using the formula:

$$A \approx \sqrt{C} \times \sqrt{b_{\text{min}} + b_{\text{max}}} - \frac{b_{\text{min}} \times b_{\text{max}}}{F / n}$$

where:

- $C$ is the projected value of the upcoming year’s total net death claims for all policies in the set (including claims projected to occur after policy renewal dates);
- $b_{\text{min}}$ is less than or equal to the lowest single-life net death benefit amount of any policy or certificate in the set;
- $b_{\text{max}}$ is the highest single-life net death benefit amount or retention limit of any policy or certificate in the set;
• $F$ is the total net face amount for the policies in the set; and
• $n$ is the total number of lives covered under the policies in the set.

The value of the average net death benefit amount $F/n$ used in the above formula must be exact, and may not be based on an estimate. If an insurer cannot establish with certainty both the average net death benefit amount and a lower bound $b_{\min}$ on the net death benefit amounts, it must use the value $b_{\min} = 0$ in the formula so that the approximation used is:

$$A \approx \sqrt{C \times b_{\max}}$$

### 6.2.5. Catastrophe risk

A catastrophe risk component is calculated for all individual and group life insurance products that are exposed to mortality risk. It is tested in aggregate (i.e., life and death supported products) by geography across all products.

The shock for catastrophe risk is an absolute increase in the number of deaths per thousand lives insured in the year following the reporting date (including claims projected to occur after policy renewal dates for group policies), and varies by the location of the business as follows:

- Canada: 1.0
- United States: 1.2
- United Kingdom: 1.2
- Europe, other than U.K.: 1.5
- Other: 2.0

For AD&D products, 60% of the above assumptions for mortality catastrophe risk are used.

The catastrophe risk component is the difference between the present value of the shocked cash flows and the present value of the best estimate cash flows.

### 6.3. Longevity risk

Longevity risk is the risk associated with the increase in liability cash flows due to increases in life expectancy caused by changes in the level and trend of mortality rates.

The following formula is used to calculate longevity risk required capital for each geography:

$$RC_{\text{longevity}} = RC_{\text{level}} + RC_{\text{trend}}$$
6.3.1. Level risk

The longevity level risk component is calculated for all annuity products that are exposed to longevity risk. The level risk component is the difference between the present value of the shocked cash flows and the present value of the best estimate cash flows. The required shock is a permanent decrease in Best Estimate Assumptions for mortality rate at each age as follows:

- Non-registered annuity business – Canada, US and UK: -20%
- Registered annuity business – Canada: -10%
- Registered annuity business – US and UK: -12%
- Non-registered and registered annuity business – all other geographies: -15%

Registered annuities are those that are purchased using tax-qualified (i.e. pre-tax) retirement savings.

6.3.2. Trend risk

The longevity trend risk component is calculated for all annuity products that are exposed to longevity risk. The required shock for trend risk is a 75% increase in the Best Estimate Assumption for mortality improvement. The shock applies per year of mortality improvement forever. That is, the shocked cash flows for trend risk are calculated using best estimate cash flows with 175% of the Best Estimate Assumption for mortality improvement.

The longevity trend risk component is the difference between the present value of the shocked cash flows and the present value of the best estimate cash flows.

6.4. Morbidity risk

Morbidity risk is the risk associated with the variability in liability cash flows arising from the incidence of policyholder disability or health claims (including critical illness), and from termination rates. The termination rate is defined as the proportion of disabled lives that cease to be disabled over one year as the result of either recovery or death.

The following products are exposed to morbidity risk:
1) Individual DI – active and disabled lives;
2) Group STD and LTD – active and disabled lives;
3) Individual and group CI (adjustable and non-adjustable products);
4) Individual and group LTC (adjustable and non-adjustable products) – active and disabled lives;
5) Group medical and dental (including other group A&S);
6) Individual and group WP;
7) Individual and group travel;
8) Individual and group credit insurance;
9) Individual other A&S.

Morbidity risk includes the impact of mortality risk on the above products.

Group morbidity business that is individually underwritten is subjected to the same shocks as individual business.

Return of premium riders are included in the cash flows of the underlying products. Changes in the return of premium rider liability are taken into consideration when calculating required capital.

In cases where an insurer does not use incidence and termination rate assumptions in the determination of its CALM liabilities, shocks on incidence or termination rates should be applied to net written premiums adjusted by the loss ratio (i.e. the percentage shocks specified for incidence/termination rate assumptions should instead be applied to net written premiums adjusted by the loss ratio for level, volatility and catastrophe risk shocks).

Morbidity risk required capital components are calculated for level, trend, volatility and catastrophe risks. Total required capital for morbidity risk is calculated separately by geography using the following formula:

\[ RC_{morbidity} = \sqrt{RC_{val}^2 + RC_{cat}^2 + RC_{level} + RC_{trend}} \]

6.4.1. Level risk

The level risk component is calculated for products that are exposed to morbidity risk. The exposure base to which the shock is applied varies according to status of the policyholder: active versus disabled.

For active lives with a guarantee coverage period exceeding 12 months, the shock for level risk is a permanent increase in Best Estimate Assumptions for morbidity incidence rate at each age.

For disabled lives, the shock for level risk is a permanent decrease in Best Estimate Assumptions for morbidity termination rate at each age. Morbidity termination rate shocks for level risk apply to currently disabled lives and IBNR claims.

Mortality rate assumptions should not change as a result of shocks to incidence or termination rates since these shocks implicitly include the impact of mortality risk.

The factors for level risk shocks are as follows:
The morbidity level risk component is the difference between the present value of the shocked cash flows and the present value of best estimate cash flows. The components for Disability, CI and LTC morbidity level risk may be reduced by a credit for within-risk diversification, which is determined using a statistical fluctuation factor (refer to section 11.1.2).

### 6.4.2. Trend risk

A trend risk component is calculated for:

1) Products with a guarantee coverage period for active lives of two years or more, such as individual CI, individual active life DI and individual other A&S; and

2) Products that provide benefits to disabled lives, such as LTD, DI and WP.

If a Best Estimate Assumption for morbidity improvement is not used, the risk charge for trend risk is zero.

The shock for trend risk is a permanent 100% decrease in the Best Estimate Assumption for morbidity improvement. The shocked cash flows for trend risk are calculated using best estimate cash flows and an annual morbidity improvement rate assumption of 0%.

The morbidity trend risk component is the difference between the present value of the shocked cash flows and the present value of the best estimate cash flows.

### 6.4.3. Volatility risk

The volatility risk component is calculated as a one-time shock to first-year incidence rates for all active lives that are exposed to morbidity risk. For individual products, the shock for volatility risk in the first year is calculated independently of the shock used for level risk (section 6.5.1). Termination rate assumptions should not change as a result of the shocks to incidence rates.
The first-year factors for the volatility risk shocks are listed below:

<table>
<thead>
<tr>
<th>Exposure Base</th>
<th>Product Type</th>
<th>Shock Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Incidence Rates</td>
<td>Individual active DI</td>
<td>+25%</td>
</tr>
<tr>
<td></td>
<td>Individual active WP</td>
<td>+25%</td>
</tr>
<tr>
<td></td>
<td>Individual CI</td>
<td>+50%</td>
</tr>
<tr>
<td></td>
<td>Individual active LTC</td>
<td>+30%</td>
</tr>
<tr>
<td></td>
<td>Individual travel</td>
<td>+30%</td>
</tr>
<tr>
<td></td>
<td>Individual credit insurance</td>
<td>+30%</td>
</tr>
<tr>
<td></td>
<td>Individual other A&amp;S</td>
<td>+30%</td>
</tr>
<tr>
<td></td>
<td>Group active STD and LTD</td>
<td>+25%</td>
</tr>
<tr>
<td></td>
<td>Group active WP</td>
<td>+25%</td>
</tr>
<tr>
<td></td>
<td>Group CI</td>
<td>+50%</td>
</tr>
<tr>
<td></td>
<td>Group active LTC</td>
<td>+30%</td>
</tr>
<tr>
<td></td>
<td>Group medical (including other group A&amp;S)</td>
<td>+15%</td>
</tr>
<tr>
<td></td>
<td>Group dental</td>
<td>+20%</td>
</tr>
<tr>
<td></td>
<td>Group travel insurance</td>
<td>+50%</td>
</tr>
<tr>
<td></td>
<td>Group credit insurance</td>
<td>+50%</td>
</tr>
</tbody>
</table>

The morbidity volatility risk component is the difference between the present value of the shocked cash flows and the present value of best estimate cash flows.

The components for Disability, CI, LTC, Travel and Group Medical and Dental (including other group A&S) morbidity volatility risk may be reduced by a credit for within-risk diversification, which is determined using statistical fluctuation factors (reference section 11.1.4).

6.4.4. Catastrophe risk

The catastrophe risk component is calculated as a one-time shock to first year incidence rates for all active lives that are exposed to morbidity risk. The shock is applied as a multiple of the Best Estimate Assumption for morbidity (i.e., \((1 + \text{shock factor}) \times \text{Best Estimate Assumption}\)).

A catastrophe shock is not applied to incidence rates for group medical and dental insurance, individual and group travel insurance, or for credit insurance.
The factors for catastrophe risk shocks are listed below:

<table>
<thead>
<tr>
<th>Exposure Base</th>
<th>Product Type</th>
<th>Shock Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Incidence Rates</td>
<td>Individual active DI</td>
<td>+25%</td>
</tr>
<tr>
<td></td>
<td>Group active STD and LTD</td>
<td>+25%</td>
</tr>
<tr>
<td></td>
<td>Individual and group active WP</td>
<td>+25%</td>
</tr>
<tr>
<td></td>
<td>Individual CI</td>
<td>+5%</td>
</tr>
<tr>
<td></td>
<td>Group CI</td>
<td>+5%</td>
</tr>
<tr>
<td></td>
<td>Individual and group active LTC</td>
<td>+10%</td>
</tr>
<tr>
<td></td>
<td>Other A&amp;S (other than disability and CI)</td>
<td>+25%</td>
</tr>
</tbody>
</table>

The morbidity catastrophe risk component is the difference between the present value of the shocked cash flows and the present value of best estimate cash flows.

### 6.5. Lapse and policyholder behaviour risk

Lapse risk and policyholder behaviour risk (“lapse risk”) is the risk associated with the variability in liability cash flows due to the incidence of policyholder lapses. Lapse risk includes risk arising from options that allow policyholders to fully or partially terminate an insurance contract, or to decrease or suspend/resume insurance coverage (e.g. the option to reduce premiums in universal life contracts).

Lapse risk required capital is calculated for all individual life insurance, individual active DI, individual critical illness, individual active life LTC and individual other A&S policies that are exposed to lapse risk.

Lapse shocks are applied to individual business, including individually underwritten group business. Lapse risk components are calculated for level and trend risks combined as well as volatility and catastrophe risks. If any shock increases a lapse rate above 97.5%, the shocked lapse rate is capped at 97.5%. Shocked cash flows that are projected should not include any lapse trend improvement assumptions. If an insurer uses dynamic lapse assumptions that vary with interest rates, the Best Estimate Assumption should be the same as that assumed in the CALM base scenario and should not be adjusted to reflect prescribed discount rates (reference section 6.1) used to calculate the capital requirement.

For aggregation purposes, components are calculated separately for lapse-supported and lapse-sensitive business.

Lapse risk required capital is calculated separately for each geography using the following formula:

\[
RC_{\text{lapse}} = \sqrt{RC_{\text{vol}}^2 + RC_{\text{cat}}^2 + RC_{\text{level+trend}}}
\]
6.5.1. Designation of lapse supported and lapse sensitive business

Lapse supported and lapse sensitive products are assumed to be negatively correlated for LICAT purposes. The direction of the lapse shock should be tested to determine whether the business is lapse supported or lapse sensitive. An insurer should use the product groupings it has in place for setting its Best Estimate Assumptions for lapse (which should result in portfolios with similar products and characteristics) and then test each individual portfolio by applying the level, trend and volatility shocks combined to determine if the portfolio is lapse supported or lapse sensitive. For the purpose of the designation test the shocks should be applied first as an increase in lapse rates (lapse sensitive) in all policy years and then as a decrease in lapse rates (lapse supported) in all policy years. The designation is done on a portfolio basis based on the largest present value using the discount rates specified in section 6.1, even if the present value under each test is lower than the best estimate present value net of registered reinsurance. Once the designation is set, it is used for the application of the appropriate shocks for catastrophe risk and the calculation of the lapse supported and lapse sensitive components of the diversification matrix.

6.5.2. Level and trend risk

A combined component is calculated for level and trend risk. The combined shock is a permanent ±30% change in Best Estimate Assumptions for lapse rate at each age and duration using crossover logic, with lapse shocks applied in a manner consistent with how lapse MfADs are applied for valuation purposes.

The combined component for lapse level and trend risk is the difference between the present value of the shocked cash flows and the present value of best estimate cash flows.

6.5.3. Volatility risk

The shock for volatility risk is ±30% in the first year and is calculated independently of the shock used for level and trend risk (section 6.5.2). The shock should be applied in a manner consistent with how lapse MfADs are applied for valuation purposes\(^{104}\). The first year shock on lapse rates is the sum of the impacts of a ±30% shock for level and trend risk and a ±30% shock for volatility risk. The shocked cash flows after year one are the best estimate cash flows as affected by the shock in the first year. The risk charge for any set is floored at zero.

The component for lapse volatility risk is the difference between the present value of the shocked cash flows and the present value of best estimate cash flows.

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\(^{104}\) As described in the November 2006 CIA Educational Note *Margins for Adverse Deviations*. The resulting aggregate capital requirement for each portfolio should be positive.
6.5.4. Catastrophe risk

The shocks for catastrophe risk are:

1) For lapse sensitive products, an absolute increase of 20 percentage points in the Best Estimate Assumption for lapse for the first year only; and

2) For lapse supported products, a reduction of the Best Estimate Assumption for lapse to 0% in the first year only.

The catastrophe risk component for any set cannot be negative.

The lapse catastrophe risk component is the difference between the present value of shocked cash flows and the present value of best estimate cash flows.

6.6. Expense risk

Expense risk is the risk associated with the unfavourable variability of expenses incurred in servicing insurance or reinsurance contracts (e.g., the variability in expense liability cash flows due to the variation of the in force policies, excess claims, lapses and surrenders, new business decrease or other circumstances that could have an impact on unit expenses).

All maintenance expenses that are estimated (including non-commission premium and claim expenses) are included in the shocks. Tax timing differences reflected in liabilities, and expenses that are contractually guaranteed by third parties are excluded from the shocks.

Expense risk required capital is calculated in aggregate for level, trend, volatility and catastrophe risks for each geography.

6.6.1. Level, trend, volatility and catastrophe risk

The combined shock is a permanent shock on the Best Estimate Assumptions for expenses including inflation\(^{105}\) for all insurance products. The shock is an increase of 20% in the first year followed by a permanent increase of 10% in all subsequent policy years. Premium taxes and investment income tax are excluded. Expenses that are fixed contractually are not subject to shocks in the periods for which the contracts remain in force.

Required capital for expense risk is the difference between the present value of the shocked cash flows and the present value of best estimate cash flows.

\(^{105}\) The Best Estimate Assumption for inflation is the same as that assumed in the CALM base scenario and should not be adjusted to reflect prescribed discount rates (reference section 6.1) used to calculate the capital requirement.
6.7 Credit for reinsurance and special policyholder arrangements

6.7.1 Unregistered reinsurance

For unregistered reinsurance arrangements (reference section 10.2.2), excess deposits placed by the reinsurer that can be applied against losses under a specific reinsurance agreement or group of agreements may be used to reduce required capital. The limit on such excess deposits that are eligible for recognition is:

$$SB_0 - SB_1 - PfAD$$

where $SB_0$ is the Base Solvency Buffer (reference section 11.3) for an insurer’s entire book of business calculated net of registered reinsurance only, $SB_1$ is the Base Solvency Buffer calculated net of registered reinsurance and excluding the insurance risks reinsured under the agreements, and PfAD is the CALM provision for adverse deviation for the insurance risks reinsured under the agreements. In the intermediate steps of the calculations of both $SB_0$ and $SB_1$, the quantity $A$ (reference section 11.2.2) includes all of the requirements for asset risks and currency risk (reference section 10.6.4) related to unregistered reinsurance deposits.

6.7.2 Policyholder deposits

Qualifying policyholder deposits, excluding actuarial and claim reserves and any due refund provisions, may be used to reduce the insurance risk requirement\(^{106}\) for a policy. Such deposits must be:

1) made by policyholders,

2) available for claims payment (e.g. claims fluctuation and premium stabilization reserves, and accrued provision for experience refunds), and

3) returnable, net of applications, to policyholders on policy termination.

When an insurer is able to recover excess losses from a deposit for a particular policy on a first-dollar, 100% coinsurance basis, the amount by which required capital may be reduced is the lower of the deposit amount, or the sum of the marginal policy requirements (as defined in section 2.1.2.9.2) for each of the insurance risks mitigated by the deposit, calculated net of all reinsurance. If the amount that the insurer is able to recover from a deposit is subject to a risk-sharing arrangement, the insurer may only take credit for the deposit if the dollar amounts of both the losses borne by the insurer and by the policyholder under the arrangement do not decrease as total excess claims increase. If a risk-sharing arrangement is eligible for credit, the amount by which required capital may be reduced is the lower of the deposit amount, or the portion of the marginal policy requirements for the policy that would be allocated to the policyholder under the risk-sharing formula.

\(^{106}\) Deposits made by agents or brokers meeting the same conditions as qualifying deposits made by policyholders may also be recognized.
6.7.3 Adjustments for group business

Required capital may be reduced if a group benefit included in the calculation of the insurance risk requirement carries one of the following risk-reduction features that provides for a full transfer of risk:

1) “guaranteed no risk”,
2) deficit repayment by policyholders, or
3) a “hold harmless” agreement where the policyholder has a legally enforceable debt to the insurer.

The amount by which required capital may be reduced is equal to a scaling factor multiplied by the sum of the marginal policy requirements for the policy (reference section 2.1.2.9.2) calculated net of all reinsurance. The scaling factor to be used is 95% if the group policyholder is the Canadian Government or a provincial or territorial government in Canada, and 85% for all other policyholders.

Where a policy has one of the above risk-reduction features, but the maximum recoverable amount (as specified in the insurance contract) from the policyholder is subject to a limit, the credit for the risk-reduction feature is calculated in the same manner as the credit for qualifying deposits in section 6.7.1, with the following modifications:

1) the maximum recoverable amount is used in place of the deposit amount in the calculation, and
2) the credit amount is multiplied by 95% if the group policyholder is the Canadian Government or a provincial or territorial government in Canada, and by 85% for all other policyholders.

“Administrative Services Only” group contracts where an insurer bears no risk and has no liability for claims should be excluded completely from the calculation of the insurance risk requirement.

