



Guideline

Title	Life Insurance Capital Adequacy Test (2023) - Chapter 2 Available Capital
Category	Capital Adequacy Requirements
Date	July 31, 2022
Sector	Life Insurance and Fraternal Companies
Effective date	January 1, 2023

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Appendix 2-A Information Requirements for Capital Confirmations

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

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

1. **availability:** whether the capital element is fully paid in, and the extent to which it is 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, and the circumstances under which 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:

Tier 1 Capital Instruments

1. Common shares issued by the insurer, other than those issued by consolidated subsidiaries and held by third party investors, that meet the criteria specified in section 2.1.1.1;
2. Tier 1 Capital Instruments other than Common Shares issued by the insurer, other than those issued by consolidated subsidiaries and held by third party investors:
 - a. that meet the criteria specified in sections 2.1.1.2 to 2.1.1.4; or
 - b. that were issued prior to August 7, 2014, do not meet the criteria specified in sections 2.1.1.2 to 2.1.1.4, but meet the Tier 1 criteria specified in Appendix 2-B and Appendix 2-C of the OSFI guideline *Minimum Continuing Capital and Surplus Requirements* effective January 1, 2016 (these instruments are subject to

the transition measures in section 2.4.1);

3. Instruments issued by consolidated subsidiaries of the insurer and held by third party investors:
 - a. 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 sections 2.1.1.2 to 2.1.1.4 (these instruments are subject to the conditions in section 2.1.1.5 and the transition measures in section 2.4.2); or
 - b. that were issued prior to August 7, 2014, do not meet the criteria specified in sections 2.1.1.2 to 2.1.1.4, but meet the Tier 1 criteria specified in Appendix 2-B and Appendix 2-C of the OSFI guideline *Minimum Continuing Capital and Surplus Requirements* effective January 1, 2016 (these instruments are subject to transition measures in sections 2.4.1 and 2.4.2).

Tier 1 Elements other than Capital Instruments

4. Contributed Surplus, comprising:
 - a. Share premium resulting from the issuance of capital instruments included in Gross Tier 1₁; and
 - 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 joint stock companies), excluding any share premium resulting from the issuance of capital instruments included in Tier 2;
5. Adjusted Retained Earnings;
6. Volatility adjustment for changes in cost of guarantee liabilities: An insurer may, at its option and for a limited period of seven quarters, partially reverse changes that have occurred in the liability for the cost of guarantees for participating and non-participating products (excluding segregated funds) since the end of the previous quarter. A one-time election of whether to use this option must be made within three months after the adoption of IFRS 17, and cannot be changed thereafter. If the insurer elects to use the adjustment, then starting after the first quarter end at which IFRS 17 is used for reporting, a percentage of the increase

(decrease) in the liability for cost of guarantees caused by market movements is added to (subtracted from) Gross Tier 1, where the increase or decrease is measured from the end of the previous quarter to the reporting date². For reporting dates within the first year after the adoption of IFRS 17, the percentage used for the adjustment is 50%, and for the second year after the adoption of IFRS 17, the percentage used is 25%.

Market movements include changes to risk-free interest rates, equity prices, and credit spreads. Insurers may use their own internal processes to determine the portion of the change in liability for cost of guarantees that has occurred due to market movements. The liability for cost of guarantees to which the partial reversal is applied comprises the liabilities for both the intrinsic value of the guarantees, and the time value of the guarantees.

7. Adjusted Accumulated Other Comprehensive Income (AOCI);
8. Participating account³;
9. Non-participating account (mutual companies)⁴;
10. Tier 1 elements, other than capital instruments, attributable to non-controlling interests that satisfy the conditions in section 2.1.1.5; and
11. Tax adjustments and amounts recoverable on surrender related to policy-by-policy negative reserves ceded under unregistered reinsurance (qq.v. sections 10.2.5 and 10.2.6).

