Guideline

Title	Regulatory Capital and Internal Capital Targets
Category	Capital Adequacy Requirements
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This guideline sets out OSFI's expectations with regard to the capital and solvency assessment of federally regulated insurers (insurer)[1], within the context of OSFI's *Supervisory Framework*.[2]

I. The Role of Capital in OSFI's Risk Assessment Process

OSFI's risk assessment process begins with an evaluation of the inherent risk within each significant activity of an insurer and the quality of risk management applied to mitigate these risks. After considering this information, OSFI determines the level of net risk and direction (i.e., whether it is decreasing, stable, or increasing) of the rating for each significant activity.

The net risks of the significant activities are combined, by considering their relative importance, to arrive at the Overall Net Risk (ONR) of the insurer. The ONR is a consolidated rating or assessment of the potential adverse impact that the significant activities collectively could have on the insurer's earnings performance and adequacy of capital. OSFI then develops a Composite Risk Rating (and its direction) for the insurer, after considering the assessments of its earnings and capital in relation to the ONR, and the assessment of liquidity.

While regulatory capital is an important factor in OSFI's capital assessment, other factors are also considered. OSFI's *Capital Assessment Criteria* include, for example:

- adequacy of capital to support the insurer's risk profile and business plan, including risks that are not fully captured in the regulatory capital guidelines;
- ability to access capital at reasonable rates to meet projected needs;
- quality of capital;
- quality or strength of the insurer's capital management policy, including its capital management processes; and
- effectiveness of oversight with respect to the insurer's capital management processes.

Capital considerations should include elements of capital that contribute to financial strength through periods when an insurer is under stress (e.g., common shares) as well as elements that contribute to policyholder and creditor protection during wind-up (e.g., subordinated debt). Some elements may contribute to both, while others are less likely to do so.

OSFI expects the level and quality of an insurer's capital and its capital management to be commensurate with its circumstances, including its risk profile, appetite for risk and operating environment. Past and emerging trends, including the outlook for capital, earnings and liquidity, as well as the insurer's preparedness to deal with potential capital deficiencies, are relevant in assessing the adequacy of an insurer's capital position. In this regard, the number, severity and overall quality of the stress scenarios used by an insurer to assess its capital adequacy in relation to all relevant regulatory and internal capital expectations are important considerations for OSFI when it assesses the strength of an insurer's capital.

Insurers should have risk and capital management processes that take into account their risk profile and business strategy, potential stress situations and future changes to enable them to effectively monitor and manage their ability to meet, on a continuous basis, regulatory as well as internal capital expectations.

II. Regulatory Capital

The *Insurance Companies Act* requires federally regulated insurance companies and fraternal benefit societies to maintain adequate capital and companies operating in Canada on a branch basis to maintain an adequate margin of assets in Canada over liabilities in Canada. Guidelines A: Mortgage Insurer Capital Adequacy Test (MICAT), Minimum Capital Test (MCT) and Life Insurance Capital Adequacy Test (LICAT) (together referred to as Capital Guidelines) provide the framework within which the Superintendent assesses whether a mortgage insurer, a P&C insurer that is not a mortgage insurer, or a life insurer, respectively, maintains adequate capital or margin.[3]

The Capital Guidelines establish standards for measuring specific insurer risks and for aggregating these results to calculate the amount of an insurer's regulatory capital needed to support these risks (capital requirement). For P&C insurers, the MICAT and the MCT guidelines define the capital requirement amount as the minimum capital required. For life insurers the capital requirement amount is referred to as the Base Solvency Buffer in the LICAT. In relation to these capital requirements, OSFI has determined industry minimum and target capital levels.[4] These serve as a gauge of a financial institution's regulatory capital adequacy and can trigger intervention actions.[5]

The Capital Guidelines also define and establish criteria and limits for determining the amount of an insurer's qualifying regulatory capital (Capital Resources). For P&C insurers, this is referred to as capital available in the MICAT and MCT guidelines, while for life insurers, it is Available Capital plus Surplus Allowance (SA) and Eligible Deposits (ED) in the LICAT.