6.7.4 Reinsurance claims fluctuation reserves

Claims fluctuation reserves, deposits, or loss positions retained by a ceding insurer that serve to reduce the assuming insurer’s risk under a reinsurance agreement may be used to reduce required capital. The reduction is limited to the lower of the claims fluctuation reserve or:

$$SB_0 - SB_1 - PfAD - d$$

where $SB_0$ is the Base Solvency Buffer (reference section 11.3) for the assuming insurer’s entire book of business calculated net of all reinsurance, $SB_1$ is the Base Solvency Buffer calculated net of all reinsurance and excluding the reinsurance agreement for which the deposit has been made, $PfAD$ is CALM provision for adverse deviation for the insurance risks assumed under the agreement, and $d$ is the amount of any reductions that have been taken on account of policyholder deposits for the business assumed under the reinsurance agreement.
6.7.5 Stop loss arrangements

A ceding insurer may reduce its capital requirement for insurance risk if it has reinsured its risks under a stop loss treaty. The reduction is calculated separately for each component of the insurance risk requirement before between-risk diversification, and is equal to the increase in the value of the reinsurance asset corresponding to the stop loss treaty under the shocks specified for the component.

Any reduction in required capital for insurance risk is subject to the prior approval of the Superintendent. To obtain such approval, it is necessary for the ceding insurer to demonstrate the validity of its valuation methodology for the stop loss reinsurance asset under the relevant insurance risk shocks. As a minimum requirement for approval, the valuation methodology must encompass more than deterministic valuation of a single set of cash flows.

If the assuming insurer providing the stop loss protection is subject to the requirements of this guideline, the ceding insurer must retain in its records the assuming insurer’s actuary’s certification that the assuming company has included all reductions claimed by the ceding insurer in its own LICAT insurance risk calculation. If the stop-loss arrangement constitutes unregistered reinsurance under section 10.2, the treatment of excess deposits placed to cover the ceded insurance risk requirement is the same as in section 6.7.1.
Chapter 7  Segregated Fund Guarantee Risk

This component is for the risk associated with investment or performance-related guarantees on segregated funds or other similar products. The risk is determined using prescribed or approved factors, or an approved internal model.

OSFI permits, subject to materiality considerations, criteria and explicit prior approval, the use of internal models for the development of segregated fund capital requirements. Institutions seeking to use their internal models must follow the requirements outlined in OSFI's Instruction Guide: Use of Internal Models for Determining Required Capital for Segregated Fund Risks (MCCSR) dated March 2002 and Advisory: Revised Guidance for Companies that Determine Segregated Fund Guarantee Capital Requirements Using an Approved Model dated December 2010.

7.1. Products

Capital factors are provided for a variety of standardized product forms for guaranteed minimum death and maturity benefits commonly offered for segregated fund guarantee products in Canada and the United States. Below is a general description of the product forms modelled. More details can be found in Table 5 of section 7.5.

**Guaranteed Minimum Death Benefit (GMDB)** forms modelled include the following:

1) **Return of Premium (ROP):** provides a death benefit guarantee equal to the higher of the account value or the premiums paid.
2) **5% Annual Roll-up (ROLL):** provides a guaranteed benefit that increases 5% per annum compounded at each contract anniversary with the guarantee frozen at age 80.
3) **Maximum Anniversary Value/Annual Ratchet (MAV):** automatic annual reset of guarantee at each contract anniversary with resets frozen at age 80.
4) **10-year Rollover Contract (GMDB_10):** guarantee can reset and term-to-maturity also will reset to 10 years. No resets are permitted in the final 10 years prior to contract maturity.

**Guaranteed Minimum Maturity Benefits (GMMB)** forms modelled include:

1) **Fixed Maturity Date (FIXED):** guarantee is level and applies up to the fixed maturity date.
2) **10-year Rollover Maturity Benefit (GMMB_10):** guarantee can be reset and term-to-maturity also resets to 10 years. No resets are permitted in the 10 years prior to contract maturity.
3) **Guaranteed Minimum Surrender Benefit After 10 Years (GMSB_10):** guarantee comes into effect 10 years after contract issue. If the guaranteed value at 10 years is greater than the account value at surrender, a “top-up” benefit equal to the difference is paid.
7.2. Documentation and reporting

Given the complexity of this calculation, for auditing purposes the Appointed Actuary is required to keep supporting schedules of all the calculations for each step building up to the final numbers detailed in the MCCSR form. Also, the Appointed Actuary is required to detail the calculation in the segregated fund section of the Appointed Actuary’s Report. Forms 90.010 and 90.015 must be completed.

The columns of the reporting form on page 90.010 are filled in as follows:

Column 01 - Guaranteed Value

This is the amount guaranteed in all segregated funds. If the funds are subject to guarantees of differing amounts, for example 100% on death and 75% on maturity, report the larger amount here.

Column 02 - Market Value

This is the market value of all segregated funds.

Column 03 - Total Gross Calculated Requirements

This is the total gross calculated requirement for all segregated funds.

Column 04 - Credit for Reinsurance Ceded

Report credit for amounts ceded in column 04. Note that amounts ceded under arrangements deemed to constitute unregistered reinsurance (reference section 10.2) must be deducted from Available Capital/Margin on page 20.030, line 085 of the OSFI 87 form by Canadian companies, and on page 12.200, line 340 of the OSFI 86 form by foreign branches. Deposits held for unregistered reinsurance, for a period not less than the remaining guarantee term, in excess of policy liabilities and any required margins (see section 10.6) can be used to reduce the net required segregated fund risk component on the reinsured policies to a minimum of zero.

Column 05 - Net Requirements

This is determined as:

\[(\text{Total Gross Calculated Requirements} – \text{Credit for Reinsurance Ceded})\]

Column 06 – Credit for OSFI-Approved Hedging Programs

This is the dollar equivalent of the maximum allowable reduction. It is determined as:
(Maximum allowable percentage reduction * Net Requirements)

where the maximum percentage reduction is the reduction that was determined at the
time of approval. See the OSFI Advisory: Recognition of Hedge Contracts in the
Determination of the Segregated Fund Guarantee Capital Requirement for Life
Insurance Companies dated December 2008.

This column may also be used to enter the amount of a negative Guaranteed Minimum
Withdrawal Benefit Hedging Liability (enter the amount as a positive value in this
column) to effectively floor this negative value at zero in determining the Net Required
Component in Column 8.

Column 07 - Net Actuarial Liabilities Held

This is the total net actuarial liability held on the balance sheet for segregated fund
guarantee risks, excluding deferred income taxes\(^{107}\).

Column 08 - Net Required Component

This is determined as:

\[(\text{Net Requirements (column 5)} - \text{Credit for OSFI-Approved Hedging Programs}
\text{ (column 6)} - \text{Net Actuarial Liabilities Held (column 7)}) \times 1.25\]

Net required component is multiplied by 1.25 to bring the required capital to the
supervisory target level.

Line 099 must not be less than zero in total.

The columns of the reporting form on page 90.015 are filled in as follows:

Column 01 - Factor Requirements on Business

This is the gross calculated requirement based on the OSFI-approved factors.

Column 02 - OSFI Approved Internal Model Requirements

For OSFI-approved models, this is the gross calculated requirement based on company-
specific internal models.

\(^{107}\) Wherever the term “Net Actuarial Liabilities Held” or a similar term appears, it should be calculated on a basis
that is consistent with the calculation of the TGCR with respect to the inclusion or exclusion of deferred income
taxes.
Column 03 - **Total Gross Calculated Requirements**

For OSFI-approved models, transition rules apply:

In the first year of approval, Total Gross Calculated Requirements = 50% of the Factor Requirements + 50% of the Internal Model Requirements.

Thereafter, Total Gross Calculated Requirements = 100% of the Internal Model Requirements.

Otherwise, Total Gross Calculated Requirements = 100% of the Factor Requirements.

Column 04 - **Credit for Reinsurance Ceded**

Report credit for amounts ceded in column 04. Note that policy liabilities ceded under arrangements deemed to constitute unregistered reinsurance (reference section 10.2) must be deducted from Available Capital/Margin on page 20.030, line 085 of the OSFI 87 form by Canadian companies, and on page 12.200, line 340 of the OSFI 86 form by foreign branches. Deposits held for unregistered reinsurance, for a period not less than the remaining guarantee term, in excess of policy liabilities and any required margins (see section 10.6) can be used to reduce the net required segregated fund risk component on the reinsured policies to a minimum of zero.

Column 05 - **Net Requirements**

This is determined as:

\[(\text{Total Gross Calculated Requirements (column 3)} - \text{Credit for Reinsurance Ceded (column 4)})\]

Column 06 - **Credit for OSFI-Approved Hedging Programs**

This is the dollar equivalent of the maximum allowable reduction. It is determined as:

\[(\text{Maximum allowable percentage reduction} \times \text{Net Requirements (column 5)})\]

where the maximum percentage reduction is the reduction that was determined at the time of approval. See the OSFI Advisory: *Recognition of Hedge Contracts in the Determination of the Segregated Fund Guarantee Capital Requirement for Life Insurance Companies* dated December 2008.

This column may also be used to enter the amount of a negative Guaranteed Minimum Withdrawal Benefit Hedging Liability (enter the amount as a positive value in this column) to effectively floor this negative value at zero in determining the Net Required Component in Column 8.
Column 07 - **Net Actuarial Liabilities Held**

This is the total net actuarial liability held on the balance sheet for segregated fund guarantee risks, excluding deferred income taxes.\textsuperscript{107}

Column 08 - **Net Required Component**

This is determined as:

\[
(\text{Net Requirements (column 5)} - \text{Credit for OSFI Approved Hedging Programs (column 6)} - \text{Net Actuarial Liabilities Held (column 7)}) \times 1.25
\]

Net required component is multiplied by 1.25 to bring the required capital to the supervisory target level.

Note that the amount reported on page 90.010, column 08, line 230 should be the same as the amount reported on page 90.015, column 08, line 100.

### 7.3. Total gross calculated requirement

#### 7.3.1. Overview

It is expected that the MCCSR methodology for Total Gross Calculated Requirement ("TGCR") will be applied on a policy-by-policy basis (i.e., seriatim). If the company adopts a cell-based approach, only materially similar contracts should be grouped together. Specifically, all policies comprising a “cell” must display substantially similar characteristics for those attributes expected to affect risk-based capital (e.g., definition of guaranteed benefits, attained age, policy duration, years-to-maturity, market-to-guaranteed value, asset mix, etc.). The TGCR and Net Actuarial Liabilities held for the purpose of determining capital requirements for segregated funds using prescribed or approved factors should not include deferred income taxes.

The portfolio TGCR is the sum of the TGCR calculations for each policy or cell. The result for any given policy (cell) may be negative, zero or positive. In total, the TGCR cannot be negative.

The TGCR for a given policy is equal to: \[TGCR = GV \times \hat{f}(\bar{\theta}) - AV \times \hat{g}(\bar{\theta})\]

where:
- \(GV\) = current guaranteed minimum benefit,
- \(AV\) = current account balance,
- \(\hat{f}(\bar{\theta})\) = benefit cost factor,
- \(\hat{g}(\bar{\theta})\) = margin offset factor and
- \(\bar{\theta}\) is a vector that defines the risk characteristics for the policy.
The factors $\hat{f}(\hat{\phi})$ and $g(\hat{\phi})$ are described more fully in section 7.7.1. The \textit{TGCR} is calculated separately for each guaranteed minimum benefit (i.e., death, maturity and surrender).

The model assumptions for the \textit{TGCR} Factors are documented in section 7.3.2.

There are four (4) major steps in determining the \textit{TGCR} for a given policy/cell:

a) Classify the asset exposure (section 7.4);

b) Determine the risk attributes (section 7.5);

c) Retrieve the appropriate nodes (section 7.6);

d) Use the supplied functions to determine the requirement (section 7.7).

The first step requires the company to categorize the asset value for the given policy/cell by mapping the entire exposure to one of the prescribed “fund classes” as described in section 7.4. \textit{TGCR} factors are provided for each asset class.

The second step requires the company to determine (or derive) the appropriate attributes for the given policy or cell. The attributes needed to access the factor tables and calculate the required values are:

1) Product form (“Guarantee Definition”), $P$.

2) Guarantee level, $G$.

3) Adjustment to guaranteed value upon partial withdrawal (“GMDB/GMMB Adjustment”), $A$.

4) Fund class, $F$.

5) Attained age of the policyholder, $X$, (for GMDB only, use a 4-year setback for female lives).

6) Contract maturity age, $M$, (for GMDB only, use a 4-year setback for female lives).

7) Time-to-next maturity date, $T$.

8) Ratio of account value to guaranteed value, $\phi$.

9) Total “equivalent” account-based charges, $MER$ (“management expense ratio”).

10) Reset utilization rate, $R$ (where applicable).

11) In-the-money termination rate, $S$ (guaranteed surrender benefits only).

Other required policy values include:

12) Total account value on which the guaranteed benefit is calculated, $AV$.

13) Current $GMDB$, $GMMB$ and/or $GMSB$.

14) Total net spread available to fund guaranteed benefits (“margin offset”), $\alpha$. 
The next steps – retrieving the appropriate nodes and using the supplied functions to determine the requirement – are explained in sections 7.6 and 7.7. Software tools have been developed to assist companies in these efforts. If an insurer is unable to use the supplied tools, it will be required to develop software of its own. In such a situation, the insurer should contact OSFI for specific guidance on how to develop its own lookup and extraction routines. A calculation example demonstrating the application of the various component factors to a sample policy is provided in section 7.7.3.

In this chapter, GMDB, GMMB, GMSB are generically denoted by $GV$. $AV$ generically denotes either Account Value or Market Value. The total “equivalent” account charges should include all amounts assessed against policyholder accounts, expressed as a level spread per year (in basis points). This quantity is called the Management Expense Ratio (“MER”) and is defined as the average amount (in dollars) charged against policyholder funds in a given year divided by average account value. Normally, the MER would vary by fund class and be the sum of investment management fees, mortality & expense charges, guarantee fees/risk premiums, etc. The total spread available to fund the guaranteed benefits (i.e., GMDB, GMMB, GMSB costs) is called the “margin offset” (denoted by $\alpha$) and should be net of spread-based costs and expenses (e.g., net of maintenance expenses, investment management fees, trailer commissions, amounts required to provide for amortization of deferred acquisition costs, etc.). Section 7.8 describes how to determine MER and $\alpha$.

The GMDB/GMMB/GMSB definition for a given policy/cell may not exactly correspond to those provided. In some cases, it may be reasonable to use the factors/formulas for a different product form. In other cases, the company might determine the TGCR based on two different guarantee definitions and interpolate the results to obtain an appropriate value for the given policy/cell. However, if the policy form is sufficiently different from those provided and there is no practical or obvious way to obtain a reasonable result, the insurer should follow the instructions outlined in section 7.10.

The general form of the $TGCR$ may be written as:

$$TGCR = GV \times h(\phi) \times w(\phi) \times f(\phi) - \frac{\alpha}{100} \times AV \times g(\phi)$$

where:

$GV$ = current guaranteed minimum benefit (dollars)

$AV$ = current account value (dollars)

$f(\phi) = f(\bar{\phi})$ = cost factor per $1$ of $GV$

$g(\phi) = g(\bar{\phi})$ = margin offset factor per $1$ of $AV$ (assuming 100 bps of available spread)

$h(\phi) = h(\bar{\phi})$ = asset mix diversification factor

$w(\phi) = w(\bar{\phi})$ = time diversification factor
Under this notation, \( \tilde{\theta} \) is used to generically represent the risk attribute set (e.g., product form, guaranteed level, asset class, attained age, etc.) for the policy, or some relevant subset thereof. \( \alpha \) is the company-determined net spread (“margin offset”, in basis points per annum) available to fund the guaranteed benefits.

Where more than one feature (i.e., guaranteed benefit) is present in a product, unless the company has a justifiable alternative for allocating the total available spread between the benefit types (e.g., explicitly defined risk charges), the split should be based on the proportionate gross guaranteed benefit costs. An example is provided in section 7.7.3 to illustrate this concept.

In practice, \( f(\cdot) \), \( g(\cdot) \), \( h(\cdot) \) and \( w(\cdot) \) are values interpolated from the factor grid. The use of the factor grid is discussed more fully in section 7.7. The factor grid is a large pre-computed table developed using stochastic modeling for a wide array of combinations of the risk attribute set. The risk attribute set is defined by those policy/product characteristics that affect the risk profile (exposure) of the business: product form (guarantee definition), fund class, attained age, AV/GV ratio, time-to-maturity, etc.

### 7.3.2. Assumptions for TGCR methodology published factors

Each node in the factor grid is effectively the modeled result for a given “cell” assuming a $100 single deposit.

#### Table 1: Model Assumptions & Product Characteristics

<table>
<thead>
<tr>
<th>Account Charges (MER)</th>
<th>Vary by fund class. See Table 2 later in this section.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base Margin Offset</td>
<td>100 basis points per annum.</td>
</tr>
<tr>
<td>GMDB Description</td>
<td>ROP = return of premium.</td>
</tr>
<tr>
<td></td>
<td>ROLL = 5% compound roll-up, frozen at age 80.</td>
</tr>
<tr>
<td></td>
<td>MAV = annual ratchet (maximum anniversary value), frozen at age 80.</td>
</tr>
<tr>
<td></td>
<td>GMDB_10 = 10-year rollover contract.</td>
</tr>
<tr>
<td>GMMB &amp; GMSB Descriptions</td>
<td>FIXED = fixed maturity date.</td>
</tr>
<tr>
<td></td>
<td>GMSB_10 = 10-year guaranteed surrender benefit.</td>
</tr>
<tr>
<td></td>
<td>GMMB_10 = 10-year rollover maturity benefit.</td>
</tr>
<tr>
<td>GV Adjustment on Withdrawal</td>
<td>“Pro-Rata by Market Value” and “Dollar-for-Dollar” are tested separately.</td>
</tr>
<tr>
<td>Surrender Charges</td>
<td>Ignored (i.e., zero).</td>
</tr>
<tr>
<td>Base Policy Lapse Rate</td>
<td>6% p.a. at all policy durations. See also “Dynamic Lapse Multiplier”.</td>
</tr>
<tr>
<td>Partial Withdrawals</td>
<td>Flat 4% p.a. at all policy durations (as a % of AV). No dynamics.</td>
</tr>
<tr>
<td>Rollover (Renewal) Rate</td>
<td>85% at the end of each 10-year term (GMDB_10 and GMMB_10 only).</td>
</tr>
<tr>
<td>Dynamic Lapse Multiplier</td>
<td>Actual lapse rate = ( \lambda \times [ \text{Base Policy Lapse Rate} ] ), where:</td>
</tr>
<tr>
<td></td>
<td>( \lambda = \text{MIN} \left[ \lambda^+, \text{MAX} \left[ \lambda^-, \left[ a + b \times \left( \frac{AV}{GV} \right) \right] \times [c + d \times \text{MIN}(h,T)] \right] \right] )</td>
</tr>
<tr>
<td></td>
<td>( \lambda^+ = 1.6667, \quad \lambda^- = 0.3333, \quad a = -0.0952, \quad b = 0.8010, \quad c = 0.6279, \quad d = 0.0654, )</td>
</tr>
</tbody>
</table>
\[ h = 10 \text{ and } T = \text{time-to-next maturity}. \]

<table>
<thead>
<tr>
<th>Mortality</th>
<th>100% of CIA 1986–92 ALB Male Aggregate Ultimate.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed Expenses, Annual Fees</td>
<td>Ignored (i.e., zero).</td>
</tr>
<tr>
<td>Discount Rate</td>
<td>5.5% annual effective (non-dynamic).</td>
</tr>
<tr>
<td>Elective Reset of GV</td>
<td>Whenever the AV/GV ratio exceeds 115% (maximum 2 resets per year). No resets are permitted in the 10 years prior to the final “contract” maturity date.</td>
</tr>
<tr>
<td>In-The-Money Surrender (GMSB_10 only)</td>
<td>Whenever the benefit is payable (i.e., 10 years after issue or last reset) and the AV/GV ratio is less 85%.</td>
</tr>
</tbody>
</table>

Notes on Factor Development:

1) The GMDB roll-up is compounded (not simple interest, not stepped at each anniversary) and is applied to the previous roll-up guaranteed value.