To determine Adjusted Retained Earnings, the following adjustments are made to retained earnings⁵:

1. All contractual service margins that are reported as liabilities in the financial statements⁶, other than those in respect of segregated fund contracts with guarantee risks, are added;
2. All contractual service margins that are reported as assets in the financial statements⁶, other than those in respect of segregated fund contracts with guarantee risks, are subtracted;
3. The impact of accumulated after-tax gains or losses on fair-valued liabilities arising from changes to the insurer's own credit risk is reversed;
4. The impact of the following items related to real estate is reversed:

- a. After-tax fair value gains or losses on owner-occupied property upon conversion to IFRS (cost model)⁷;
 - b. Accumulated after-tax revaluation loss on owner-occupied property (revaluation model);
 - c. Gains or losses up to the transfer date on owner-occupied property that was previously classified as investment property⁸;
5. The impact of any discretionary participation features reported in a component of equity that is included in Gross Tier 1 is reversed.

To determine Adjusted AOCI, the following adjustments are made to total reported AOCI:

1. The impact of accumulated after-tax gains or losses on fair-valued liabilities arising from changes to the insurer's own credit risk is reversed;
2. The impact of /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 and debt obligations) is reversed; and
3. Accumulated after-tax fair value revaluation gains on own-use property under the revaluation method are subtracted.

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-in⁹ 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 entity¹⁰, 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 be

deemed fully equivalent to common shares in terms of their capital quality, including their loss absorption capacity, and do not possess features that 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 Qualifying Criteria for Tier 1 Capital Instruments Other than Common Shares¹¹

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 creditors¹².
4. The instrument is perpetual, i.e., there is no maturity date, and there are no step-ups¹³ or other incentives to redeem¹⁴.
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 insurer¹⁵; or
 - ii. The insurer demonstrates that its capital position is well above the supervisory target capital requirements after the call option is exercised¹⁶.
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/ payments¹⁷.
 - 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.
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 standing¹⁸.
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 entity¹⁹ or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 1²⁰.

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 defined as “the date 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”.

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 an amendment or variance will only be permitted with the prior approval of the Superintendent²¹.

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:

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 should 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

an 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 Consolidated Subsidiaries having Tier 1 Third Party Investors / Non-Controlling Interests

Both:

- i. Common Shares, and Tier 1 Capital Instruments other than Common Shares, issued by a consolidated subsidiary of the insurer and held by third party investors, and
- ii. Tier 1 elements, other than capital instruments, attributable to non-controlling interests²²

are subject to limited recognition in the consolidated Tier 1 capital of the parent insurer²³.

Tier 1 capital instruments issued by a subsidiary and held by third party investors are included in consolidated Tier 1 capital if:

1. They are issued for the funding of the parent insurer and meet all of the following criteria:
 - a. The subsidiary uses the proceeds of the issue to purchase a similar instrument from the parent insurer that meets the criteria in section 2.1.1.1, or sections 2.1.1.2 to 2.1.1.4;
 - b. The terms and conditions of the issue, as well as the intercompany transfer, place the investors in the same position as if the instrument were issued by the parent insurer; and
 - c. The instrument held by third party investors is not effectively secured by other assets, such as cash, held by the subsidiary.

or:

2. They were issued prior to September 13, 2016 and qualify for recognition in consolidated Available Capital under section 2.4.2.

Tier 1 capital instruments issued by a subsidiary and held by third party investors that do not meet the above criteria, and Tier 1 elements, other than capital instruments, attributable to non-controlling interests, may be included in the consolidated Tier 1 capital of the parent insurer subject to the following Third Party Share limit:

Third Party Share Percentage × (Marginal capital requirement for the subsidiary + Total deductions from the subsidiary's Available Capital)

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 that do not meet the above criteria, plus Tier 1 elements, other than capital instruments, attributable to non-controlling interests²², divided by the sum of Available Capital and the Surplus Allowance of the subsidiary.
2. Marginal capital requirement for the subsidiary² is equal to:
 - a. the difference between the Base Solvency Buffer (q.v. 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 sum of Tier 1 and Tier 2 capital instruments issued by a subsidiary and held by third parties and of Tier 1 elements, other than capital instruments, attributable to non-controlling interests is equal to or greater than 1% of Gross Tier 1, or
 - b. the capital requirement of the subsidiary calculated based on local regulatory requirements at the equivalent local level of the LICAT supervisory target,²⁴ if the sum of Tier 1 and Tier 2 capital instruments issued by a subsidiary and held by third parties and Tier 1 elements, other than capital instruments, attributable to non-controlling interests is less than 1% of Gross Tier 1.

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 subsidiaries²⁵ and goodwill included in the carrying amount of equity accounted substantial investments²⁶ is deducted from Gross Tier 1. The amount deducted 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 were to become impaired or derecognized²⁷.