Components of Regulatory Capital[6]

	MICAT Total	MCT / BAAT Total	LICAT / LIMAT Total	LICAT / LIMAT Core
Capital Resources	Capital available	Capital available	Available Capital + SA + ED	Tier 1 Capital [7] + 70% of SA + 70% of ED
Capital requirement	Minimum capital required	Minimum capital required	Base Solvency Buffer	Base Solvency Buffer

Minimum Capital

The Capital Guidelines address specific insurer risks and determine minimum capital levels (Minimums) to support these risks.

Minimums: The minimum levels of capital necessary for an insurer to cover the risks specified in the Capital Guidelines.

If an insurer's Capital Resources approached, or were to fall below, the Minimums, OSFI would be very concerned about the ongoing viability of the insurer and/or the level of risk to policyholders and creditors.

Supervisory Target Capital

OSFI's mandate includes an early intervention approach. This is partly addressed by establishing supervisory target capital levels (Supervisory Targets) above the Minimums that provide an early signal so that intervention will be timely and for there to be a reasonable expectation that actions can successfully address difficulties.[8]

Supervisory Targets: The target levels of capital necessary for an insurer to cover the risks specified in the Capital Guidelines as well as to provide a margin for other risks.

From a supervisory perspective, an insurer's failure to maintain Capital Resources above the Supervisory Targets is indicative of material safety and soundness concerns and a vulnerability to adverse business and economic conditions that require immediate attention. An insurer whose Capital Resources approach or fall below the Supervisory Targets will attract increased supervisory attention, which would generally include an early warning intervention status (i.e. stage 1). The intensity and nature of supervisory intervention would depend on the circumstances of the particular insurer.

Regulatory Capital Levels

OSFI has set the following capital levels expressed as a percentage of the amount of an insurer's capital requirements :

Regulatory Capital Levels

	MICAT Total	MCT / BAAT Total	LICAT / LIMAT Total	LICAT / LIMAT Core
Minimums	100%	100%	90%	55%[9]
Supervisory Targets	150%	150%	100%	70%

For monitoring purposes and in OSFI supervisory and other documentation, the amount of Capital Resources is generally expressed as a percentage of the amount of an insurer's capital requirements and compared to the above capital levels.

III. Internal Capital Targets

All risks specific to an individual insurer cannot be explicitly addressed by industry-wide Capital Guidelines alone. The Minimums and Supervisory Targets are based upon simplifying assumptions applicable on an industry-wide basis, and are not tailored to individual insurers' risk profiles. Accordingly, an insurer should not unduly rely on these regulatory capital measures but should conduct its Own Risk and Solvency Assessment (ORSA) and, based on this process, determine its own capital needs and establish Internal Capital Targets (Internal Targets).[10]

Internal Targets: The target levels of capital, determined as part of an insurer's ORSA, needed to cover all the risks of the insurer, including the risks specified in the Capital Guidelines.

Insurers are expected to determine an Internal Target of total capital. Life insurers are expected to determine, in addition to the Internal Target of total capital, an Internal Target of core capital. OSFI should be notified when an insurer changes its Internal Targets.

Internal Targets should be set above Supervisory Targets. To determine whether Internal Targets are above Supervisory Targets, insurers should compare their total and core capital Internal Targets to the total and core Supervisory Targets, respectively.[11]

Parent/head office guarantees, potential future injections of capital or other potential management actions that change the insurer's business or risk profile are not assumed in the determination of the Supervisory Targets[12] and should therefore not be assumed in the setting of Internal Targets.[13] These factors should only be considered when determining the level at which the insurer will operate.

Insurers are expected to operate at Capital Resources levels above the Internal Targets.[14] OSFI understands that an insurer's Capital Resources levels may fall below its Internal Targets on unusual and infrequent occasions. If this happens, or is anticipated to happen within two years[15], the insurer should inform OSFI promptly and provide plans on how it expects to manage the risks and/or restore its Capital Resources levels to its Internal Targets within a relatively short period of time.