2) The “Base Policy Lapse Rate” is the rate of policy termination (surrenders). Policy terminations (surrenders) are assumed to occur throughout the policy year (not only on anniversaries).

3) Partial withdrawals are assumed to occur at the end of each time period (quarterly).

4) Account charges (“MER”) represent the total amount (annualized, in basis points) assessed against policyholder funds (e.g., sum of investment management fees, mortality and expense charges, risk premiums, policy/administrative fees, etc.). They are assumed to occur throughout the policy year (not only on anniversaries).

5) For the GMDB_10 and GMMB_10 products, the contract rolls over (renews) at the end of each 10-year term for another 10 years. The guaranteed benefit resets to \( Z\% \) of MV (after payment of any top-up maturity benefit for in-the-money maturity guarantees) where \( Z \) is typically 75 or 100.

6) The guaranteed minimum surrender benefit (GMSB_10) comes into effect 10 years after contract issue. If the guaranteed value at 10 years is greater than the account value at surrender, a “top-up” benefit equal to the difference is paid.

Table 2: Account-Based Fund Charges (bps per annum)

<table>
<thead>
<tr>
<th>Asset Class / Fund</th>
<th>Account Value Charges (MER)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Money Market</td>
<td>110</td>
</tr>
<tr>
<td>Fixed Income (Bond)</td>
<td>200</td>
</tr>
<tr>
<td>Balanced</td>
<td>250</td>
</tr>
<tr>
<td>Low Volatility Equity</td>
<td>265</td>
</tr>
<tr>
<td>Diversified Equity</td>
<td>265</td>
</tr>
<tr>
<td>Intermediate Risk Equity</td>
<td>280</td>
</tr>
<tr>
<td>Aggressive or Exotic Equity</td>
<td>295</td>
</tr>
</tbody>
</table>
The annualized total fund depletion rates (i.e., including the fixed 4% per annum partial withdrawal) are illustrated in Figure 1 for various AV/GV ratios and times to maturity.

Figure 1: Fund Depletion Rates (Lapse + Partial Withdrawal) by AV/GV Ratio & Time-to-Maturity

7.4. Classifying the asset exposure

7.4.1. Definition of asset classes

The following criteria should be used to select the appropriate factors, parameters and formulas for the exposure represented by a specified guaranteed benefit. When available, the volatility of the long-term annualized total return for the fund(s) – or an appropriate benchmark – should conform to the limits presented. For this purpose, “long-term” is defined as twice the average projection period that would be applied to test the product in a stochastic model (generally, at least 25 years).

Where data for the fund or benchmark are too sparse or unreliable, the fund exposure should be moved to the next higher volatility class than otherwise indicated. In reviewing the asset
classifications, care should be taken to reflect any additional volatility of returns added by the presence of currency risk, liquidity (bid-ask) effects, short selling and speculative positions.

All exposures/funds must be categorized into one of the following seven (7) asset classes:

1) Money Market/Short-Term
2) Fixed Income
3) Balanced
4) Low Volatility Equity
5) Broad-Based Diversified Equity
6) Intermediate Risk Equity
7) Aggressive or Exotic Equity

**Money Market/Short-Term.** The fund is invested in money market instruments with an average remaining term-to-maturity of less than 365 days.

**Fixed Income.** The fund is invested primarily in investment grade fixed income securities. Up to 25% of the fund within this class may be invested in diversified equities or high-yield bonds. The expected volatility of the fund returns will be lower than the Balanced fund class.

**Balanced.** This class is a combination of fixed income securities with a larger equity component. The fixed income component should exceed 25% of the portfolio. Additionally, any aggressive or ‘specialized’ equity component should not exceed one-third (33.3%) of the total equities held. Should the fund violate either of these constraints, it should be categorized as an equity fund. These funds usually have a long-term volatility in the range of 8% – 13%.

**Low Volatility Equity.** This fund is comparable to the Broad-Based Diversified Equity class with the additional attributes noted below. Only funds that otherwise would be classified as Broad-Based Diversified Equity are candidates for this fund classification. For foreign funds, volatility should take into account the impact of currency fluctuations.

The expected volatility of the fund should be less than 15.5% (annualized) and the aggressive/exotic equity component of the equity holdings should be less than 33.3% of the total equities by market value. Further, the overall asset holdings should satisfy at least one of the following conditions:

1) The fund permanently maintains a relatively large cash or fixed income position (greater than 10% of the market value of assets) as part of its investment strategy;

2) The fund is “income” oriented and contains a significant (greater than 10% of the market value of assets) proportion of stocks paying material and regular dividends that are automatically reinvested in the fund.
**Broad-Based Diversified Equity.** The fund is invested in a well-diversified mix of Canadian, U.S. or global equities. The foreign equity component must be comprised of liquid securities in well-developed markets. Funds in this category would exhibit long-term volatility comparable to that of the TSX. These funds should usually have a long-term volatility in the range of 13% – 19%.

**Intermediate Risk Equity.** The fund has a mix of characteristics from both the Diversified and Aggressive Equity Classes. These funds have a long-term volatility in the range of 19% – 25%.

**Aggressive or Exotic Equity.** This class comprises more volatile funds where risk can arise from: (a) underdeveloped markets, (b) uncertain markets, (c) high volatility of returns, (d) narrow focus (e.g., specific market sector), etc. The fund (or market benchmark) either does not have sufficient history to allow for the calculation of a long-term expected volatility, or the volatility is very high. This class would be used whenever the long-term expected annualized volatility is indeterminable or exceeds 25%.

### 7.4.2. Selecting appropriate investment classes

The selection of an appropriate investment type should be done at the level for which the guarantee applies. For guarantees applying on a deposit-by-deposit basis, the fund selection is straightforward. However, where the guarantee applies across deposits or for an entire contract, the approach can be more complicated. In such instances, the approach is to identify for each policy where the “grouped holdings” fit within the categories listed and to classify the associated assets on this basis.

A seriatim process is used to identify the “grouped” fund holdings, to assess the risk profile of the current fund holdings (possibly calculating the expected long-term volatility of the funds held with reference to the indicated market proxies), and to classify the entire ‘asset exposure’ into one of the specified choices. Here, ‘asset exposure’ refers to the underlying assets (segregated and/or general account investment options) on which the guarantee will be determined. For example, if the guarantee applies separately for each deposit year within the contract, then the classification process would be applied separately for the exposure of each deposit year.

In summary, mapping the benefit exposure (i.e., the asset exposure that applies to the calculation of the guaranteed minimum benefits) to one of the prescribed asset classes is a multi-step process:

1) Map each separate and/or general account investment option to one of the prescribed asset classes. For some funds, this mapping will be obvious, but for others it will involve a review of the fund’s investment policy, performance benchmarks, composition and expected long-term volatility.

2) Combine the mapped exposure to determine the expected long-term volatility of current fund holdings. This will require a calculation based on the expected long-term volatilities for each fund and the correlations between the prescribed asset classes as given in Table 3.
3) Evaluate the asset composition and expected volatility (as calculated in step 2) of current holdings to determine the single asset class that best represents the exposure, with due consideration to the constraints and guidelines presented earlier in this section.

In step 1, the company should use the fund’s actual experience (i.e., historical performance, inclusive of reinvestment) only as a guide in determining the expected long-term volatility. Due to limited data and changes in investment objectives, style and/or management (e.g., fund mergers, revised investment policy, different fund managers, etc.), the company may need to give more weight to the expected long-term volatility of the fund’s benchmarks. In general, the company should exercise caution and not be overly optimistic in assuming that future returns will consistently be less volatile than the underlying markets.

In step 2, the company should calculate the “volatility of current fund holdings” ($\sigma$ for the exposure being categorized) by the following formula using the volatilities and correlations in Table 3.

$$\sigma = \sqrt{\sum_{i=1}^{n} \sum_{j=1}^{n} w_i w_j \rho_{ij} \sigma_i \sigma_j}$$

where $w_i = \frac{AV_i}{\sum_k AV_k}$ is the relative value of fund $i$ expressed as a proportion of total contract value, $\rho_{ij}$ is the correlation between asset classes $i$ and $j$ and $\sigma_i$ is the volatility of asset class $i$ (see Table 3). An example is provided in Table 4.

**Table 3: Volatilities and Correlations for Prescribed Asset Classes**

<table>
<thead>
<tr>
<th>ANNUAL VOLATILITY</th>
<th>GENERAL ACCOUNT</th>
<th>MONEY MARKET</th>
<th>FIXED INCOME</th>
<th>BALANCED</th>
<th>LOW VOL EQUITY</th>
<th>DIVERSE EQUITY</th>
<th>INTERM EQUITY</th>
<th>AGGR EQUITY</th>
</tr>
</thead>
<tbody>
<tr>
<td>1%</td>
<td>GENERAL ACCOUNT</td>
<td>1</td>
<td>0.50</td>
<td>0.15</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1%</td>
<td>MONEY MARKET</td>
<td>0.50</td>
<td>1</td>
<td>0.20</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>6%</td>
<td>FIXED INCOME</td>
<td>0.15</td>
<td>0.20</td>
<td>1</td>
<td>0.50</td>
<td>0.25</td>
<td>0.25</td>
<td>0.20</td>
</tr>
<tr>
<td>11%</td>
<td>BALANCED</td>
<td>0</td>
<td>0</td>
<td>0.50</td>
<td>1</td>
<td>0.80</td>
<td>0.95</td>
<td>0.75</td>
</tr>
<tr>
<td>15%</td>
<td>LOW VOL EQUITY</td>
<td>0</td>
<td>0</td>
<td>0.25</td>
<td>0.80</td>
<td>1</td>
<td>0.80</td>
<td>0.75</td>
</tr>
<tr>
<td>17%</td>
<td>DIVERSE EQUITY</td>
<td>0</td>
<td>0</td>
<td>0.25</td>
<td>0.95</td>
<td>0.80</td>
<td>1</td>
<td>0.75</td>
</tr>
<tr>
<td>22%</td>
<td>INTERM EQUITY</td>
<td>0</td>
<td>0</td>
<td>0.20</td>
<td>0.75</td>
<td>0.75</td>
<td>0.75</td>
<td>1</td>
</tr>
<tr>
<td>26%</td>
<td>AGGR EQUITY</td>
<td>0</td>
<td>0</td>
<td>0.10</td>
<td>0.65</td>
<td>0.65</td>
<td>0.65</td>
<td>0.70</td>
</tr>
</tbody>
</table>

\[\text{Table 3: Volatilities and Correlations for Prescribed Asset Classes}\]
As an example, suppose three funds (Fixed Income, Diversified Equity and Aggressive Equity) are offered to clients on a product with a contract level guarantee (i.e., across all funds held within the policy). The current fund holdings (in dollars) for five sample contracts are shown in Table 4.

Table 4: Fund Categorization Example

<table>
<thead>
<tr>
<th></th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>MV Fund X (Fixed Income):</td>
<td>5,000</td>
<td>6,000</td>
<td>8,000</td>
<td>-</td>
<td>5,000</td>
</tr>
<tr>
<td>MV Fund Y (Diversified Equity):</td>
<td>9,000</td>
<td>5,000</td>
<td>2,000</td>
<td>5,000</td>
<td>-</td>
</tr>
<tr>
<td>MV Fund Z (Aggressive Equity):</td>
<td>1,000</td>
<td>4,000</td>
<td>-</td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td><strong>Total Market Value:</strong></td>
<td>$15,000</td>
<td>$15,000</td>
<td>$10,000</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td><strong>Total Equity Market Value:</strong></td>
<td>$10,000</td>
<td>$9,000</td>
<td>$2,000</td>
<td>$10,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>Fixed Income % (A):</td>
<td>33%</td>
<td>40%</td>
<td>80%</td>
<td>0%</td>
<td>50%</td>
</tr>
<tr>
<td>Fixed Income Test (A&gt;75%):</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Aggressive % of Equity (B):</td>
<td>10%</td>
<td>44%</td>
<td>n/a</td>
<td>50%</td>
<td>100%</td>
</tr>
<tr>
<td>Balanced Test (A&gt;25% &amp; B&lt;33.3%):</td>
<td>Yes</td>
<td>No</td>
<td>n/a</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Volatility of Current Fund Holdings:</td>
<td>12.0%</td>
<td>12.1%</td>
<td>6.5%</td>
<td>19.6%</td>
<td>13.6%</td>
</tr>
<tr>
<td>Fund Classification:</td>
<td>Balanced</td>
<td>Diversified</td>
<td>Fixed Income</td>
<td>Intermediate</td>
<td>Diversified</td>
</tr>
</tbody>
</table>

The “Volatility of Fund Holdings” for policy #1 is calculated as $\sqrt{A+B} = 12.04\%$ where:

$$A = \left(\frac{5}{15} \times 0.06\right)^2 + \left(\frac{9}{15} \times 0.17\right)^2 + \left(\frac{1}{15} \times 0.26\right)^2 = 1.1104\%$$

$$B = 2 \left(\frac{5}{15} \times \frac{9}{15} \times (0.25 \times 0.06 \times 0.17)\right) + 2 \left(\frac{5}{15} \times \frac{1}{15} \times (0.10 \times 0.06 \times 0.26)\right) + 2 \left(\frac{9}{15} \times \frac{1}{15} \times (0.65 \times 0.17 \times 0.26)\right) = 0.3388\%$$

Importantly, the volatility would be understated if we assumed zero correlation (e.g., all market returns are independent) since $B$ contributes materially to the final value.

7.5. Determining the risk attributes

The ‘Tabular’ approach for the $TGCR$ component creates a multi-dimensional grid (array) by testing a very large number of combinations for the policy attributes. The results are expressed as factors. The $TGCR$ is calculated by looking into (based on a “key”) the large, pre-computed multi-dimensional tables and using multi-dimensional linear interpolation. The lookup “key”

*Although the volatility suggests “Balanced Fund”, the Balanced Fund criteria were not met. Therefore, this ‘exposure’ is moved “up” to Diversified Equity. For those funds classified as Diversified Equity, additional analysis would be required to assess whether they can be reclassified as “Low Volatility Equity”. In the examples above, none qualify.*
depends on the risk attributes for the policy \( \hat{\theta} = (P, G, A, F, X, M, T, \phi, \Delta, R, S) \) where \( \hat{\phi} \) is the AV/GV ratio for the benefit exposure under consideration, \( \Delta \) is the “MER Delta”, \( R \) is the utilization rate of the elective reset option (if applicable) and \( S \) is the “in-the-money” termination rate on GMSB_10 policies. The “MER Delta” is calculated based on the difference between the actual MER and that assumed in the factor testing (see Table 2), subject to a cap (floor) of 100 bps (–100 bps). See Table 5 for more details.

For GMDB, there are \( 4 \times 2 \times 2 \times 7 \times 4 \times 4 \times 5 \times 7 \times 3 \times 2 = 376,320 \) “nodes” in the “Basic Factor” grid. Interpolation will only be permitted across the six (6) dimensions: Contract Maturity Age (\( M \)), Attained Age (\( X \)), Time to Next Maturity (\( T \)), AV/GV Ratio (\( \phi \)), MER Delta (\( \Delta \)) and Reset Utilization Rate (\( R \)). The “In-the-Money” termination rate (\( S \)) is not used for GMDBs.

For GMMB, there are \( 3 \times 2 \times 2 \times 7 \times 1 \times 7 \times 5 \times 7 \times 3 \times 2 \times 2 = 246,960 \) “nodes” in the “Basic Factor” grid. Interpolation will only be permitted across the six (6) dimensions: Contract Maturity Age (\( M \)), Time to Next Maturity (\( T \)), AV/GV Ratio (\( \phi \)), MER Delta (\( \Delta \)), Reset Utilization Rate (\( R \)) and In-the-Money Termination Rate (\( S \)). The “In-the-Money” termination rate (\( S \)) is only applies to the “GMSB_10” product form. The testing for guaranteed minimum maturity and surrender benefits assumed all lives were attained age 55 at the calculation date.

Functions are available to assist the company in applying the TGCR Methodology. More fully described in section 7.7, these functions perform the necessary factor table lookups and associated multi-dimensional linear interpolations. If the insurer is unable to use the supplied functions, it will be required to develop its own. In such a case, the insurer should contact OSFI for specific details.

The GMDB and GMMB/GMSB factors are respectively contained in the files “GMDBFactors_CTE95.csv” and “GMMBFactors_CTE95.csv”. These are comma-separated value text files where each “row” represents the factors for a test policy as identified by its lookup key. Rows are terminated by new line and line feed characters. Factors are also provided at the CTE80 confidence level – the factor files are “GMDBFactors_CTE80.csv” and “GMMBFactors_CTE80.csv”. For the determination of capital requirements, the “GMDBFactors_CTE95.csv” and “GMMBFactors_CTE95.csv” factors are to be used.

Each row in the factor tables consists of three entries, described further below.

<table>
<thead>
<tr>
<th>1</th>
<th>2</th>
<th>3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Test Case Identifier (Key)</td>
<td>Basic Cost or Diversification Factor</td>
<td>Basic Margin Offset Factor or Zero (N/A)</td>
</tr>
</tbody>
</table>

An individual test case (i.e., a node on the multi-dimensional matrix of factors) can be uniquely identified by its key, which is the concatenation of the relevant individual policy attribute keys (or some subset thereof) prefixed by a leading ‘factor code’. The factor codes are shown below.
### Factor Code | Description
--- | ---
1 | Basic GMDB “Cost” and “Margin Offset” factors.
2 | Basic GMMB and GMSB “Cost” and “Margin Offset” factors.
3 | Asset Mix Diversification factors for GMDB options.
4 | Asset Mix Diversification factors for GMMB and GMSB options.
5 | Time Diversification factors for GMDB options.
6 | Time Diversification factors for GMMB and GMSB options.

