

CANADIAN INSURANCE REGULATION: THE CHANGE TO A RISK BASED APPROACH

J. Brian Reeve, Esq.
(416) 869-5745

In recent years, Canada has developed an insurance regulatory model that is far ahead of many other countries. In fact, Canada may provide a good model for insurance regulation around the world.

There is actually less regulation of insurance in Canada than in many other countries. There is a division of responsibility between the Office of the Superintendent of Financial Institutions (“OSFI”), which is the federal regulator of insurance and provincial departments of insurance.

Canada provides a good model for effective insurance regulation. Our dual system of regulation has slowly evolved from being inefficient with significant overlaps to being reasonably well harmonized. The Canadian Council of Insurance Regulators had done an effective job of standardizing many areas of insurance regulation. OSFI has emerged as the dominant insurance solvency regulator in Canada and has significant resources and experience that most provincial departments of insurance are unable to match. As a result, there has been a continuing trend to delegate and transfer authority in many areas of insurance regulation to OSFI. The role of provincial departments of insurance is appropriately focused on distribution issues such as market conduct and consumer protection.

There is no rate or form filing with respect to insurance policies in Canada except with respect to automobile insurance. As a result there is no need for an excess and surplus lines market in Canada. The ability to introduce products and make changes to them quickly is an important advantage for insurance companies doing business in Canada.

The collapse of companies such as Enron has brought a significant move towards a better corporate governance. There is also a move towards risk based regulation. The approach of risk based regulation moves away from detailed rules. It requires an insurance company to understand the risks of its business and to manage them. For example, insurance companies are required to develop a prudent person investment policy that is suitable for their operations. This approach replaces a previous list of permitted investments. It requires an insurance company to be responsible for the type of investments that it makes.

Traditional compliance based regulation has generally been replaced at the federal level in Canada with the new model based on corporate governance and risk assessment based regulation. During 2003, OSFI will be providing a risk rating to each insurance company it regulates. The risk rating will not be publicly available. The purpose of the risk rating will be to provide information to insurance companies and their boards of directors as to how effectively they are managing risks.

The failure of Confederation Life was probably a critical event causing insurance regulators in Canada to realize that their traditional compliance orientated approach was not an effective way to regulate insurance companies. Confederation Life was able to manipulate the regulatory system by using subsidiaries rather than the parent company to do financings in order to avoid certain rules regarding permitted amounts of debt. These are the same types of techniques that Enron used. Under a corporate governance and risk-based supervision system, it is more difficult for this type of behaviour to occur since it would clearly be contrary to the intent of the legislation.

Boards of directors will be increasingly scrutinized in the future and must ensure that systems are in place to guarantee compliance with applicable insurance regulatory requirements. OSFI has implemented a number of new requirements over the past few years including Standards of Sound Business Practices and the requirement to have a Legislative Compliance Management System (the “LCMS”).

Every insurance company is required to develop its own Standards of Sound Business Practices in a number of areas. An insurance company is required to develop rules in the following areas:

- capital management
- credit risk management
- foreign exchange risk management
- securities portfolio management
- real estate appraisals
- product design and pricing management
- underwriting and liability management
- interest rate risk management
- accrediting management
- internal controls

The requirement to have a LCMS is necessary to ensure that insurance companies operate in compliance with the Insurance Companies Act. The LCMS is intended to operate as part of the internal controls of an insurance company.

OSFI also requires insurance companies to develop policies with respect to outsourcing. There is concern that the core business functions of the insurance company should be within the control of the insurance company.

Insurance companies are now also required to do dynamic solvency testing to determine the adequacy of their capital in the future based on their projected operations under a number of different types of circumstances, including changes in interest rates.

Examinations done by OSFI of insurance companies were previously more similar to an audit. Under the new approach, a relationship manager is appointed for each insurance company. The relationship manager acts as the liaison between the insurance company and OSFI for all matters. Rather than visiting an insurance company every few years to do an examination, the intent is that the relationship manager has ongoing communication with it. The role of the relationship manager is to understand the operations and business risks of an insurance company and to assist it in meeting the regulatory requirements.

The move to a risk based regulatory system in Canada has been an important development. OSFI is now more concerned with an insurance company's business plan and direction than ensuring absolute compliance with every regulation.

In recent years, rating agencies have assumed a more significant role in evaluating insurance companies. Rating agencies have been considered to be doing a more effective job of evaluating the risks of operations of insurance companies. In order for insurance regulators to continue to provide effective supervision, it will be necessary for them to adopt a similar risk based approach.

The use of a rules based approach is now clearly out of date and has a number of deficiencies. Other types of financial services companies such as banks are also now being regulated using a risk based approach.

The emphasis of a risk based regulatory approach is to understand what the current risks to the operations of an insurance company are. It also looks at how future operations will be affected and whether sufficient capital will be available. A rules based regulatory system looks at an insurance company's compliance in the past with specific rules. Although it may help to identify weaknesses in internal controls and corporate governance, it will do little to assist in predicting future problems.

Insurance regulators in many parts of the world are increasingly looking at Canada as an efficient insurance regulatory model. OSFI has successfully implemented a risk based regulatory system that should help insurance companies in Canada to operate more effectively and with better corporate governance. Insurance companies as well as consumers will benefit from this change in the approach to regulation. ■