IV. Capital Management Policy

Capital management is the on-going process of determining and maintaining the quantity and quality of capital appropriate to support an insurer's planned operations. Capital should be managed to maintain financial strength, absorb losses so as to withstand adverse economic conditions, allow for growth opportunities and meet other risk management and business objectives. It should also be managed in order to provide, in extreme cases such as imminent failure or insolvency, sufficient assets to transfer or run-off policyholder obligations and pay creditor claims.

The insurer's ORSA and its strategic and business plans should support the insurer in establishing and maintaining capital management policies and procedures that include, among other things[16]:

- Clearly defined roles and responsibilities with respect to the design and execution of relevant policies and procedures;
- A policy that states capital adequacy goals relative to risk, taking into account the insurer's strategic focus and business plan, and that sets its Internal Targets;

Please refer to OSFI's *Corporate Governance Guideline* for OSFI's expectations of insurer Boards of Directors in regards to the management of capital and liquidity.

1 Insurer refers to federally regulated insurers including Canadian branches of foreign life and property and casualty companies, fraternal benefit societies, regulated insurance holding companies and non-operating insurance companies.

2 Consult OSFI's website for more information regarding OSFI's *Supervisory Framework*, including related *Assessment Criteria* documents.

3 In this guideline, the use of concepts applicable to companies and societies also includes the equivalent concepts applicable to foreign companies' and societies' branch operations in Canada. For example, the concept "capital" includes the equivalent concepts of "margin" and "Net Assets Available" as it applies to branches; "Available Capital" includes "Available Margin" and "Tier 1" includes "Available Margin excluding Other Admitted Assets".

4 For life insurers, regulatory minimum and target capital levels are calculated on the basis of both total and core, while P&C insurers base theirs solely on total.

5 The *Guide to Intervention for Federally Regulated Life Insurance Companies* and *Supervisory Guide Applicable to Federally Regulated Insurance Companies* can be found on OSFI's website.

6 The terms capital available, Available Capital, Surplus Allowance, Eligible Deposits, minimum capital required and Base Solvency Buffer are defined in the Capital Guidelines.

7 For life insurers, the LICAT includes additional criteria for determining the amount that qualifies as Tier 1 Capital (Tier 1), which is comprised of only the highest quality capital elements.

8 Supervisory Targets are not applicable to regulated insurance holding companies and non-operating insurance companies.

9 During 2023 and 2024, regulated life insurance holding companies and non-operating life insurance companies are required to maintain a minimum Core level of 50%. Starting in 2025, the minimum Core Ratio for regulated insurance holding companies and non-operating insurance companies will be 55%.

10 Guideline E-19: *Own Risk and Solvency Assessment* outlines OSFI expectations and principles with respect to setting Internal Targets, based on an insurer's ORSA.

11 To determine whether Internal Targets are above Supervisory Targets, Internal Targets should be expressed as a percentage of the amount of an insurer's capital requirements and compared to the Regulatory Capital Levels.

12 Parent/head office guarantees, potential future injections and other potential management actions that change the insurer's business or risk profile are also not considered in the calculation of the Minimums.

13 Consistent with Canadian P&C insurers that are not mortgage insurers, Canadian branches of foreign P&C insurers use a specified amount of the company's worldwide capital and surplus in the calculation of their capital requirements for earthquake risk, a component of the Supervisory Target. Both Canadian P&C insurers that are not mortgage insurers and Canadian branches of foreign P&C insurers may therefore include such amounts, to the extent permitted in the MCT, in the determination of their Internal Target.

14 For monitoring purposes, an insurer's capital ratios, calculated per the Capital Guidelines, are used to determine whether an insurer is operating above its Internal Targets.

15 As may be contained in financial forecasts or other reports (e.g., projections of very likely scenarios) prepared for Senior Management, the Board, investors or the public.

16 For additional guidance on how an insurer's ORSA links risk management, capital management and other management processes, please refer to OSFI's Guideline E-19: *Own Risk and Solvency Assessment*.