**Basic Cost Factor.** This is the term $f(\phi)$ in the formula for $TGCR$. The values in the factor grid represent CTE95 (or CTE80) of the sample distribution\(^{108}\) for the present value of guaranteed minimum benefit cash flows (in excess of account value) in all future years (i.e., to the earlier of contract maturity and 30 years), normalized by current guaranteed value.\(^{109}\) The policy attribute keys for the Cost factors are shown in Table 5.

**Basic Margin Offset Factor.** This is the term $g(\phi)$ in the formula for $TGCR$. The values in the factor grid represent CTE95 (or CTE80) of the sample distribution for the present value of margin offset cash flows in all future years (i.e., to the earlier of contract maturity and 30 years), normalized by current account balance. The Basic Margin Offset Factors assume $\hat{\alpha} = 100$ basis points of “margin offset” (net spread available to fund the guaranteed benefits). The policy attribute keys for the Margin Offset factors are shown in Table 5.

**Asset Mix Diversification Factor.** This is the term $h(\phi)$ in the formula for $TGCR$.

$h(\phi) = h(P, G, R, S)$ is an adjustment factor that reflects the benefits of fund diversification (asset mix) at the company (i.e., total portfolio) level. Note that $h(\phi) \leq 1$ depends on product form “$P$”, guarantee level “$G$”, reset utilization rate “$R$” (where applicable) and in-the-money termination rate “$S$” (GMSB only). The lookup keys for the Asset Mix Diversification factors are given in Table 6.

$DF$ should be set equal to 1 in the GetCost and GetTGCR functions (see section 7.7.1).

**Time Diversification Factor.** This is the term $w(\phi)$ in the formula for $TGCR$.

$w(\phi) = w(P, G, F, R, S)$ is an adjustment factor that attempts to capture the benefits (i.e., net reduction in guaranteed benefit costs) of a dispersed maturity profile. This adjustment applies on to maturity benefit factors only; it does not apply to death benefit factors. Note that $w(\phi) \leq 1$ also

\(^{108}\) Technically, the sample distribution for “present value of net cost” = $PV[benefit claims] – PV[Margin Offset]$ was used to determine the scenario results that comprise the CTE95 risk measure. Hence, the “Cost Factors” and “Base Margin Offset Factors” are calculated from the same scenarios.

\(^{109}\) In other words, the Basic Cost Factors are expressed “per $1 of current guaranteed benefit” and the Margin Offset Factors are “per $1 of account balance”, assuming 100 basis points (per annum) of available spread.
depends on fund class “F”. If the company does not satisfy the time diversification criteria, then \( w(\phi) = 1 \) (i.e., no time diversification benefit). Although the structure permits otherwise, the time diversification factors for GMDB are set to 1. The lookup keys for the Time Diversification factors are given in Table 7.

This factor is set either to zero or one, based on the results of a time diversification test.

To perform the test, the in-force maturity dates for each product/maturity guarantee form are grouped by “quarter-to-maturity” (i.e., 1, 2, …, \( N \)). For limited-term contracts that offer the client the opportunity to renew (“rollover”), the next maturity date should be used (not final contract maturity). Using current market value (at the calculation date), the current market value in each future 3-month time period is determined.

If the current market value in any given quarter exceeds 10% of the total, then the portfolio fails the test. If the current market value in each quarter is less than or equal to 10% of the total, the portfolio passes the test. If the portfolio fails the test, \( DT \) is set equal to zero in the GetCost and GetTGCR functions (see section 7.7.1). Otherwise, \( DT \) is set equal to one.
Table 5: Grid of Cost and Margin Offset Factors

<table>
<thead>
<tr>
<th>Policy Attribute</th>
<th>Key : Possible Values &amp; Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Product Definitions, $P$.</strong></td>
<td></td>
</tr>
<tr>
<td><strong>GMDB</strong></td>
<td>0 : Return-of-premium. 1 : Roll-up (5% per annum). 2 : Maximum Anniversary Value (MAV). 3 : 10-year rollover.</td>
</tr>
<tr>
<td><strong>GMMB &amp; GMSB</strong></td>
<td>0 : Fixed maturity date. 1 : 10-year CSV (benefit paid on surrender) 2 : <em>Not used.</em> 3 : 10-year rollover.</td>
</tr>
<tr>
<td><strong>Guarantee Level (% of deposits), $G$.</strong></td>
<td>0 : 75% 1 : 100%</td>
</tr>
<tr>
<td><strong>GV Adjustment Upon Partial Withdrawal, $A$.</strong></td>
<td>0 : Pro-rata by market value. 1 : Dollar-for-dollar.</td>
</tr>
<tr>
<td><strong>Fund Class, $F$.</strong></td>
<td>0 : <em>Not used.</em> 1 : Money Market. 2 : Fixed Income (Bond). 3 : Balanced Asset Allocation. 4 : Low Volatility Equity. 5 : Diversified Equity. 6 : Intermediate Risk Equity. 7 : Aggressive / Exotic Equity.</td>
</tr>
<tr>
<td><strong>Contract Maturity Age, $M$.</strong> (years from valuation date)</td>
<td></td>
</tr>
<tr>
<td><strong>GMDB</strong></td>
<td>0 : 5 years 1 : 15 years 2 : 25 years 3 : 30 years</td>
</tr>
<tr>
<td><strong>GMMB &amp; GMSB</strong></td>
<td>0 : 1 year 4 : 10 years 1 : 3 years 5 : 20 years 2 : 5 years 6 : 30 years 3 : 8 years</td>
</tr>
<tr>
<td><strong>Attained Age (Last Birthday), $X$.</strong></td>
<td></td>
</tr>
<tr>
<td><strong>GMDB</strong></td>
<td>0 : 35 2 : 65 1 : 55 3 : 75</td>
</tr>
<tr>
<td><strong>GMMB &amp; GMSB</strong></td>
<td>0 : 55</td>
</tr>
<tr>
<td><strong>Time to Next Maturity, $T$.</strong> (years from valuation date)</td>
<td>0 : 1 year 3 : 8 years 1 : 3 years 4 : 10+ years 2 : 5 years</td>
</tr>
<tr>
<td><strong>Account Value-to-Guaranteed Value Ratio, $ϕ$.</strong></td>
<td>0 : 0.25 4 : 1.25 1 : 0.50 5 : 1.50 2 : 0.75 6 : 2.00 3 : 1.00</td>
</tr>
<tr>
<td><strong>Annualized Account Charge Differential from Table 2 Assumptions (“MER Delta”), $Δ$.</strong></td>
<td>0 : −100 bps 1 : 0 bps 2 : +100 bps</td>
</tr>
<tr>
<td><strong>Reset Utilization Rate, $R$.</strong></td>
<td>0 : 0% 1 : 100%</td>
</tr>
<tr>
<td><strong>In-the-Money Surrender Rate (GMSB only), $S$.</strong></td>
<td>0 : 0% 1 : 100%</td>
</tr>
</tbody>
</table>
It is important to note that the lookup keys for the factor tables define certain values differently from the parameters (arguments) passed to the lookup/retrieval functions, as indicated in the following table. More details are provided in section 7.7.

<table>
<thead>
<tr>
<th>Policy Attribute</th>
<th>Key Interpretation</th>
<th>Function Arguments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract Maturity Age, M.</td>
<td>Years from Valuation Date. Equal to [Contract Maturity Age] less [Attained Age].</td>
<td>Actual contract maturity age.</td>
</tr>
<tr>
<td>AV/GV Ratio, ( \phi )</td>
<td>Ratio of current Account Balance (AV) to Guaranteed Value (GV).</td>
<td>AV and GV are provided separately.</td>
</tr>
<tr>
<td>MER Delta, ( \Delta )</td>
<td>[Actual MER] less [Assumed MER], in basis points. The “Assumed MERs” are shown in</td>
<td>MER (annualized, in basis points p.a.) is passed directly.</td>
</tr>
</tbody>
</table>

Table 6: Grid of Asset Mix Diversification Factors

<table>
<thead>
<tr>
<th>Policy Attribute</th>
<th>Key : Possible Values &amp; Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product Definitions, ( P ).</td>
<td>GMDB</td>
</tr>
<tr>
<td></td>
<td>0 : Return-of-premium.</td>
</tr>
<tr>
<td></td>
<td>1 : Roll-up (5% per annum).</td>
</tr>
<tr>
<td></td>
<td>2 : Maximum Anniversary Value (MAV).</td>
</tr>
<tr>
<td></td>
<td>3 : 10-year rollover.</td>
</tr>
<tr>
<td></td>
<td>GMMB &amp; GMSB</td>
</tr>
<tr>
<td></td>
<td>0 : Fixed maturity date.</td>
</tr>
<tr>
<td></td>
<td>1 : 10-year CSV (benefit paid on surrender).</td>
</tr>
<tr>
<td></td>
<td>2 : Not used.</td>
</tr>
<tr>
<td></td>
<td>3 : 10-year rollover.</td>
</tr>
<tr>
<td>Guarantee Level (% of deposits), ( G ).</td>
<td>0 : 75%</td>
</tr>
<tr>
<td>Reset Utilization Rate, ( R ).</td>
<td>0 : 0%</td>
</tr>
<tr>
<td>In-the-Money Surrender Rate (GMSB only), ( S ).</td>
<td>0 : 0%</td>
</tr>
</tbody>
</table>
Table 7: Grid of Time Diversification Factors

<table>
<thead>
<tr>
<th>Policy Attribute</th>
<th>Key</th>
<th>Possible Values &amp; Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Product Definition, ( P ).</strong></td>
<td>GMDB</td>
<td>0: Return-of-premium.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1: Roll-up (5% per annum).</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2: Maximum Anniversary Value (MAV).</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3: 10-year rollover.</td>
</tr>
<tr>
<td><strong>Guarantee Level (% of deposits), ( G ).</strong></td>
<td>GMMB &amp; GMSB</td>
<td>0: Fixed maturity date.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1: 10-year CSV (benefit paid on surrender).</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2: Not used.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3: 10-year rollover.</td>
</tr>
<tr>
<td><strong>Fund Class, ( F ).</strong></td>
<td></td>
<td>0: Not used.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1: Money Market.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2: Fixed Income (Bond).</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3: Balanced Asset Allocation.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>4: Low Volatility Equity.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>5: Diversified Equity.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>6: Intermediate Risk Equity.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>7: Aggressive / Exotic Equity.</td>
</tr>
<tr>
<td><strong>Reset Utilization Rate, ( R ).</strong></td>
<td></td>
<td>0: 0%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1: 100%</td>
</tr>
<tr>
<td><strong>In-the-Money Surrender Rate (GMSB only), ( S ).</strong></td>
<td></td>
<td>0: 0%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1: 100%</td>
</tr>
</tbody>
</table>

7.6. Retrieving the appropriate nodes

Table 8 provides some sample lookup keys (assuming the annualized fund based charges equal the base assumption, hence \( \Delta = 0 \)), while Table 9 shows the “Basic Cost” and “Basic Margin Offset” values from the factor grid for some sample GMDB and GMMB policies. All sample policies in Table 9 use a 100% guarantee level, base MERs and no resets. As mentioned earlier, the Base Margin Offset factors (in the tables) assume 100 basis points of “available spread”. The “Margin Offset Factors” are therefore scaled by the ratio \( \frac{\alpha}{100} \), where \( \alpha \) = the actual margin offset (in basis points per annum) for the policy being valued. Hence, the margin factor for the 7th policy is exactly half the factor for node ‘11105214210’ (the 4th sample policy in Table 9). That is, 0.02093 = 0.5 × 0.04187.

Where more than one feature (i.e., guaranteed benefit) is present in a product, unless the company has a justifiable alternative for allocating the total available spread between the benefit types (e.g., explicitly defined risk charges), the split should be based on the proportionate gross guaranteed benefit costs. An example of this allocation is provided in section 7.7.3.
Table 8: Sample Lookup Keys

<table>
<thead>
<tr>
<th>KEY</th>
<th>NODE TYPE</th>
<th>PRODUCT / GV%</th>
<th>GV ADJUST</th>
<th>FUND CLASS</th>
<th>ATT. AGE / MAT. AGE</th>
<th>NEXT MAT.</th>
<th>AV/GV</th>
<th>RESET UTIL.%</th>
<th>ITM TERM%</th>
</tr>
</thead>
<tbody>
<tr>
<td>10103214110</td>
<td>A</td>
<td>GMDB-ROP / 100%</td>
<td>Pro-rata</td>
<td>Balanced Allocation</td>
<td>65 / 80</td>
<td>10+</td>
<td>50</td>
<td>0%</td>
<td>n/a</td>
</tr>
<tr>
<td>200150444110</td>
<td>A</td>
<td>GMMB-Fixed / 75%</td>
<td>$-for-$</td>
<td>Diverse Equity</td>
<td>55 / 75</td>
<td>5</td>
<td>125%</td>
<td>100%</td>
<td>n/a</td>
</tr>
<tr>
<td>3311</td>
<td>B</td>
<td>GMDB_.10 / 100%</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>100%</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>43100</td>
<td>B</td>
<td>GMMB_.10 / 100%</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>0%</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>611411</td>
<td>C</td>
<td>GMSB_.10 / 100%</td>
<td>n/a</td>
<td>Low Vol. Equity</td>
<td>n/a</td>
<td>n/a</td>
<td>100%</td>
<td>100%</td>
<td></td>
</tr>
</tbody>
</table>

A = Basic Cost and Margin Offset Factors; B = Asset Mix Diversification Factors; C = Time Diversification Factors.

Table 9: Sample Nodes on the Basic Factor Grids

<table>
<thead>
<tr>
<th>KEY</th>
<th>PRODUCT</th>
<th>GV ADJUST</th>
<th>FUND CLASS</th>
<th>ATT. AGE / MAT. AGE</th>
<th>NEXT MAT.</th>
<th>AV/GV</th>
<th>OFFSET</th>
<th>COST FACTOR</th>
<th>MARGIN FACTOR</th>
</tr>
</thead>
<tbody>
<tr>
<td>10113124310</td>
<td>GMDB ROP</td>
<td>$-for-$</td>
<td>Balanced Allocation</td>
<td>55 / 80</td>
<td>10+</td>
<td>1.00</td>
<td>100</td>
<td>0.01802</td>
<td>0.05762</td>
</tr>
<tr>
<td>10113214310</td>
<td>GMDB ROP</td>
<td>$-for-$</td>
<td>Balanced Allocation</td>
<td>65 / 80</td>
<td>10+</td>
<td>1.00</td>
<td>100</td>
<td>0.03926</td>
<td>0.04747</td>
</tr>
<tr>
<td>10113302310</td>
<td>GMDB ROP</td>
<td>$-for-$</td>
<td>Balanced Allocation</td>
<td>75 / 80</td>
<td>5</td>
<td>1.00</td>
<td>100</td>
<td>0.04443</td>
<td>0.02653</td>
</tr>
<tr>
<td>11105214210</td>
<td>GMDB 5% Rollup</td>
<td>Pro-rata</td>
<td>Diverse Equity</td>
<td>65 / 80</td>
<td>10+</td>
<td>0.75</td>
<td>100</td>
<td>0.16780</td>
<td>0.04187</td>
</tr>
<tr>
<td>11105214310</td>
<td>GMDB 5% Rollup</td>
<td>Pro-rata</td>
<td>Diverse Equity</td>
<td>65 / 80</td>
<td>10+</td>
<td>1.00</td>
<td>100</td>
<td>0.13091</td>
<td>0.04066</td>
</tr>
<tr>
<td>11105214410</td>
<td>GMDB 5% Rollup</td>
<td>Pro-rata</td>
<td>Diverse Equity</td>
<td>65 / 80</td>
<td>10+</td>
<td>1.25</td>
<td>100</td>
<td>0.09925</td>
<td>0.03940</td>
</tr>
<tr>
<td>11105214210</td>
<td>GMDB 5% Rollup</td>
<td>Pro-rata</td>
<td>Diverse Equity</td>
<td>65 / 80</td>
<td>10+</td>
<td>0.75</td>
<td>50</td>
<td>0.16780</td>
<td>0.02093</td>
</tr>
<tr>
<td>231050513100</td>
<td>GMMB_.10</td>
<td>Pro-rata</td>
<td>Diverse Equity</td>
<td>55 / 75</td>
<td>3</td>
<td>1.00</td>
<td>100</td>
<td>0.32250</td>
<td>0.05609</td>
</tr>
<tr>
<td>231050523100</td>
<td>GMMB_.10</td>
<td>Pro-rata</td>
<td>Diverse Equity</td>
<td>55 / 75</td>
<td>5</td>
<td>1.00</td>
<td>100</td>
<td>0.25060</td>
<td>0.05505</td>
</tr>
<tr>
<td>231050533100</td>
<td>GMMB_.10</td>
<td>Pro-rata</td>
<td>Diverse Equity</td>
<td>55 / 75</td>
<td>8</td>
<td>1.00</td>
<td>100</td>
<td>0.16758</td>
<td>0.05545</td>
</tr>
</tbody>
</table>

7.7. Use of supplied functions to determine the requirement

7.7.1. Function descriptions

Special functions have been supplied in the file OSFIFactorCalc.dll (C++ dynamic linked library) to retrieve the “cost”, “margin offset” and “diversification” factors from the factor files and perform the multi-dimensional linear interpolation. Cover functions in the Microsoft®
Visual Basic “Add-In” are provided in the file OSIFFactorCalc.xla so that the C++ routines are callable from Microsoft Excel through VBA\(^\text{110}\). The function arguments are described in Table 10. Not all parameters apply to all functions (i.e., some are optional and/or not applicable). The keys for the input parameters are given in Table 5.

Installation instructions are given later in this section. A call to an Excel function (built-in or VBA) must be preceded by a “+” or “=” character.

Table 10: Input Parameters (Arguments) to Supplied Lookup/Retrieval Functions

<table>
<thead>
<tr>
<th>Input Parameter – Variable Name</th>
<th>Variable Type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>B – BenefitType</td>
<td>Long Integer</td>
<td>Benefit Type code (1=GMDB, 2=GMMB/GMSB).</td>
</tr>
<tr>
<td>F – FundCode</td>
<td>Long Integer</td>
<td>Fund Class code.</td>
</tr>
<tr>
<td>M – FinalMatAge</td>
<td>Floating Point Double</td>
<td>Contract Maturity Age of annuitant (in years).</td>
</tr>
<tr>
<td>X – AttainedAge</td>
<td>Floating Point Double</td>
<td>Attained Age of annuitant (in years).</td>
</tr>
<tr>
<td>T – TimeToMat</td>
<td>Floating Point Double</td>
<td>Time to Next Maturity Date (in years).</td>
</tr>
<tr>
<td>MVGV – MVGV</td>
<td>Floating Point Double</td>
<td>Ratio of Account Balance to Guaranteed Value (AV/GV).</td>
</tr>
<tr>
<td>MER – MER</td>
<td>Floating Point Double</td>
<td>Total Equivalent Account Charges (annualized, in bps).</td>
</tr>
<tr>
<td>R – ResetUtil</td>
<td>Floating Point Double</td>
<td>Reset Utilization Rate (from 0 to 1).</td>
</tr>
<tr>
<td>S – SurrenderUtil</td>
<td>Floating Point Double</td>
<td>In-The-Money Termination Rate (from 0 to 1).</td>
</tr>
<tr>
<td>RC – RiskCharge</td>
<td>Floating Point Double</td>
<td>Margin Offset (annualized, in basis points).</td>
</tr>
<tr>
<td>AV – AccountValue</td>
<td>Floating Point Double</td>
<td>Current Account Balance, in dollars.</td>
</tr>
<tr>
<td>GV – GuarValue</td>
<td>Floating Point Double</td>
<td>Current Guaranteed Value, in dollars.</td>
</tr>
<tr>
<td>DF – FundDivAdj</td>
<td>Floating Point Double</td>
<td>The fraction of the Asset Mix Diversification adjustment reflected in the Adjusted Cost Factor (from 0 to 1).</td>
</tr>
<tr>
<td>DT – TimeDivAdj</td>
<td>Floating Point Double</td>
<td>The fraction of the Time Diversification adjustment reflected in the Adjusted Cost Factor (from 0 to 1).</td>
</tr>
</tbody>
</table>

\(^{110}\) Visual Basic for Applications.
See section 7.5 for instructions on setting the parameters for DF and DT.