An insurer 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 it obtains prior written OSFI supervisory approval²⁸.

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.

Deferred tax assets (DTA) must be classified as either DTA arising from temporary differences (DTA Temporary) or DTA other than those arising from temporary differences (DTA Non-Temporary). For example, DTA relating to tax credits and DTA relating to carry forwards of operating losses are classified as DTA Non-Temporary.

No regulatory adjustments are required under this section for legal entities in a net Deferred Tax Liability (DTL) position. Regulatory adjustments associated with legal entities in net DTA positions are set out in sections 2.1.2.5.1 and 2.1.2.5.2 below.

Eligible DTL, in this section, are limited to those permitted to offset DTA for balance sheet reporting purposes at the legal entity level, excluding DTL that have been netted against the deductions for goodwill, intangible assets and defined benefit pension plan assets. Eligible DTL are allocated on a pro rata basis between DTA Temporary and DTA Non-Temporary.

2.1.2.5.1 DTA – other than those arising from temporary differences

Insurers should deduct 100% of DTA Non-Temporary, net of eligible DTL, from Gross Tier 1.

2.1.2.5.2 DTA – arising from temporary differences

The amount that insurers should deduct from Gross Tier 1 is:

$$\max \left(DTAT_{\text{net}} - 0.1 \times T1_{\text{gross}} - T1_{\text{deductions}}, 0 \right) \times 0.9$$

where:

- $DTAT_{\text{net}}$ is equal to DTA Temporary net of eligible DTL
- $T1_{\text{gross}}$ is equal to Gross Tier 1

- $T1_{\text{deductions}}$ is equal to the sum of all deductions from Gross Tier 1 in sections 2.1.2.1 to 2.1.2.5.1, and sections 2.1.2.6 to 2.1.2.10.

DTA Temporary included in Available Capital is limited to 10% of Net Tier 1, and is subject to a 25% credit risk factor (q.v. section 3.1.8).

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

Example: Deferred Tax Assets

Item	Amount
Gross Tier 1	4,075
All deductions from Gross Tier 1 except those relating to both types of DTA	2,000
DTA Non-Temporary	100
DTA Temporary	300
DTL associated with goodwill	50
DTL other	100
Net DTA position	$(100 + 300 - 50 - 100) = 250$
DTL allocated to DTA Non-Temporary	$100 \cdot 400 \times 100 = 25$ (excludes DTL associated with goodwill)
DTL allocated to DTA Temporary	$300 \cdot 400 \times 100 = 75$ (excludes DTL associated with goodwill)
DTA Non-Temporary, net of eligible DTL	$100 - 25 = 75$
DTA Temporary, net of eligible DTL	$300 - 75 = 225$
Gross Tier 1, net of 2.1.2.1 to 2.1.2.5.1 and 2.1.2.6 to 2.1.2.10 deductions	$4,075 - 2,000 - 75 = 2,000$
DTA deducted from Gross Tier 1	1) 75 (DTA Non-Temporary) 2) $225 - (10\% \times 2000) \cdot 0.9 = 28$ (DTA Temporary)
Validation: Amount included in Available Capital does not exceed 10% of Tier 1	$2,000 - 28 = 1,972$ $197 / 1,972 = 10\%$
Capital charged on DTA Temporary included in Available Capital	$(250 + 50) - (75 + 28) = 197 \times 25\% = 49$

2.1.2.6. Encumbered Assets

Encumbered assets in excess of the allowable amount are deducted from Gross Tier [129](#). The allowable amount, which is calculated for each pool of encumbered assets and the liabilities they secure³⁰, is equal to the sum of:

1. the value of on-balance sheet liabilities secured by the encumbered assets; and
2. the marginal capital requirement², floored at zero, 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 (q.v. section 11.3) of the insurer, and the Base Solvency Buffer of the insurer excluding the encumbered assets and the liabilities they secure³¹, 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.

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 are deducted³² 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 capital³³ by the controlled non-life financial corporation, the full amount of the facility is deducted from Gross Tier 1³⁴.

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 or guarantees are provided to controlled non-life financial corporations and are not deducted from Available Capital, they are treated as direct credit substitutes in accordance with this guideline (refer to Chapters 3 and 4).

