
GUIDELINE:	PRUDENT PERSON APPROACH
DATE:	OCTOBER 2014
DISTRIBUTION:	BC INCORPORATED INSURERS AND NON-FEDERAL EXTRA-PROVINCIAL INSURERS

PURPOSE

This document provides background information and analysis that support FICOM's intention to adopt OSFI guidelines B-1, B-2 (Life/P&C), B-4 (Life/P&C), B-5, B-7, B-11, B-20 and E-2 under the prudent person approach.

BACKGROUND

Investment and lending activities form a critical part of the insurance business. Given their key role in ensuring the continued solvency of insurers, establishing sound and prudent standards and practices in these activities is in the interest of individual companies, the public, and FICOM.

Insurers are expected to maintain a system of internal oversight and control over their investment and lending practices. Section 136(1) & (2)¹ of the *Financial Institutions Act* (FIA) requires that insurers adhere to "prudent standards" in all aspects of their investment and lending decisions:

"... those that, in the overall context of an investment and loan portfolio, a prudent person would apply to investments and loans made on behalf of another person to whom there is owed a fiduciary duty to make investments without undue risk of loss and with a reasonable expectation of a fair return on the investments." (s.136(1))

In addition to the above requirements, all BC incorporated insurers are responsible for setting out appropriate policies to manage risks arising from their investment and lending activities in a written Investment and Lending Policy (ILP)². The ILP is expected to:

- address all aspects of risk associated with the investments and loans of the insurer, including mechanisms for measuring, limiting, and managing risk;
- comply with the legislation and relevant regulations; and

¹ Section 136(1) & (2) apply to non-federal extra-provincial insurers pursuant to section 158(3)(b) of the FIA.

² Note that the requirement to produce a written ILP does not apply to non-federal extra-provincial insurers.

- Superintendent of Financial Institutions
- Superintendent of Pensions
- Superintendent of Real Estate
- Registrar of Mortgage Brokers

- be approved by the Board and reviewed at least annually.

PROBLEM IDENTIFICATION

The requirements set out in the FIA are principles based. While there are some controls imposed indirectly over investment and lending practices through capital treatment of investments and loans under the Minimum Capital Test (MCT) and Minimum Continuing Capital, and Surplus Requirements (MCCSR) test, to date FICOM has not provided any substantive guidance regarding expectations for prudent investment and lending.

OSFI has issued a series of guidelines under its prudent person approach which provide guidance on best practices for investment and lending activities. In order to provide further clarity on what is considered to be “prudent standards”, FICOM intends to adopt the best practices promulgated by OSFI. These practices are set out in the following OSFI guidelines:

No.	Subject	Life	P&C
B-1	Prudent Person Approach	X	X
B-2	Large Exposure Limits	X	
B-2	Investment Concentration Limit		X
B-4	Securities Lending	X	
B-4	Securities Lending		X
B-5	Asset Securitization	X	X
B-7	Derivatives Best Practices	X	X
B-11	Pledging	X	X
B-20	Residential Mortgage Underwriting Practices and Procedures	X	X
E-2	Commercial Lending Criteria	X	

OBJECTIVES

FICOM intends to align its expectations with the federal prudent person approach in order to address the following objectives:

- promote sound practices in investment and lending activities;
- provide clarity for potential investment and lending activities that insurers might choose to engage in;
- assist insurers in developing more effective controls and oversight of risks associated with their investment and lending practices;
- provide additional clarity to existing requirements under the FIA; and
- align with industry practices.

ISSUES

FICOM recognizes that certain OSFI guidance relates to types of investment and lending activities that insurers are not currently engaged in. Insurers will only be required to incorporate those parts of the guidance relevant to their investment and lending activities. FICOM also recognizes that the size, scope, and complexity of the insurer's investment and lending practices and the materiality of each activity will impact on the manner in which each insurer adheres to the OSFI guidance.

FICOM understands that certain aspects of the OSFI guidance are directly related to prescriptive requirements set out in federal legislation, and has identified where those prescriptive requirements are not applicable.

For non-federal extra-provincial insurers whose home jurisdiction has applied a prudent approach aligned with that of OSFI's prudent person guidelines, FICOM will generally rely on that approach. Where the home jurisdiction has not adopted a prudent person approach to investment and lending, or that approach is not substantively aligned with the OSFI expectations, then FICOM expects the insurer to implement guidance from OSFI to ensure that it is meeting the required prudent standards.

For BC-incorporated insurers, establishing clearer expectations regarding "prudent standards" may assist the Board and its investment and loan committee in preparing and assessing the comprehensiveness of the written ILP required under the FIA. The written ILP should include a risk appetite statement regarding investment and lending activities, caps or limits for different types of investments and loans, and be comprehensive in addressing all aspects of the risk associated with the investment and loan activities of the insurer.

OPTIONS AND ASSESSMENT

Option 1: Adopt OSFI's Prudent Person Approach

This option would have FICOM adopt industry best practices in the form of OSFI's guidance to the prudent person approach for investment and lending. FICOM believes that adopting the guidance issued by OSFI would provide a level of clarity for the industry on what is meant by the legislative requirement to meet "prudent standards" and ensure greater consistency between federal and provincial expectations.

Option 2: Do Not Adopt OSFI's Prudent Person Approach

This option would retain the status quo for insurers. FICOM would not adopt the prudent person approach and would rely on existing supervisory practices to ensure the safety and stability of insurers. However, FICOM believes that the adoption would assist insurers in developing more effective risk management policies over their investment and lending activities, and that insurers

and their Boards would benefit from the additional clarity around prudent standards provided in the OSFI guidelines.

RECOMMENDATION

FICOM recommends that it pursue Option 1: Adopt OSFI's Prudent Person Approach.

CONSULTATION

FICOM is seeking comments from BC incorporated insurers and non-federally regulated extra-provincial insurers on FICOM's intended adoption of the prudent person approach until December 10, 2014. FICOM will review all comments to determine if any amendments need to be made before implementation.

IMPLEMENTATION

If FICOM decides to proceed, it will adopt the prudent person approach immediately. FICOM will issue communication to the industry regarding the implementation process once its expectations have been finalized.