Using the notation given earlier,

$$TGCR = GV \times h(\omega) \times w(\omega) \times \left[ BasicCostFactor \right] - \frac{\alpha}{100} \times AV \times \left[ BasicMarginFactor \right]$$

$$= GV \times h(\omega) \times w(\omega) \times f(\tilde{\theta}) - \frac{\alpha}{100} \times AV \times g(\tilde{\theta})$$

The VBA functions are:


- Returns the Adjusted Dollar Cost \( \hat{F}(\tilde{\theta}) \), interpolating between nodes where necessary.  \( S \) and \( RC \) are required arguments, but \( RC \) is ignored in the calculations (i.e., the margin offset does not affect the “cost” component).  Also, \( S \) is ignored for GMDB calculations (i.e., \( S = 0 \) if \( B = 1 \)).  DF and DT are optional, but assumed to be zero if not supplied.


- Returns the Adjusted Dollar Margin Offset \( \hat{G}(\tilde{\theta}) \), interpolating between nodes where necessary.  \( S \) is required, but ignored for GMDB calculations (i.e., \( S = 0 \) if \( B = 1 \)).  DF and DT are optional, but ignored regardless (i.e., the diversification factors only apply to the “cost” component).


- Returns the Adjusted Dollar TGCR \( \hat{F}(\tilde{\theta}) - \hat{G}(\tilde{\theta}) \), interpolating between nodes where necessary.  \( S \) is required, but ignored for GMDB calculations (i.e., \( S = 0 \) if \( B = 1 \)).  DF and DT are optional, but assumed to be zero if not supplied.

To retrieve the Basic Cost Factor \( f(\tilde{\theta}) \), simply use the function **GetCost** with \( AV = AV/GV \), \( GV = 1 \) and \( DF = DT = 0 \).  Similarly, the Basic Margin Factor \( g(\tilde{\theta}) \) may be obtained by calling **GetMargin** with \( GV = GV/AV, AV = 1 \) and \( RC = 100 \).

For reference, the underlying C++ routines are listed below.  These tools are also available as VBA functions where the name is prefixed with an “x” (e.g., **xGetGMDBCostFactor**).

**GetGMDBCostFactor** *(P, G, A, F, M, X, T, MVGV, MER, R)*

- Returns the GMDB Basic Cost Factor \( f(\tilde{\theta}) \), interpolating between nodes where necessary.
- Returns the GMDB Scaled Margin Offset Factor \( \hat{g}(\hat{\theta}) \), interpolating between nodes where necessary. In this case, the Basic (i.e., tabular) Margin Offset Factor has already been scaled by the ratio \( \frac{\alpha}{100} \) to account for the actual available spread. To extract the tabular factor \( g(\hat{\theta}) \), use RC = 100.

GetGMDBFundDiversification(P, G, R)
- Returns the GMDB Asset Mix Diversification Factor \( h(\hat{\theta}) \), interpolating between nodes where necessary.

GetGMDBTimeDiversification(P, G, F, R)
- Returns the GMDB Time Diversification Factor \( w(\hat{\theta}) \), interpolating between nodes where necessary. Currently, \( w(\hat{\theta}) = 1 \) for all nodes, so this function call is unnecessary for GMDB.

- Returns the GMMB/GMSB Basic Cost Factor \( \sim f(\hat{\theta}) \), interpolating between nodes where necessary.

- Returns the GMMB/GMSB Scaled Margin Offset Factor \( \sim \hat{g}(\sim \hat{\theta}) \), interpolating between nodes where necessary. In this case, the Basic (i.e., tabular) Margin Offset Factor has already been scaled by the ratio \( \frac{\alpha}{100} \) to account for the actual available spread. To extract the tabular factor \( \sim g(\sim \hat{\theta}) \), use RC = 100.

GetGMMBFundDiversification(P, G, R, S)
- Returns the GMMB/GMSB Asset Mix Diversification Factor \( h(\sim \hat{\theta}) \), interpolating between nodes where necessary.

GetGMMBTimeDiversification(P, G, F, R, S)
- Returns the GMMB/GMSB Time Diversification Factor \( w(\sim \hat{\theta}) \), interpolating between nodes where necessary.

7.7.2. Installing and using the OSFI factor calculation routines

The files shown in Table 11 comprise the “OSFI Factor Calculation” tools, supplied by OSFI to assist the company in calculating the TGCR for GMDB, GMMB and GMSB options.
Table 11: OSFI Factor Calculation Tools – Required Files

<table>
<thead>
<tr>
<th>File Name</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Setup.exe</td>
<td>Windows® setup program to unzip and install the calculation tools.</td>
</tr>
<tr>
<td>OSIFactorCalc.xla</td>
<td>Microsoft® Excel Visual Basic Add-In. This functionality ‘wraps’ the C++ routines, allowing them to be called directly from Microsoft Excel workbooks (i.e., can be invoked the same way as built-in Excel functions).</td>
</tr>
<tr>
<td>OSIFactorCalc.dll</td>
<td>The C++ dynamic linked library that contains the lookup and interpolation functions as described in this section.</td>
</tr>
<tr>
<td>GMDBFactors_CTE95.csv</td>
<td>Comma separated value (flat text) files containing the factors and parameters described in section 5.6.5. Each “row” in the file corresponds to a test policy as identified by the lookup keys shown in Table 5. Each row consists of three entries and is terminated by new line and line feed characters. See Section 5.6.5 for more details. Files are also provided at the CTE80 confidence level.</td>
</tr>
<tr>
<td>GMMBFactors_CTE95.csv</td>
<td></td>
</tr>
</tbody>
</table>

To install the OSFI factor calculation routines, run the setup utility and follow the instructions. This will unzip (decompress) the files and register the DLL in the Windows program registry.

The Microsoft Add-In must be loaded (into Excel) before the VBA functions can be called. The factor files and the Microsoft Excel Add-In (*.xla) must reside in the same folder. Simply open “OSIFactorCalc.xla” from Microsoft Excel. To view the VBA program, press [Alt-F11].

The following dialog should appear when the Add-In “OSIFactorCalc.xla” is loaded, prompting the user to select the appropriate CTE confidence level for calculation (either CTE95 or CTE80). This controls which factor tables are read into memory. For a given workbook, only a single set of factor files can be accessed (i.e., either CTE80 or CTE95).
7.7.3. Calculation example

Suppose we have the policy/product parameters as specified in Table 12. Further assume that the portfolio satisfies the criteria in order to apply the “Time Diversification” factors.

<table>
<thead>
<tr>
<th>Parameter / Attribute</th>
<th>Value</th>
<th>Description and/or Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Account Value (AV)</td>
<td>$90.00</td>
<td>Total account value at valuation date, in dollars.</td>
</tr>
<tr>
<td>Original Deposit</td>
<td>$100.00</td>
<td>Original deposit, in dollars.</td>
</tr>
<tr>
<td>GMDB (GV)</td>
<td>$100.00</td>
<td>Current guaranteed death maturity benefit, in dollars.</td>
</tr>
<tr>
<td>GMMB (GV)</td>
<td>$100.00</td>
<td>Current guaranteed minimum maturity benefit, in dollars.</td>
</tr>
<tr>
<td>Guarantee Level</td>
<td>100%</td>
<td>Initial guaranteed value as % of original deposit.</td>
</tr>
<tr>
<td>Gender</td>
<td>Female</td>
<td>Use 4-year age setback for X and M (GMDB only).</td>
</tr>
<tr>
<td>Actual Attained Age (X)</td>
<td>62</td>
<td>Attained age at the valuation date (in years).</td>
</tr>
<tr>
<td>Contract Maturity Age (M)</td>
<td>85</td>
<td>Contract maturity age (in years).</td>
</tr>
<tr>
<td>Time to Next Maturity (T), GMDB</td>
<td>23</td>
<td>Time to next maturity/rollover date (in years).</td>
</tr>
<tr>
<td>Time to Next Maturity (T), GMMB</td>
<td>3</td>
<td>Time to next maturity/rollover date (in years).</td>
</tr>
<tr>
<td>GV Adjustment</td>
<td>Pro-Rata</td>
<td>GV adjusted pro-rata by MV upon partial withdrawal.</td>
</tr>
<tr>
<td>Fund Class</td>
<td>Diversified Equity</td>
<td>Contract exposure mapped to Diversified Equity as per the Fund Categorization instructions in section 7.4.</td>
</tr>
<tr>
<td>MER</td>
<td>265</td>
<td>Total charge against policyholder funds (bps).</td>
</tr>
<tr>
<td>GMDB Product Code (P)</td>
<td>0</td>
<td>Product Definition code as per lookup key in Table 5.</td>
</tr>
<tr>
<td>GMMB Product Code (P)</td>
<td>3</td>
<td>Product Definition code as per lookup key in Table 5.</td>
</tr>
<tr>
<td>Guarantee Level Code (G)</td>
<td>1</td>
<td>Guarantee Code as per key in Table 5.</td>
</tr>
<tr>
<td>GV Adjustment Code (A)</td>
<td>0</td>
<td>GV Adjustment Upon Partial Withdrawal as per Table 5.</td>
</tr>
<tr>
<td>Fund Code (F)</td>
<td>5</td>
<td>Fund Class code as per lookup key in Table 5.</td>
</tr>
<tr>
<td>GMMB Reset Utilization (R)</td>
<td>0.35</td>
<td>Reset utilization rate (from 0 to 1).</td>
</tr>
<tr>
<td>In-The-Money Termination (S)</td>
<td>0</td>
<td>In-the-money termination rate (from 0 to 1).</td>
</tr>
<tr>
<td>Total Allocated Spread (RC)</td>
<td>80</td>
<td>Total margin offset (bps p.a.) for GMDB &amp; GMMB combined.</td>
</tr>
<tr>
<td>Asset Mix Diversification (DF)</td>
<td>1</td>
<td>Credit for asset mix diversification.</td>
</tr>
<tr>
<td>Time Diversification (DT)</td>
<td>1</td>
<td>Credit for time diversification (GMMB).</td>
</tr>
</tbody>
</table>
Using the notation from section 7.7.1,

\[
TGCR = GV \times h(\phi) \times w(\phi) \times [BasicCostFactor] - \frac{\alpha}{100} \times AV \times [BasicMarginFactor]
\]

\[
= GV \times h(\phi) \times w(\phi) \times f(\tilde{\theta}) - \frac{\alpha}{100} \times AV \times g(\tilde{\theta})
\]

\[
= GV \times \hat{f}(\tilde{\theta}) - AV \times \hat{g}(\tilde{\theta})
\]

\[
\hat{f}_{GMDB}(\tilde{\theta}) = GetCost(1, 0, 1, 0, 5, 81, 58, 23, 0.9, 1, 265, 0, 0, 80, 1, 1)
\]

\[= 0.04592\]

\[
\hat{f}_{GMMB}(\tilde{\theta}) = GetCost(2, 3, 1, 0, 5, 85, 62, 3, 0.9, 1, 265, 0.35, 0, 80, 1, 1)
\]

\[= 0.32849\]

In the absence of specific and well-defined risk charges for each guaranteed benefit, we allocate the total spread by the claims cost and obtain (in bps per annum):

\[
\alpha_{GMDB} = \frac{0.04592}{0.04592 + 0.32849} \times 80 = 0.12264 \times 80 = 9.81 \text{ basis points per annum available to fund the GMDB claims and } \alpha_{GMMB} = 80 - 9.81 = 70.19 \text{ bps p.a. to fund GMMB payouts.}
\]

\[
\hat{f}_{GMDB}(\tilde{\theta}) = GetCost(1, 0, 1, 0, 5, 81, 58, 23, 90, 100, 265, 0, 0, 9.81, 1, 1)
\]

\[= 0.04592 \times 80 = 0.04592 \times 100 = 4.59\]

\[
\hat{f}_{GMMB}(\tilde{\theta}) = GetCost(2, 3, 1, 0, 5, 85, 62, 3, 90, 100, 265, 0.35, 0, 70.19, 1, 1)
\]

\[= 0.32849 \times 80 = 0.32849 \times 100 = 32.85\]

For reference, the Basic Cost Factors (i.e., before diversification adjustments) are:

\[
f_{GMDB}(\tilde{\theta}) = GetCost(1, 0, 1, 0, 5, 81, 58, 23, 0.9, 1, 265, 0, 0, 9.81)
\]

\[= 0.04794\]
\[ f_{GMMB}(\hat{\theta}) = \text{GetCost}(2, 3, 1, 0, 5, 85, 62, 3, 0.9, 1, 265, 0.35, 0, 70.19) \]
\[ = 0.36461 \]

\[ g_{GMDB}(\hat{\theta}) = \text{GetMargin}(1, 0, 1, 0, 5, 81, 58, 23, 0.9, 1, 265, 0, 0, 100) \]
\[ = 0.04227 = 0.04697 \times 0.9 \]

\[ g_{GMMB}(\hat{\theta}) = \text{GetMargin}(2, 3, 1, 0, 5, 85, 62, 3, 0.9, 1, 265, 0.35, 0, 100) \]
\[ = 0.06201 = 0.06890 \times 0.9 \]

\[ \hat{G}_{GMDB}(\hat{\theta}) = \text{GetMargin}(1, 0, 1, 0, 5, 81, 58, 23, 90, 100, 265, 0, 0, 9.81) \]
\[ = \$0.41 = 0.04697 \times \$90 \times \left( \frac{9.81}{100} \right) \]

\[ \hat{G}_{GMMB}(\hat{\theta}) = \text{GetMargin}(2, 3, 1, 0, 5, 85, 62, 3, 90, 100, 265, 0.35, 0, 70.19) \]
\[ = \$4.35 = 0.06890 \times \$90 \times \left( \frac{70.19}{100} \right) \]

\[ TGCR_{GMDB} = \text{GetTGCR}(1, 0, 1, 0, 5, 81, 58, 23, 90, 100, 265, 0, 0, 9.81, 1, 1) \]
\[ = \$4.18 \]
\[ = \$4.59 - \$0.41 \]

\[ TGCR_{GMMB} = \text{GetTGCR}(2, 3, 1, 0, 5, 85, 62, 3, 90, 100, 265, 0.35, 0, 70.19, 1, 1) \]
\[ = \$28.50 \]
\[ = \$32.85 - \$4.35 \]

Finally, the \( TGCR \) for the policy is \$4.18 + \$28.50 = \$32.68

If desired, the Asset Mix and Time Diversification Factors may be obtained through additional function calls by setting \( DF \) or \( DT \) to zero as required and solving for the other factor. For example, if we set \( DF = 1 \) and \( DT = 0 \), we obtain for the GMMB component:
0.34307 = \text{GetCost}(2, 3, 1, 0, 5, 85, 62, 3, 0.9, 1, 265, 0.35, 0, 80, 1, 0)

However, with $DF = 1$ and $DT = 1$ we obtained $\hat{f}_{GMMB}(\tilde{\theta}) = 0.32849$ (see earlier in this section).

Hence, the GMMB Time Diversification Factor is equal to $0.9575 = \frac{0.32849}{0.34307}$.

### 7.8. Margin Offset Adjustment

The total equivalent account charge (“MER”) is meant to capture all amounts that are deducted from policyholder funds, not only those that are commonly expressed as spread-based fees. The MER, expressed as an equivalent annual basis point charge against account value, should include (but not be limited to) the following: investment management fees, mortality & expense charges, administrative loads, policy fees and risk premiums. It may be necessary to estimate an equivalent MER if there are fees withdrawn from policyholder accounts that are not expressed as basis point charges against account value.

The margin offset, $\alpha$, represents the total amount available to fund the guaranteed benefit claims and amortization of the unamortized surrender charge allowance after considering most other policy expenses (including overhead). The margin offset, expressed as an equivalent annual basis point charge against account value, should be deemed permanently available in all future scenarios. However, the margin offset should not include per policy charges (e.g., annual policy fees) since these are included in fixed expenses. It is often helpful to interpret the margin offset as $\alpha = MER - X$, where $X$ is the sum of:

a. Investment management expenses and advisory fees;

b. Commissions, bonuses (dividends) and overrides;

c. Maintenance expenses; and

d. Amounts required to amortize unamortized acquisition costs (net of available surrender charges).

### 7.9. Credit for reinsurance ceded or capital markets hedging

This is the reduction in the $TGCR$ available on account of risk mitigation strategies, including reinsurance and hedging.

For registered reinsurance of segregated fund liabilities that is directly expressible in terms of the component factors, ceding companies may take credit through an appropriate reduction of the factors.

For more complex reinsurance arrangements that cannot be expressed using the factors, the impact will need to be modelled (refer to section 7.10) and submitted to OSFI for approval. For example, a reinsurance treaty that has the ceding company retain losses to a predetermined level (a “deductible”), with the reinsurer assuming losses above this level, but with a cap on the
reinsurance claims (e.g., a maximum annual payment cap under the treaty) would normally require the use of suitable valuation model.

Policy liabilities ceded under arrangements deemed to constitute unregistered reinsurance (reference section 10.2) must be reported on page 20.030, line 085 by Canadian companies, and on page 12.200, line 340 by foreign branches.

Deposits held for unregistered reinsurance per section 10.6, for the period not less than the fund guarantee term remaining and that are in excess of the actuarial liabilities for the risk reinsured, may reduce the net required segregated fund risk component requirement on the reinsured policies to a minimum of zero (report this amount in column 08 on page 90.010). For Canadian business, the deposits must be held in Canada, and OSFI must have given the company permission to reduce its reserves by the deposits held corresponding to the reserves. The reduction is limited to that available had the business been ceded to a reinsurer subject to these requirements.

7.10. Custom factors and internal models

7.10.1. Custom factors

Should the company be evaluating a product type that is materially different from those presented in the tables, or where a company needs to evaluate a complex reinsurance or hedging arrangement, it will be necessary to use stochastic modelling to calculate factors for the particular product or treaty.

The use of modelling to calculate factors specific to a product requires approval by the Actuarial Division of OSFI. Life Insurers should contact OSFI’s Actuarial or Capital Division for specific details.