2.1.2.8. Cash surrender value deficiencies calculated by aggregated sets

Cash surrender value (CSV) deficiencies are calculated net of all reinsurance on an aggregate basis within sets by product type. Deficiencies are calculated relative to fulfillment cash flows. The deduction from Gross Tier 1 is the sum of the positive deficiencies taken over each set of policies, where the positive deficiency for a set is the higher of the set's aggregate deficiency or zero. All of the policies in an aggregated set 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.

2.1.2.9. Negative reserves and deferred acquisition costs calculated policy-by-policy

In this section, policy-by-policy negative reserves are defined to be negative Best Estimate Liabilities calculated on a policy-by-policy basis. Insurers should calculate policy-by-policy negative reserves net of all reinsurance³⁵. Policy-by-policy negative reserves are reduced by a percentage factor of either 10% or 30%, and then reduced further 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 negative reserves net of reductions, with the net amount for each policy subject to a minimum of zero.

Policy-by-policy negative reserves should be calculated for all products and lines of business, including group and accident and sickness business, and future business assumed through reinsurance contracts issued². The calculation should include:

1. the negative reserve for each certificate under group insurance 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 (including deferred acquisition costs for policies for which coverage has not yet become effective) over its termination or surrender charges; and
3. negative group insurance refund provisions where recovery is not completely assured, calculated policy by policy.

The negative reserve for any policy may be reduced by 10%. In order to account for the effect of income taxes, the negative reserve for a policy may be reduced by an additional 20% of the original negative reserve amount if it arises from either of the following:

- a. active life reserves for individually underwritten Canadian health business, or
- b. Individually underwritten Canadian life business.

No reduction for the effect of income taxes is made to negative reserves relating to any other type of business.

The negative reserve may then be further reduced, to a minimum of zero, by the sum of the following amounts recoverable on surrender:

1. 85% of the net commission chargeback for the policy;
2. The product of y , $1 + f$, and 70% of the policy's marginal insurance risk requirement, where y is the scalar defined in section 1.1.5, and f is the operational risk factor applied to required capital for insurance risk in section 8.2.336;
3. a specified amount if the policy is part of a yearly renewable term (YRT) reinsurance treaty; and
4. outstanding earned premiums for group insurance business.

However, the maximum total amount by which the deduction from Gross Tier 1 of reduced policy-by-policy negative reserves for a Canadian insurer may be further reduced for amounts recoverable on surrender is limited to 130% of:

1. Gross Tier 1; plus
2. 70% of Surplus Allowance; less
3. All deductions from Gross Tier 1 used to determine Net Tier 1 as specified in section 2.1.2, excluding negative reserves and adjustments for unregistered reinsurance; less
4. Total policy-by-policy negative reserves reduced by percentage factors, but not by any amounts recoverable on surrender; less
5. The deductions from Tier 1 for unregistered reinsurance in sections 10.2.1 to 10.2.4, net of any credits applicable in sections 10.2.1 and 10.2.2; plus
6. The addition to Tier 1 in section 10.2.5.

For a foreign insurer, the maximum amount by which reduced policy-by-policy negative reserves included in Assets Required may be further reduced for amounts recoverable on surrender is limited to 130% of:

1. admitted assets vested in trust; plus
2. investment income due and accrued on admitted vested assets; plus
3. 70% of Surplus Allowance; less
4. Deductions/Adjustments (q.v. section 12.2.4); less

5. Assets Required (q.v. section 12.2.5) excluding negative reserves in item 10) and amounts recoverable on surrender in item 21); less
6. total policy-by-policy negative reserves reduced by percentage factors, but not by any amounts recoverable on surrender.

If the amount by which policy-by-policy negative reserves is reduced for amounts recoverable on surrender is below the applicable limit, then the difference may be allocated among unregistered reinsurers to increase the corresponding limits in the unregistered reinsurance adjustments for amounts recoverable on surrender (q.v. section 10.2.6).