Approved factors apply until new factors or an internal model are approved by OSFI.

With the passage of time, the assumptions underlying approved factors may not reflect emerging experience and can become inconsistent with the current valuation assumptions.

In such instances, an inconsistency between the TGCR calculated using the approved factors and that determined at CTE (95) using the company’s stochastic model with current valuation assumptions might develop. The actuary should regularly review this relationship to ensure that the TGCR held using the approved factors is not materially less than that calculated at CTE (95) using the company’s stochastic model with current valuation assumptions. *If the TGCR using the previously approved factors is materially less than the TGCR calculated at CTE (95) using the company’s stochastic model with current valuation assumptions, the institution should use the higher TGCR and apply to OSFI for approval of new factors or make an application to use its internal model to calculate capital requirements.*
7.10.2. **Internal models**

OSFI permits, subject to criteria, the use of internal models for the development of segregated fund capital requirements. Institutions seeking to use their internal models must follow the requirements outlined in OSFI’s *Instruction Guide on Use of Internal Models for Determining Required Capital for Segregated Fund Risks (MCCSR).* Internal model usage requires OSFI’s prior written approval and is subject to materiality considerations. The requirements also include transitional rules: in the first year of approval, only 50% credit is permitted (i.e., the Total Gross Calculated Requirement is equal to 50% of the value calculated under the approved internal model plus 50% of the value calculated using the factor requirements). However, in subsequent years, the requirement is based 100% upon the value determined by the approved internal model.

7.11. **Analysis of results**

The development of capital requirement factor grids using stochastic methods is a complex process. While the work done in developing the factors was extensive, there is still the possibility that the factors may contain anomalies.

Many insurers use their own stochastic models to determine liability requirements. An insurer that uses a stochastic model that has not been approved should regularly compare the present value of net costs at CTE(95) that is output by its model with OSFI’s capital requirements based on the application of the factor grid. Insurers should report to OSFI any unusual results that appear to be caused by logical or methodological errors within the capital requirements.
Chapter 8 Operational Risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk\(^{111}\) but excludes strategic and reputational risk.

8.1 Operational risk formula

Required capital for operational risk is the sum of:

1) Business volume required capital;
2) Large increase in business volume required capital; and
3) General required capital.

8.2 Operational risk exposures and factors

This section outlines exposures and factors used to calculate required capital for operational risk.

8.2.1 Business volume required capital

Business volume required capital is determined by applying the following factors to direct premiums and assumed reinsurance premiums written in the past 12 months, and to account values/liabilities for deposit-type products:

<table>
<thead>
<tr>
<th>Exposure</th>
<th>Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct Premiums Written(^{112})</td>
<td>2.50%</td>
</tr>
<tr>
<td>Assumed Reinsurance Premiums</td>
<td>1.75%</td>
</tr>
<tr>
<td>Investment-type Product Account Values and Annuity Liabilities(^{113}):</td>
<td></td>
</tr>
<tr>
<td>Segregated Funds</td>
<td>0.40%</td>
</tr>
<tr>
<td>Annuity Liabilities in Payout Period</td>
<td>0.15%</td>
</tr>
<tr>
<td>Universal Life</td>
<td>0.10%</td>
</tr>
<tr>
<td>Mutual Funds, GICs, Other Investment-type Products, and Annuity Liabilities in Accumulation Period</td>
<td>0.10%</td>
</tr>
</tbody>
</table>

---

\(^{111}\) Legal risk includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements.

\(^{112}\) Direct premiums for individual and group life policies include universal life premiums, but exclude mutual fund deposits, GICs, segregated fund deposits or premium equivalents for administrative service only/investment management services.

\(^{113}\) The liability values to which factors are applied are calculated gross of reinsurance (where applicable) and include PfADs.
Segregated funds with no guarantees receive the factor for mutual funds. Business from controlled non-life financial corporations that are deducted from Available Capital is excluded from business volume operational risk charges.

8.2.2 Large increase in business volume required capital

Large increase in business volume required capital is calculated by geography. The factors in 8.2.1 are applied to the amounts by which the year-over-year increases in direct written premiums, assumed reinsurance premiums, and account values for investment-type products plus liabilities for annuities exceed a threshold of 20%.

For direct written premiums, the year-over-year increase\(^{114}\) is calculated for:

a. Individual Life (including Universal Life);

b. Group Life (including Universal Life); and

c. Other (excluding annuities).

For reinsurance premiums, the year-over-year increase\(^{115}\) is calculated for:

a. Assumed premiums.

For investment-type product account values and liabilities for annuities, the year-over-year increase is calculated for:

a. Segregated funds;

b. Annuity liabilities (including PfADs) in payout period;

c. Universal life; and

d. Mutual funds, GICs, other investment-type products, and annuity liabilities in accumulation period.

In the case of an acquisition of another entity or an acquisition of a block of business through assumption reinsurance, the premiums for any prior reporting period (before the acquisition) is the sum of the premiums written by the two separate entities/blocks of business, i.e. the sum of the acquiring company’s and the acquired company’s/blocks of business’ premiums.

8.2.3 General required capital

General required capital has two components. The first component is calculated as a factor applied to the sum of required capital for all other risk components, net of credits for reinsurance,

\(^{114}\) A 2.50% risk factor applies to the total amount of direct premiums written in the past 12 months above the 20% growth threshold compared to the gross premiums written for the same period in the previous year.

\(^{115}\) A 1.75% risk factor for assumed premiums applies to the total amount of reinsurance premiums assumed in the past 12 months above the 20% growth threshold compared to the premiums assumed for the same period in the previous year.
participating products and adjustable products, and before application of credit for diversification. The second component is calculated as a factor applied to ceded reinsurance premiums, and compensates for understatement of the first component arising from its calculation net of reinsurance (which does not normally transfer operational risk).

<table>
<thead>
<tr>
<th>Proxy</th>
<th>Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Required Capital for Credit, Insurance and Market Risks</td>
<td>4.5%</td>
</tr>
<tr>
<td>Ceded Reinsurance Premiums</td>
<td>2.5%</td>
</tr>
</tbody>
</table>
Chapter 9  Participating and Adjustable Products

Required capital components for participating and adjustable products are calculated in the prior chapters as if the products were non-participating and non-adjustable. However, participating and adjustable policies allow insurers to share risk with policyholders through discretionary benefits. Therefore, insurers may include credits for participating products (par credit) and for contractually adjustable policies (adjustable credit) in the calculation of the Base Solvency Buffer provided certain conditions are met.

An insurer should calculate the credit for participating products by geography. However, if not all participating products within a geography are homogeneous with respect to the risks that are passed through to policyholders via reductions in dividends, it will be necessary for the insurer to partition its participating business within the geography into separate blocks that are homogeneous with respect to the risks passed through to policyholders. A standalone capital requirement net of par credit is calculated for each such block.

The adjustable credit is calculated for each adjustable product within a geography.

A non-trivial reduction in dividends or significant adjustments made to adjustable features may result in other adverse impacts (second-order effects) due to lapses, anti-selection, unit expense increases or legal action undertaken by policyholders. Such second-order effects should not be reflected in cash flows when calculating the credit for participating and adjustable products.

9.1. The participating product credit

9.1.1. Conditions for the par credit

A par credit may be used to reduce the required capital for a block of participating policies provided that the experience with respect to specified risk elements is incorporated into the annual dividend adjustment process in a consistent manner from year to year. A par credit may be taken for the block only if the following three criteria are met:

1) The insurer’s participating dividend policy must be publicly disclosed and must make clear that policyholder dividends are not guaranteed and will be adjusted to reflect actual experience. The insurer should publicly disclose the elements of actual experience that are incorporated in the annual dividend adjustment process. Insurers must disclose all material elements and indicate whether and how the risks are passed through to the policyholders (e.g. investment income, asset defaults, mortality, lapses and expenses).

2) The insurer should regularly (at least once a year) review the policyholder dividend scale in relation to the actual experience of the participating account (i.e., including all blocks of business). The insurer should be able to demonstrate to the satisfaction of OSFI which individual elements of actual experience, to the extent that they were not anticipated in the current dividend scale, have been passed through in the annual dividend adjustment. Furthermore, the insurer should be able to demonstrate that shortfalls in actual overall experience, to the extent that they are not fully absorbed in any additional reserves or
other similar experience levelling mechanisms, are recovered\textsuperscript{116} on a present value basis through level or declining reductions in the dividend scale\textsuperscript{117}. The dividend scale reductions required to effect recovery must be made within two years from when the shortfall occurs.

3) The insurer should be able to demonstrate to OSFI that it follows the dividend policy and practices referred to above.

9.1.2. **Calculation of the standalone requirement for a block**

The standalone requirement for a block of par business takes into account the present value of dividend cash flows. The net capital requirement $P_i$ for the block that is included in the Base Solvency Buffer (reference section 11.3) is given by:

$$
P_i = \max \left[ K_{i, \text{reduced interest}} - \left( 1 - \frac{IRR_i}{\max(C_{i, \text{adverse}}, IRR_i)} \right) C_{i, \text{base}}, K_{i, \text{floor}} \right]
$$

where:

- $C_{i, \text{base}}$ is [70\%] of the present value dividend cash flows for the block used in the interest rate risk calculation, discounted using the rates under the base scenario in Chapter 5
- $C_{i, \text{adverse}}$ is [70\%] of the present value of dividend cash flows for the block used in the interest rate risk calculation, discounted using the rates under the most adverse scenario that determines the requirement for interest rate risk
- $IRR_i$ is the gross interest rate risk requirement for the block
- $K_i$ is the adjusted diversified requirement $K$ for the block (reference section 11.2)
- $K_{i, \text{reduced interest}}$ is the adjusted diversified requirement $K$ for all risks in the block, with the interest rate risk component reduced. This quantity is calculated by setting the interest rate risk component of the block to $\max(IRR_i - C_{i, \text{adverse}}, 0)$, and leaving all other risk components unchanged.
- $K_{i, \text{floor}}$ is the minimum adjusted diversified requirement for the block. This quantity is calculated by aggregating, within the calculation of $K$:
  - 100\% of the requirements for all risks in the block that cannot be passed through to policyholders by making adjustments to the dividend scale

\textsuperscript{116} The recovery of shortfalls must be demonstrated based on reductions in the dividend scale compared to what would have been paid taking into account all of the elements, and only those elements, that are passed through to policyholders.

\textsuperscript{117} Reductions in the dividend scale must be level or must represent front-loaded or accelerated experience recovery. Reductions in terminal dividends, where there are no periodic dividends, are considered to be level reductions in the dividend scale.
\[15\%\] of the gross interest rate risk requirement for the block, if interest rate risk can be passed through to policyholders by making adjustments to the dividend scale

\[30\%\] of all other risk components that can be passed through to policyholders by making adjustments to the dividend scale.

9.2. The contractually adjustable product credit

9.2.1. Conditions for the adjustable credit

Products that are contractually adjustable qualify for a credit if all of the following conditions are met:

1) Contractual adjustability is at the sole discretion of the insurer.

2) The adjustability is reasonably flexible, and the insurer has tested the reasonable flexibility of the adjustable features in pricing the policy or subsequent to pricing the product. The insurer should demonstrate that it is able to recover at least half of any unexpected losses by comparing the price with and without future adjustments. Tests of adjustability may not take into consideration amounts recoverable through arrangements that are accorded a separate credit in the insurance risk components, such as hold harmless agreements, deposits made by policyholders or claims fluctuation reserves. The tests should be documented and available for review by OSFI on request, and should demonstrate, to the satisfaction of OSFI, that these conditions are met.

3) All adjustable features associated with the products (e.g. premiums, fees or benefits) have been explicitly disclosed in the contract.

A product that is only adjustable up to a certain age or has a one-time adjustment may be considered adjustable provided that it meets all other conditions. A credit should not be calculated for an adjustment that is no longer available (e.g., used up or expired), or that the insurer would not be willing to exercise in the event of unexpected losses. The credit must be reduced to reflect documented internal policies that, if followed, would restrict contractual adjustability.

Products that are adjustable at the discretion of the insurer but that are also subject to regulatory approval will be considered adjustable; however, such products will be subject to a lower credit than other adjustable products that do not require regulatory approval.

Products with adjustable features that are not at the discretion of the insurer (such as formula or index based adjustments) are treated as non-adjustable business\textsuperscript{118}.

\textsuperscript{118} It is possible, for example, that a product with a formula or an index based adjustment to have other contractually adjustable features that are at the sole discretion of management such as cost of insurance (COI) charges. In such a case, only the contractually adjustable features that are at the sole discretion of management are treated as adjustable for the calculation of the credit.
9.2.2. Calculation of the adjustable credit

The gross adjustable credit $C_j$ is calculated for two categories of products where there are contractually adjustable liability cash flows:

1) Products adjustable at the sole discretion of the insurer and that do not require regulatory approval, and

2) Products adjustable at the sole discretion of the insurer and that do require regulatory approval.

The gross adjustable credit is equal to the difference between non-adjusted cash flows and adjusted cash flows discounted using CALM base scenario rates. The adjusted cash flows are based on the maximum amount of adjustment permitted in the contracts, up to a limit, for each adjustable feature. The limit for each adjustable feature is set depending on whether adjustments to the feature require regulatory approval or not.

For products with adjustable features that do not require regulatory approval, the increases or decreases for each feature recognized in adjusted cash flows are capped at 50% of the feature’s current level, phased-in on a straight line basis over a period of five years (i.e. 10% per year).\textsuperscript{119}

For products with adjustable features that do require regulatory approval, the increases or decreases for each feature recognized in adjusted cash flows are capped at 30% of the current level, phased-in on a straight line basis over a period of five years after a delay period of two years (i.e. adjustments of 6% per year occur after a waiting period of two years).\textsuperscript{120}

Once the gross adjustable credit $C_j$ for a product has been calculated, the adjustable credit $CR_j$ for the product used to calculate the Base Solvency Buffer (reference section 11.3) is given by:

$$CR_j = \min \left[ C_j, 0.5 \times \left( K_{\text{non-par}} - K_{\text{non-par excluding adjustable product } j} \right) \right]$$

where:

- $K_{\text{non-par}}$ is the requirement $K$ (reference section 11.2) calculated for the non-participating block, and

- $K_{\text{non-par excluding adjustable product } j}$ is the requirement $K$ for the non-participating block recalculated by excluding the insurance risk requirements for the adjustable product.

\textsuperscript{119} If it is not possible to calculate adjusted cash flows under a phase in, the adjustments are capped at 25% of the feature’s current level starting after one year.

\textsuperscript{120} If it is not possible to calculate adjusted cash flows under a phase in, the adjustments are capped at 10% of the feature’s current level starting after one year.
Chapter 10  Credit for Other Risk Mitigation and Risk Transfer

10.1. Introduction

The risk mitigation arrangements for which it is possible to obtain credit in the LICAT guideline, and the risk components to which they may be applied, are:

1. reinsurance (insurance risk components);
2. collateral (credit risk component for fixed-income and reinsurance assets);
3. guarantees and credit derivatives (credit risk component for fixed-income and reinsurance assets);
4. other derivatives serving as hedges (market risk); and
5. asset securitization (credit risk component).

Additionally, credit may be obtained for products having participating or adjustable features, as described in Chapter 9.

Any arrangement (including securitization) under which a third party assumes, or agrees to indemnify an insurer for any obligation or risk that would normally be reflected in policy liabilities or in required capital for insurance risk is treated as reinsurance for capital purposes and is subject to the requirements in sections 10.2 to 10.6 below.

Collateral, guarantees and credit derivatives may be used to reduce the credit risk requirements for fixed-income financial assets. The conditions for their use and the capital treatment are described in sections 3.2 and 3.3. Collateral and letters of credit may be used to reduce the credit risk requirement for reinsurance assets described in section 10.4, subject to the conditions in section 10.5. Derivatives serving as equity hedges may be applied to reduce the market risk requirements for equities, as described in section 5.2.2, and derivatives serving as foreign exchange risk hedges may be applied to reduce the requirement as described in sections 5.6.2 and 5.6.4. Asset securitization may be used to reduce credit risk requirements as provided for in Guideline B-5: Asset Securitization; guarantees providing tranched protection are treated as synthetic securitizations, and fall within the scope of the securitization guideline.

Reinsurance arrangements that are intended to mitigate the credit risk associated with a ceding insurer’s on-balance sheet assets, irrespective of whether such arrangements mitigate other risks simultaneously, must meet the conditions and follow the capital treatment specified for a form of risk mitigation that is eligible to reduce the credit risk component (i.e., guarantees, credit derivatives, or asset securitization). Although credit risk mitigation techniques and reinsurance have some features in common, the markets they refer to and their respective specific characteristics are sufficiently different to require distinct capital treatments.
10.2. Definitions

10.2.1. Registered reinsurance

An arrangement is deemed to constitute registered reinsurance if it is conducted with a registered reinsurer. OSFI considers a reinsurer to be registered if it is:

(a) a reinsurer that is either:
   i) incorporated federally and has reinsured the risks of the ceding insurer; or
   ii) a foreign insurer that has reinsured in Canada the risks of the ceding insurer, and is authorized by order of the Superintendent to do so; or

(b) a provincially/territorially regulated insurer that has been approved by the Superintendent.

Note that in respect of item (a)(ii) above, a ceding foreign insurer will be permitted to treat a reinsurance arrangement as registered reinsurance only where the arrangement provides that the reinsurer does not have any right of set-off against obligations of the ceding foreign insurer other than those obligations related to the insurance business in Canada of the ceding foreign insurer.

Subsection 578(5) of the Insurance Companies Act requires a foreign insurer, in respect of risks it reinsures in Canada, to set out in all premium notices, applications for policies and policies (which may include cover notes offer letters or quotations) a statement that the document was issued or made in the course of its insurance business in Canada. In cases where the cover note, offer letter or quotation can be considered neither an application for a policy nor a policy, an insurer will be permitted to treat a reinsurance arrangement as registered reinsurance only if the foreign reinsurer includes, in the cover note, offer letter or quotation, a statement that the reinsurer intends to issue the reinsurance contract under negotiation in the course of its insurance business in Canada, and that it will take measures to ensure that the cedant’s risks will be reinsured in Canada in accordance with OSFI’s Advisory No. 2007-01-R1 entitled Insurance in Canada of Risks.

10.2.2. Unregistered reinsurance

OSFI considers an entity to be an unregistered reinsurer if it is not a registered reinsurer as defined in section 10.2.1 above. Special purpose vehicles formed for the purpose of securitizing insurance risks are considered to be unregistered reinsurers.

All reinsurance arrangements conducted by an insurer or one of its subsidiaries with an unregistered reinsurer will be treated as unregistered reinsurance for the purpose of this guideline, unless:

(a) the ceding insurer is a Canadian insurer or one of its subsidiaries; and

(b) all of the policies reinsured under the arrangement are issued outside of Canada; and

(c) either:
   i) the branch or subsidiary of the Canadian insurer issuing or reinsuring the policies is subject to local solvency supervision by an OECD country in respect of the
risks being ceded, and the reinsurance or retrocession arrangement is recognized\textsuperscript{121} by that country’s solvency regulator, or

\begin{enumerate}[i)]
\item the risks being ceded relate to policies that have been issued or reinsured by a subsidiary of the Canadian insurer that is incorporated in a non-OECD country, and the reinsurance or retrocession arrangement is recognized\textsuperscript{121} by that country’s solvency regulator,
\end{enumerate}

and;

(d) either:

\begin{enumerate}[i)]
\item the reinsurer is regulated and subject to meaningful risk-based solvency supervision (including appropriate capital requirements) for insurance risks, or
\item the foreign solvency regulator has recognized the reinsurance arrangement on the basis that it has been fully collateralized by the reinsurer.
\end{enumerate}

Reinsurance arrangements meeting all of conditions (a) through (d) above may be treated as registered reinsurance.

\section*{10.2.3. Ceded liabilities}

In the remainder of this chapter, references to liabilities that have been “ceded” denote actuarially valued obligations due from a reinsurer under a reinsurance arrangement, before any reduction to account for the credit quality of the reinsurer. For the purpose of this chapter, all reinsured business should be valued based on the ceded policy liability and not the reinsurance asset appearing on the balance sheet.

\section*{10.3. Valuation basis for ceded liabilities}

Policy liabilities that are ceded by an insurer under unregistered reinsurance as defined in section 10.2 must be valued, in accordance with CALM, using assumptions about the assets supporting the liabilities that are consistent with the assets used to collateralize the reinsurer's obligation. Therefore, in this chapter, for the purpose of valuing aggregate and policy-by-policy liabilities ceded to an unregistered reinsurer, the assets backing the ceded liability should be assumed to consist of all or a portion of:

\begin{enumerate}[1)]
\item the assets held by the insurer or vested in trust that are used to support funds withheld from or other amounts due to the unregistered reinsurer;
\item the assets located in Canada for which the insurer has a valid and perfected first priority security interest under applicable law that are used to obtain credit in respect of the unregistered reinsurer (reference section 10.5); and
\end{enumerate}

\textsuperscript{121} The term “recognized”, as applied to a reinsurance arrangement by a foreign solvency regulator, means that the ceding company is able to report an improved capital adequacy position to the solvency regulator as a result of the reinsurance arrangement.
3) letters of credit held to secure payment to the insurer by the reinsurer that are used to obtain credit in respect of the unregistered reinsurer (reference section 10.5). These amounts should be treated as non-interest bearing cash equivalents for the purpose of valuation.

If all of the above assets are not sufficient to back the ceded liability, the remaining assets backing the ceded liability should be assumed to be assets held by the ceding insurer or vested in trust that back the ceding insurer’s unallocated Available Capital or Available Margin.

10.4. Deductions from Available Capital for unregistered reinsurance

Insurers are required to deduct from Available Capital the ceded policy liabilities corresponding to reinsurance assets arising from arrangements deemed to constitute unregistered reinsurance.

10.4.1. Requirement for aggregate positive liabilities ceded

For every unregistered reinsurer, the total value of the policy liabilities ceded to the reinsurer, if positive, must be included within an insurer’s Deductions/Adjustments (reference sections 2.1.2 and 12.6).

10.4.2. Requirement for offsetting policy-by-policy liabilities ceded

Where an insurer cedes positive policy-by-policy liabilities and negative policy-by-policy liabilities to the same unregistered reinsurer, the amount of offsetting policy-by-policy liabilities ceded to the reinsurer is defined to be the lower of the total:

a. positive policy-by-policy liabilities ceded to the reinsurer; or

b. negative policy-by-policy liabilities ceded to the reinsurer.

This offsetting amount, net of any adjustments made to negative reserves under section 2.1.2.9, must be deducted from Tier 1 as a negative reserve and included in Tier 2 for Canadian insurers, or included in the negative reserve component of Assets Required for foreign insurers operating in Canada on a branch basis. This requirement is equivalent to the requirements that would apply under sections 2.1.2 and 2.3.1, or sections 12.3and 12.5, had an insurer retained equal amounts of positive and negative policy-by-policy liabilities.

10.4.3. Requirement for aggregate negative liabilities ceded – Canadian insurers

Where the total value of the policy liabilities that a Canadian insurer has ceded to a particular unregistered reinsurer is negative, the insurer should deduct from Tier 1 and include in Tier 2 the reported amount of any assets appearing in the Life annual return arising from transactions with the reinsurer unless the assets:

122 No reduction of the adjusted amount is permitted for amounts recoverable on surrender.
123 Assets appearing in the Life annual return that should be deducted exclude negative reinsurance assets and reinsurance liabilities due to the reinsurer. The value of other assets arising from transactions with the reinsurer
1) are unencumbered and held in Canada in custody of the insurer;
2) are not receivables;
3) do not bear any credit exposure to the unregistered reinsurer or any of its affiliates (obligations of the reinsurer or any of its affiliates that have been guaranteed by a third party must be deducted from Tier 1 and included in Tier 2); and
4) have been transferred to the insurer permanently; for example, they may not become repayable in the event of the occurrence of a contingency.

The deduction from Tier 1 and inclusion in Tier 2 required on account of any unregistered reinsurer is limited to the value of the aggregate negative policy liability ceded to the reinsurer, net of any tax adjustment to the negative reserve amount made under section 2.1.2.9.

10.4.4. Requirement for aggregate negative liabilities ceded – foreign insurers

Where the total value of the policy liabilities that a foreign insurer has ceded to a particular unregistered reinsurer is negative, the insurer must include in Assets Required the amount of any assets reported as vested in trust in the Life annual return arising from transactions with the reinsurer unless the assets:

1) do not bear any credit exposure to the unregistered reinsurer or any of its affiliates (obligations of the reinsurer or any of its affiliates that have been guaranteed by a third party must be included in Assets Required); and
2) have been transferred to the insurer permanently; for example, they may not become repayable in the event of the occurrence of a contingency.

The amount required to be added to Assets Required on account of any unregistered reinsurer is limited to 75% of the value of the aggregate negative policy liability ceded to the reinsurer.

10.4.5. Examples

1) A Canadian insurer cedes policy liabilities to an unregistered reinsurer whose aggregate value is $100, where the liabilities consist of $300 in positive policy-by-policy liabilities and $200 in negative policy-by-policy liabilities. In the absence of any collateral or letters of credit (reference section 10.5), the insurer will be required under section 10.4.1 to deduct $100 from Gross Tier 1 Capital. Additionally, under section 10.4.2, the insurer will be required to deduct $140 (70% of $200) from Gross Tier 1 and add this amount to Tier 2.

2) A Canadian insurer cedes policy liabilities to an unregistered reinsurer whose aggregate value is negative $400, where the liabilities consist of $100 in positive policy-by-policy liabilities and $500 in negative policy-by-policy liabilities. The reinsurer has no recourse to the Canadian insurer if all or part of the ceded business lapses. In the absence of any collateral or letters of credit, the insurer will be required under section 10.4.2 to deduct $70
(70% of $100) from Gross Tier 1 Capital and add this amount to Tier 2. There may be an additional deduction required under section 10.4.3, depending on the assets the insurer receives in consideration for the aggregate negative cession. For example:

a. If the insurer receives $300 cash in exchange for ceding the business, then no additional deduction is required under section 10.4.3, as cash is not precluded under the criteria in this section.

b. If the insurer records a receivable for $350 from the unregistered reinsurer, then it is required to deduct $280 (equal to the lower of $350 or 70% of $400) from Gross Tier 1 Capital and add this amount to Tier 2. The amount of the deduction is $280 and not $350 in this case because it is limited to 70% of the aggregate negative reserve ceded.

c. If the insurer receives no compensation for ceding the business, then no additional deduction is required under section 10.4.3; the cession itself will cause a $400 reduction in Tier 1 Available Capital via a reduction in retained earnings.

### 10.5. Collateral and letters of credit

This section describes the forms of credit risk mitigation for which the deductions from Available Capital that are required under section 10.4 may be reduced, and replaces the rules that would otherwise apply under sections 3.2 and 3.3.

#### 10.5.1. Credit available

An insurer is given credit, for each unregistered reinsurer, equal to the sum of:

1) the funds held by the ceding company for the exclusive benefit of the ceding insurer (e.g. funds withheld reinsurance) to secure the payment to the ceding insurer by the reinsurer of the reinsurer's share of any loss or liability for which the reinsurer is liable under the reinsurance agreement;

2) the value of assets pledged by the unregistered reinsurer that are located in Canada and subject to the ceding insurer’s claim under a valid and perfected first priority security interest under applicable law in accordance with OSFI’s guidance for reinsurance security agreements. All pledged assets must:

   a. be held to secure the payment to the ceding insurer by the reinsurer of the reinsurer's share of any loss or liability for which the reinsurer is liable under the reinsurance agreement.\(^\text{124}\),

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\(^{124}\) A foreign insurer ceding risks related to its Canadian business will be given credit for assets located in Canada only where the reinsurance arrangement provides that the reinsurer does not have any right of set-off against the obligations of the foreign insurer other than obligations related to the foreign insurer’s insurance business in Canada. In particular, the reinsurer must not be able to set off amounts due to the foreign insurer against any liabilities of the home office or affiliates of the foreign insurer that are not liabilities arising out of the Canadian operations of the foreign insurer.
b. be in the form of cash\textsuperscript{125} or securities,
c. be owned by the reinsurer, and
d. be freely transferrable.

and

3) the amount of acceptable letters of credit\textsuperscript{126} held to secure the payment to the ceding insurer by the reinsurer of the reinsurer's share of any loss or liability for which the reinsurer is liable under the reinsurance agreement.

All collateral must be available for as long as the assuming insurer will have financial obligations under the reinsurance agreements for which the ceding insurer is taking credit. Where contract stipulations regarding the collateral may vary during the period, credit may only be taken if the ceding insurer maintains the exclusive option to retain the collateral and the additional cost of that option, if any, is fully recognized and explicitly accounted for at inception of the agreement.

All letters of credit used to obtain credit in respect of an unregistered reinsurer must be issued by or have a separate confirming letter from a Canadian bank that is listed on Schedule I or Schedule II of the Bank Act. In aggregate, the amount of credit taken for letters of credit is limited to 30% of the total positive policy-by-policy liabilities ceded to unregistered reinsurers.

The assets used to obtain credit for a specific unregistered reinsurer must materially reduce the risk arising from the credit quality of the reinsurer. In particular, the assets used may not be related-party obligations of the unregistered reinsurer (i.e., obligations of the reinsurer itself, its parent, or one of its subsidiaries or affiliates). With respect to the above three sources available to obtain credit, this implies that:

1) To the extent that a ceding insurer is reporting obligations due from a related party of the reinsurer as assets in its Life annual return, the ceding insurer is precluded from taking credit for funds held to secure payment from an unregistered reinsurer;

2) Assets located in Canada in which a ceding insurer has a valid and perfected first priority security interest under applicable law may not be used to obtain credit if they are obligations of a related party of the unregistered reinsurer; and

3) A letter of credit is not acceptable if it has been issued by a related party of the unregistered reinsurer.

\textsuperscript{125} Cash must be in a form in which it is possible to perfect a security interest under applicable law.

\textsuperscript{126} Insurers should contact OSFI’s Securities Administration Unit (SAU) to obtain OSFI’s standards for letters of credit. The SAU’s contact information is:
- Via mail: 121 King Street West, 22nd Floor, Toronto, ON M5H 3T9;
- Via facsimile: 416-973-1171; or
- Via email: SAU@osfi-bsif.gc.ca.

Templates as well as general guidelines for the use of letters of credit may be found on OSFI’s web site at http://www.osfi-bsif.gc.ca/Eng/fi-fi/app/aag-gad/Pages/General_Guidelines_Letters_of_Credit.aspx.
Guideline B-2: **Large Exposure Limits** applies to assets used to obtain credit in respect of unregistered reinsurance. As a consequence, an insurer may not take credit for assets in which it has perfected a security interest or letters of credit, held under an unregistered reinsurance transaction or a series of such transactions (not necessarily all with the same reinsurer), if consolidating these assets\(^{127}\) on the insurer’s balance sheet, along with the ceded liabilities they support, would cause a large exposure limit to be breached\(^{128}\). An insurer must comply with all other OSFI guidelines and advisories concerning investments (e.g., Guideline B-1: **Prudent Person Approach**, Guideline B-5: **Asset Securitization**) in respect of the aggregate of the assets it has used to obtain credit for unregistered reinsurance with the assets it holds in its own portfolio.

### 10.5.2. Application to requirements for ceded liabilities

The credit available in respect of an unregistered reinsurer may be applied to the following requirements of section 10.4:

1) The requirement for aggregate positive liabilities ceded to the reinsurer (refer to section 10.4.1). This requirement may be reduced to a minimum of zero using the credit available.

2) The requirement for offsetting policy-by-policy liabilities ceded to the reinsurer (refer to section 10.4.2). The requirement may be reduced to a minimum of zero for a particular reinsurer, but the credit taken for this requirement in aggregate is subject to the limit below.

The total credit available that may be applied toward requirement 2) in respect of all reinsurers in aggregate is limited to the greater of zero or:

\[
N - \max (R - C, 0)
\]

where:

- \(N\) is the total requirement for offsetting policy-by-policy liabilities ceded to unregistered reinsurers;
- \(R\) is equal to 50% of the insurer’s required capital or required margin, where the required capital or margin is calculated net of registered reinsurance only; and
- \(C\) is Tier 1 capital (for Canadian insurers) or Available Margin less Other Admitted Assets (for foreign insurers), where the amount is calculated without deducting the requirement for offsetting policy-by-policy liabilities ceded to unregistered reinsurers.

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\(^{127}\) The expression “consolidating these assets” means, for letters of credit, recording the full amount of the letters of credit as obligations due from the issuing banks.

\(^{128}\) This consolidation test must be performed in respect of unregistered reinsurance notwithstanding that Guideline B-2 does not establish quantitative limits for exposures to reinsurers. Assets and letters of credit having a residual maturity of less than one year may not be excluded from the definition of exposure. For the purpose of the consolidation test, the additional amount of total capital that a ceding insurer may assume would be available is limited to the lower of 150% of the marginal capital requirements for the ceded business, or the value of the assets and letters of credit posted by the reinsurer(s) that are used to support the capital requirements for the ceded business.
If the maximum credit that may be applied toward requirement 2) is less than the total of the requirement, the difference must be deducted from Tier 1 and added to Tier 2 (for Canadian insurers) or added to Assets Required (for foreign insurers) and may not be covered by collateral or letters of credit. If this situation occurs, the ceding insurer may allocate the maximum total credit allowed to particular unregistered reinsurers in any manner it chooses.

Any credit available for a particular reinsurer that exceeds the sum of the maximums allowed under 1) and 2) above or that is otherwise not applied towards these requirements may be applied towards the capital requirements for business ceded to the reinsurer, subject to the conditions in section 10.6.

10.5.3. Asset risk requirements

Consistent with the substitution capital treatment used for collateral and guarantees, insurers are required to include, in required capital or required margin, the capital charges for credit risk (as determined under Chapter 3) and market risk (as determined under sections 5.2, 5.3 and 5.4) for all assets subject to the insurer’s claim under a perfected security interest, and for all letters of credit, that are used to obtain credit for ceded liability or insurance risk capital requirements relating to unregistered reinsurance.

10.6. Calculation of required capital/margin

10.6.1. Necessary conditions for credit

In order for a ceding insurer to obtain a reduction in its Base Solvency Buffer or Required Margin on account of any registered or unregistered reinsurance arrangement, the arrangement must conform to all of the principles contained in Guideline B-3: Sound Reinsurance Practices and Procedures. The arrangement must also meet all of the conditions necessary for effective risk transfer specified in this section. The ceding company must be able to demonstrate that the change in risk it is exposed to as a result of the arrangement is commensurate with the amount by which it reduces its Base Solvency Buffer or Required Margin.\(^{129}\)

Risk transfer must be effective in all circumstances under which the ceding insurer relies on the transfer to cover the capital/margin requirement. In assessing an arrangement, the ceding insurer must take into account any contract terms whose fulfilment is outside the ceding insurer’s direct control, and that would reduce the effectiveness of risk transfer. Such terms include, among others, those which:

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\(^{129}\) Without limiting the requirement that ceding insurers should abide by the risk transfer principle with respect to all reinsurance transactions, OSFI may, if it is unclear how much risk the ceding insurer bears post-reinsurance and OSFI determines it is desirable to provide greater certainty, issue further guidance (including quantitative requirements) to implement this principle with respect to any reinsurance arrangement. Insurers are encouraged to contact OSFI to discuss reinsurance arrangements for which the measure of risk transfer may be unclear when applying this principle or for which implementation guidance may be required.
1) would allow the reinsurer to unilaterally cancel the arrangement (other than for non-payment of reinsurance premiums due under the contract);

2) would increase the effective cost of the transaction to the ceding insurer in response to an increased likelihood of the reinsurer experiencing losses under the arrangement;

3) would obligate the ceding insurer to alter the risks transferred for the purpose of reducing the likelihood that the reinsurer will experience losses under the arrangement;

4) would allow for the termination of the arrangement due to an increased likelihood of the reinsurer experiencing losses under the arrangement;

5) could prevent the reinsurer from being obligated to pay out any amounts due under the arrangement in a timely manner; or

6) could allow for early maturity of the arrangement.

The ceding insurer must also take into account circumstances under which the benefit of the risk transfer could be undermined. For example, this may occur if the ceding insurer provides support (including non-contractual support) to the arrangement with the intention of reducing potential or actual losses to the reinsurer.

In determining whether there is effective risk transfer, the reinsurance arrangement must be considered as a whole. Where the arrangement consists of several contracts, the entire set of contracts, including contracts between third parties, must be considered. The ceding insurer must also consider the entire legal relationship between itself and the reinsurer.

No reduction of the Base Solvency Buffer or Required Margin is allowed for a reinsurance arrangement that has material basis risk with respect to the reinsured business (for example if payments under the arrangement are made according to an external indicator instead of actual losses). Reinsurance assets arising from arrangements containing basis risk may be subject to capital charges for insurance risk in addition to the capital charge for credit risk.

In assessing the effectiveness of risk transfer, the economic substance of an arrangement must be considered over the legal form or its treatment for financial statement purposes.

### 10.6.2. Retained loss positions

Where an insurer has taken credit in its capital or margin (required or available) on account of a registered or unregistered reinsurance arrangement that does not cover all losses up to the level of the ceded insurance contract liability plus the marginal insurance risk requirement for the ceded business (reference section 6.7), the ceding insurer should add to its required capital or margin the total amount of losses at or below this level for which it remains at risk. Such an addition to required capital or margin is necessary where a reinsurance arrangement contains any provision under which the reinsurer is required to cover losses only in excess of a certain amount, regardless of the treatment for financial statement purposes. Such provisions include, but are not limited to:

   a) experience rating refunds,
b) claims fluctuation reserves and reinsurance claims fluctuation reserves, and

c) variable risk transfer mechanisms other than a) or b) above whereby the level at which losses are reinsured depends upon prior experience.

The amount of the loss position that a ceding insurer retains under a reinsurance arrangement should be recalculated, according to the treaty, at each reporting date.

10.6.3. Registered reinsurance

All capital requirement calculations may be performed net of registered reinsurance. For example, policy liabilities ceded to registered reinsurers should be subtracted from the policy liabilities used to calculate a LICAT component.

10.6.4. Unregistered reinsurance

Collateral and letters of credit that are used to obtain credit for unregistered reinsurance or for insurance risk capital requirements give rise to additional capital requirements for asset risks (section 10.5.3) and currency risk (section 5.6.8).

Where the credit available for an unregistered reinsurer under section 10.5.1 exceeds the credit that has been applied towards the requirements for liabilities ceded to the reinsurer under section 10.5.2, the amount of the excess may be used to reduce the insurance risk capital requirement for the reinsured policies. Chapter 6 describes the treatment of unregistered reinsurance in the LICAT for these particular components, and specifies additional conditions necessary to take credit for excess deposits.

If a deposit used to obtain credit for a policy component is not contractually available to cover all losses arising from the component risk that are not provided for in the ceded policy liability (e.g., tranched protection), then the amount of credit for the deposit is limited to:

1) the marginal solvency buffer for the ceded business net of PfADs (reference section 6.7.1); minus

2) the highest insurance risk loss for the ceded business, net of contractually permitted recoveries from the deposit, that would be borne by the ceding insurer under any scenario in which unexpected insurance risk losses for the ceded business do not exceed the amount in 1).

The credit taken for excess deposits may not exceed the marginal solvency buffer net of PfADs for the insurance risks specifically reinsured, and may not exceed the reduction that would have been available had an insurer entered into an agreement on the same terms with a registered reinsurer.
Chapter 11  Aggregation and Diversification of Risks

Risk aggregation is the approach used to calculate the total of each and all of the risk elements. A diversification credit or benefit results when the aggregation of risks produces results that are less than the total of the individual risk elements.

11.1.  Within-risk diversification

Diversification credits are applied to specific components of the mortality and morbidity requirements calculated in Chapter 6. Since the requirements for participating business are calculated on a standalone basis (reference section 9.1.2), there are no within-risk diversification benefits between similar risks in participating blocks and non-participating blocks.

11.1.1 Mortality level and trend risk - diversification credit between life supported and death supported business

A diversification credit is calculated between individually underwritten life supported and individually underwritten death supported business. The diversification credit is determined by first calculating mortality level and trend risk components for individually underwritten life supported business and death supported business in aggregate. The aggregate component for level and trend mortality risk assumes a correlation factor of -75% between life and death supported business and is calculated as:

\[ RC_{aggregate} = \sqrt{RC_L^2 + RC_D^2 - 1.5 \times RC_L \times RC_D} \]

where:
- \( RC_{aggregate} \) is the aggregate component for mortality level and trend risk (after diversification) for all life and death supported business;
- \( RC_L \) is the sum of the individual risk charges for mortality level risk and mortality trend risk for life supported business as determined in sections 6.2.2 and 6.2.3, respectively;
- \( RC_D \) is the sum of the individual risk charges for mortality level risk and mortality trend risk for death supported business as determined in sections 6.2.2 and 6.2.3, respectively.

The diversification credit is the difference between the sum of the individual mortality level and trend risk components for life supported and death supported business (reference sections 6.2.2 and 6.2.3) and the aggregate component for mortality level and trend risk calculated using the formula above:

\[ Diversification credit = (RC_L + RC_D) - RC_{aggregate} \]
11.1.2 Morbidity risk credits

The capital requirements for morbidity risk determined in section 6.4 for certain products are reduced by multiplying the requirement by a statistical fluctuation factor (SFF). For each SFF, exposures are aggregated by product and geography before the SFF is applied. For example, all disability exposures are aggregated (individual active DI, individual active WP, individual disabled DI, group disabled LTD, individual and group disabled WP and group active and disabled STD) before the SFF is applied.

11.1.2.1 Credit for level risk

Morbidity SFFs for level risk are calculated as follows:

\[ SFF(RC) = \begin{cases} 
1 & \text{if } RC \leq 42,000,000 \\
0.9 \left(1 + \frac{648}{\sqrt{RC}}\right) & \text{if } RC > 42,000,000 
\end{cases} \]

where \( RC \) is the capital requirement for level risk.

\[ SFF(FA) = \begin{cases} 
1 & \text{if } FA \leq 300,000,000 \\
0.15 \left(1 + \frac{14,722}{\sqrt{FA}}\right) & \text{if } FA > 300,000,000 
\end{cases} \]

where \( FA \) is the total face amount, net of reinsurance.

\[ SFF(RC) = \begin{cases} 
1 & \text{if } RC \leq 75,000,000 \\
0.5 \left(1 + \frac{4330}{\sqrt{RC}}\right) & \text{if } RC > 75,000,000 
\end{cases} \]

where \( RC \) is the capital requirement for level risk.

11.1.2.2 Credit for volatility risk

Morbidity SFFs for volatility risk are calculated as follows:

\[ SFF(RC) = \begin{cases} 
1 & \text{if } RC \leq 6,000,000 \\
0.7 \left(1 + \frac{734}{\sqrt{RC}}\right) & \text{if } RC > 6,000,000 
\end{cases} \]
where $RC$ is the capital requirement for volatility risk.

**CI**

$$SFF(FA) = \begin{cases} 
1, & \text{if } FA \leq 300,000,000 \\
0.15 + \frac{14.722}{\sqrt{FA}}, & \text{if } FA > 300,000,000 
\end{cases}$$

where $FA$ is the total face amount, net of reinsurance.

**LTC**

$$SFF(RC) = \begin{cases} 
1, & \text{if } RC \leq 3,000,000 \\
0.3 + \frac{1.212}{\sqrt{RC}}, & \text{if } RC > 3,000,000 
\end{cases}$$

where $RC$ is the capital requirement for volatility risk.

**Travel**

$$SFF(RC) = \begin{cases} 
1, & \text{if } RC \leq 5,000,000 \\
0.2 + \frac{1.788}{\sqrt{RC}}, & \text{if } RC > 5,000,000 
\end{cases}$$

where $RC$ is the capital requirement for volatility risk.

**Group Medical/Dental (including other group A&S)**

$$SFF(RC) = \begin{cases} 
1, & \text{if } RC \leq 3,000,000 \\
0.7 + \frac{519}{\sqrt{RC}}, & \text{if } RC > 3,000,000 
\end{cases}$$

where $RC$ is the capital requirement for volatility risk.

**11.1.3 Mortality and morbidity risks – portfolio volume credit**

A credit is given for diversification across geographies in the level risk component of the mortality and morbidity requirements. Within each of the mortality, morbidity incidence and claims, and morbidity termination requirements, the component for level risk may be reduced by:

$$0.5 \times (L_0 - L_1)$$

where $L_0$ is the sum of the level risk components calculated by geography using volatility and statistical fluctuation factors calculated separately for each geography, and $L_1$ is the aggregate level risk component calculated across all geographies using volatility and statistical fluctuation factors based on business volumes aggregated across all geographies. Both $L_0$ and $L_1$ are calculated net of all reinsurance.
11.2 Between-risk diversification

After the individual risk components have been calculated, they are aggregated in three stages. First, a post-diversification requirement for insurance risk ($I$) is calculated. Then, an unadjusted diversified requirement for all risks ($D$) is calculated by aggregating the net requirement for insurance risk with the requirements for credit risk and market risk. This unadjusted diversified requirement is compared against the undiversified requirement ($U$) calculated as the sum of individual risk components. The adjusted diversified requirement ($K$) is calculated based on $D$ and $U$.

If an insurer wishes to take credit for participating or adjustable products (reference Chapter 9), or for unregistered reinsurance or reinsurance claims fluctuation reserves (reference section 6.7), it will be necessary to calculate the quantities $I$, $D$, $U$ and $K$ for one or more subsets of the insurer’s book of business.

11.2.1 Insurance Risk Requirement ($I$)

The requirement for insurance risk $I$ is calculated by aggregating the components of insurance risk using a correlation matrix. The formula for $I$ is:

$$I = \sqrt{\sum_{i,j=1}^{7} \rho_{ij} \times (IR_i - 0.5 \times LT_i) \times (IR_j - 0.5 \times LT_j)}$$

where:

- $IR_i$ is the required capital for insurance risk $i$, before credit for participating and adjustable products,
- $LT_i$ is the sum of the level and trend components for insurance risk $i$ ($LT_7$, the level and trend component for expense risk, is zero)
- $\rho_{ij}$ is the correlation factor between insurance risks $i$ and $j$, as specified by the following correlation matrix:
However, $I$ may not be lower than the highest risk charge for any single risk included in the correlation matrix.

### 11.2.2 Diversified Risk Requirement ($D$)

The unadjusted diversified requirement $D$ for all risks is calculated by aggregating the requirements for credit and market risks with the insurance risk requirement. The correlation assumed between the two classes of risks is $50\%$. Consequently:

$$D = \sqrt{A^2 + AI + I^2}$$

where:
- $A$ is the sum of the requirements for credit risk (for both on- and off-balance sheet items) and market risk, and
- $I$ is the insurance risk requirements from the previous section.

### 11.2.3 Undiversified Risk Requirement ($U$)

The undiversified risk requirement $U$ is calculated as:

$$U = \sum_{i=1}^{7} IR_i + A - 0.5 \sum_{i=1}^{7} LT_i$$

where $IR_i$ and $A$ are as defined in sections 11.2.1 and 11.2.2, and each $LT_i$ is as in section 11.2.1.
11.2.4 Adjusted Diversified Requirement ($K$)

After the diversified and undiversified risk requirements $D$ and $U$ have been computed, the adjusted diversified requirement $K$ for insurance, credit and market risk is calculated as:

$$K = 0.85 U + \max\left(0.3 U - 1.15 D + \frac{D^2}{U}, 0\right) + 0.5 \sum_{i=1}^{7} LT_i$$

11.3 Base Solvency Buffer

The Base Solvency Buffer is equal to:

$$[1.15] \times \left(K_{\text{non-par}} + \sum P_i - \sum CR_j + SFG + OR \right)$$

where:

- $K_{\text{non-par}}$ is the requirement $K$ calculated for the non-participating block
- The first sum is taken over all participating blocks, and the second sum is taken over all adjustable products, for which an insurer is taking credit under Chapter 9
- $P_i$ is the standalone requirement for participating block $i$ net of the applicable participating product credit, calculated under section 9.1.2
- $CR_j$ is the adjustable credit for adjustable product $j$ calculated under section 9.2.2
- $SFG$ is the capital requirement for segregated fund guarantee risk
- $OR$ is the capital requirement for operational risk.
Chapter 12  Life Insurers Operating in Canada on a Branch Basis

The Life Insurance Margin Requirements and Adequacy of Assets in Canada Test (LIMAT) set out in this guideline, along with Guideline A-4: *Regulatory Capital and Internal Capital Targets*, provide the framework within which the Superintendent assesses whether life insurers operating in Canada on a branch basis (branches) maintain an adequate margin pursuant to subsection 608(1). Under subsection 608(1) of the ICA, a foreign insurer is required to maintain in Canada an adequate margin of assets over liabilities in respect of its insurance business in Canada.

In addition, foreign insurers are required to maintain assets in Canada, with respect to their life insurance business in Canada, that are sufficient to cover:

1) reserves for actuarial and other policy liabilities;
2) unpaid claims; and
3) other liabilities and amounts related to the carrying on of their life insurance business in Canada.

These requirements are prescribed in accordance with the *Assets (Foreign Companies)* Regulations.

### 12.1. LIMAT Ratios

The LIMAT Total Ratio measures the adequacy of assets available to meet the margin requirements, as determined in accordance with this guideline. The Total Ratio focuses on policyholder and creditor protection. The formula used to calculate the Total Ratio is:

\[
\frac{\text{Available Margin} + \text{Surplus Allowance}}{\text{Required Margin}}
\]

The LIMAT Core Ratio makes an adjustment to the Total Ratio calculation by excluding Other Admitted Assets, and focuses on financial strength. The formula used to calculate the Core Ratio is:

\[
\frac{\text{Available Margin} - \text{Other Admitted Assets}}{\text{Required Margin}}
\]

### 12.2. Available Margin

The Available Margin is the difference between Assets Available and Assets Required.
12.2.1. Assets Available

Assets Available consists of:

1) Vested Assets;
2) investment income due and accrued on Vested Assets; and
3) Other Admitted Assets, as specified in section 12.2.2;

less:
4) Deductions/Adjustments per section 12.2.3

12.2.2. Vested Assets

Vested Assets are to be valued in accordance with the Insurance Companies Act.

12.2.3 Other Admitted Assets

The amount of Other Admitted Assets included in Available Assets is the lesser of:

A. The sum of:
   i) balance sheet values of amounts due from registered reinsurers (as defined in section 11.2.1) and federally regulated insurers that are not in arrears, are unencumbered, and are under the control of the Chief Agent;
   ii) all amounts included in Assets Required on account of negative reserves;
   iii) 75% of the cash surrender value deficiencies calculated on a grouped aggregate basis (refer to section 2.1.2.8); and
   iv) the adjustment amount to amortize the impact in the current period on Assets Required on account of each net defined benefit pension plan recognized as a liability on the branch’s balance sheet, net of any associated deferred tax assets.

and

B. 50% of the Required Margin

Assets under the control of the Chief Agent may be included in Other Admitted Assets only if the following conditions are met:

1) records and record keeping facilities in Canada are satisfactory to OSFI;  
2) the branch has received an unqualified auditor's opinion; and
3) the Superintendent receives an undertaking from the head office of the insurer and the Chief Agent specifying that the assets referred to in section i) above that are under the control of the Chief Agent will be maintained in Canada.

Refer to Guideline E-4A, Role of the Chief Agent and Record Keeping Requirements.
12.2.4. Deductions/adjustments

The following amounts are deducted from Assets Available:

1) first loss facilities or transfer of assets with recourse (in accordance with Guideline B-5: *Asset Securitization*);

2) aggregate positive policy liabilities ceded under arrangements deemed to constitute unregistered reinsurance, less the amount of collateral and letters of credit applied toward these liabilities (refer to Chapter 10);

3) accumulated net after tax revaluation losses in excess of gains on owner-occupied properties vested in trust; and

4) net after tax revaluation gains on owner-occupied use properties vested in trust.

12.2.5. Assets Required

Assets Required in respect of a branch’s insurance business in Canada consists of:

1) insurance contract liabilities and other policy liabilities\(^{131}\), net of all reinsurance ceded;

2) provisions for policyholder dividends, experience rating refunds, and discretionary participation features\(^{132}\);

3) outstanding claims and adjustment expenses;

4) policyholder amounts on deposit;

5) accounts payable;

6) income taxes payable;

7) mortgage loans and other real estate encumbrances;

8) deferred income tax liabilities;

9) each net defined benefit pension plan recognized as a liability on the branch’s balance sheet net of any associated deferred tax asset that would be extinguished if the liability were otherwise derecognized under relevant accounting standards;

10) other liabilities;

11) adjusted negative reserves calculated policy by policy (refer to section 2.1.2.8) and negative reserves ceded to unregistered reinsurers (refer to sections 10.4.4 and 10.5);

12) cash surrender value deficiencies calculated on a grouped aggregate basis (refer to section 2.1.2.7);

less:

\(^{131}\) For LIMAT purposes, policy liabilities should include future income tax cash flows under valuation assumptions as required by the Canadian Institute of Actuaries Standards, prior to any accounting adjustment for balance sheet presentation.

\(^{132}\) These amounts must be included in assets required irrespective of whether they are classified as liabilities or equity for financial reporting purposes.
13) loans secured by policies in Canada;
14) agents’ debit balances and outstanding premiums; and
15) amounts due from federally regulated insurers and registered reinsurers (as defined in section 10.2.1) that can be legally netted against the insurance contract liabilities of the branch, as outlined below.

In order to deduct an amount due from a registered reinsurer from Assets Required, a branch must, at a minimum, meet the following conditions:

1) The amount due is from an insurer to which the branch has a liability of an equal or greater amount. (Amounts due in excess of the liability are not deducted from Assets Required; they are included in Other Admitted Assets, below).

2) The branch has executed a written, bilateral netting contract or agreement with the insurer to which the liability is owed that creates a single legal obligation. The result of such an arrangement must be that the branch has only one obligation for payment or one claim to receive funds based on the net sum of the liabilities and amounts due in the event the counterparty to the agreement failed to perform due to default, bankruptcy, liquidation or similar circumstances.

3) The netting arrangement specifies that only the liabilities to the counterparty arising out of the Canadian operations of the foreign insurer may be taken into consideration in determining the net amount owed. In particular, the counterparty must not be able to net amounts due to the branch against any liabilities of the home office or affiliates of the branch that are not liabilities arising out of the Canadian operations of the foreign insurer.

4) The branch must have written and reasoned legal opinions confirming that, in the event of any legal challenge, the relevant courts or administrative authorities will find the amount owed under the netting agreement to be the net amount under the laws of all relevant jurisdictions. In reaching this conclusion, legal opinions must address the validity and enforceability of the entire netting agreement under its terms.
   a. The laws of “all relevant jurisdictions” are: a) the law of the jurisdiction where the counterparty is incorporated and, if the foreign branch of a counterparty is involved, the laws of the jurisdiction in which the branch is located; b) the law governing the individual insurance transaction; and c) the law governing any contracts or agreements required to effect the netting arrangement.
   b. The legal opinions must be generally recognized as such by the legal community in the firm’s home country or by a memorandum of law that addresses all relevant issues in a reasoned manner.

5) The branch must have procedures in place to update legal opinions as necessary to ensure continuing enforceability of the netting arrangement in light of possible changes in relevant law.

6) The netting contract/agreements terms and conditions and the quality and content of the legal opinions must meet the conditions of this guideline to the satisfaction of the Superintendent and be made available to OSFI for review, upon request.
12.3. Surplus Allowance

The amount of the Surplus Allowance included in the numerator of the Total Ratio is calculated based on PfADs that are calculated under CALM or any other method prescribed under the Standards of Practice of the Canadian Institute of Actuaries that is used to calculate insurance contract liabilities in respect of insurance business in Canada, except where indicated otherwise. The specific PfADs included in the Surplus Allowance are outlined in section 1.1.3 and are calculated net of registered reinsurance.

12.4. Required Margin

A branch’s Required Margin is calculated in the same way as the Base Solvency Buffer described in section 1.1.4, and applies to:

1) Vested Assets;
2) liabilities in respect of insurance business in Canada; and
3) balance sheet values of assets under the control of the Chief Agent, if these are taken into consideration in determining Other Admitted Assets above.

The Required Margin forms part of the vesting requirements for foreign insurers.

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133 If approximations are permitted by the CIA Standards of Practice and used to calculate the PfADs those approximations should continue to be used for LICAT purposes.