In order to use any amount recoverable on surrender to offset a policy's 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 equal to $S \times C$, where:

- S is 70% if the policy's negative reserve has been reduced by 20% to account for the effect of income taxes, and is 100% if it has not; 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 reduced 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 policyholder deposits and group business adjustments (qq.v. sections 6.8.2 and 6.8.3). Each marginal policy requirement should be calculated net of all reinsurance. All marginal policy requirements for qualifying participating and adjustable products should be multiplied by 30%. The 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 geographic region, the marginal policy requirement for mortality risk is equal to:

$$0.4 \times (rc_{vol}^2 + 2 \times rc_{cat} \times RC_{cat} - rc_{cat}^2) + RC_{vol}^2 + RC_{cat}^2 + 0.9 \times (rc_l + rc_t)$$

where:

- rc_{vol} is the mortality volatility risk component for the policy
- rc_{cat} is the mortality catastrophe risk component for the policy
- RC_{vol} is the mortality volatility risk component for all business in the policy's geographic region
- RC_{cat} is the mortality catastrophe risk component for all business in the policy's geographic region
- rc_l is the policy's level component for mortality risk
- rc_t is the policy's trend component for mortality risk

The marginal policy requirement for expense risk is equal to 90% of the policy's total requirement for the risk. For all other insurance risks, the marginal policy requirement is equal to:

$$0.4 \times (2 \times rc_{vol} \times RC_{vol} + 2 \times rc_{cat} \times RC_{cat} - rc_{vol}^2 - rc_{cat}^2) + RC_{vol}^2 + RC_{cat}^2 + 0.9 \times (rc_l + rc_t)$$

where:

- rc_{vol} is the volatility component of the particular insurance risk for the policy (multiplied by the statistical fluctuation factor of the policy's geographic region if applicable)
- rc_{cat} is the catastrophe component of the particular insurance risk for the policy
- RC_{vol} is the volatility component of the particular insurance risk for all business in the policy's geographic region
- RC_{cat} is the catastrophe component of the particular insurance risk for all business in the geographic region
- rc_l is the policy's level component for the particular insurance risk, multiplied by the statistical fluctuation factor of the policy's geographic region if applicable

- rc_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 negative reserve reduced by percentage factors;
- A is the total of reduced negative reserves for all policies within the insurer's eligible YRT reinsurance treaties calculated policy-by-policy; and
- B is the total of reduced negative reserves for all of the insurer's eligible YRT reinsurance treaties, calculated treaty by treaty.

2.1.2.9.4 Outstanding earned premiums for group insurance business

If all premiums due under a group insurance policy are an obligation of the plan sponsor, an amount recoverable on surrender for outstanding earned premiums on the policy may be recognized. The outstanding earned premium for the policy is defined to be:

$$R \times (EP - PP - LIC)$$

subject to a minimum of zero. In the above definition:

1. R is 95% if the group policyholder is the Canadian government or a provincial or territorial government in Canada, and 85% otherwise.
2. EP is the earned premium for the policy. If the IFRS 17 premium allocation approach is used to determine the reserve for the group policy, then EP is the difference between the total premium and liability for remaining

coverage for the policy. If the IFRS 17 general measurement model is used to determine the reserve for the policy, then:

$$EP = TP \times \frac{ECU}{TCU}$$

where:

- a. *TP* is the total premium for the policy.
 - b. *TCU* is the total number of coverage units for the policy that the insurer uses in the determination of its contractual service margin.
 - c. *ECU* is the number of coverage units that the insurer has provided under the policy as of the reporting date.
3. *PP* is the amount of premiums that the insurer has received for the policy as of the reporting date.
 4. *LIC* is the best estimate liability for incurred claims for the policy at the reporting date.

2.1.2.10. Other items deducted from Gross Tier 1

Insurers should also deduct the following from Gross Tier 1:

1. all requirements for liabilities ceded under unregistered reinsurance arrangements, net of any applicable credits, specified in sections 10.2.1 to 10.2.4;
2. the excess, calculated under Best Estimate Assumptions, of:
 - the amount of aggregate reinsurance contracts held that are assets that correspond to future business, other than future business that has been assumed through reinsurance contracts issued;
over
 - the amount of aggregate reinsurance contracts held that are liabilities that correspond to future business, other than future business that has been assumed through reinsurance contracts issuedif this amount is positive; and

3. purchased options for which the insurer elects deduction under section 5.2.3.3; and
4. negative dividend stabilization reserves (DSRs) and negative reserves resulting from similar experience levelling mechanisms related to participating business (q.v. section 9.1.1), calculated by participating block.

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. Consequently, 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 (q.v. 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. Tier 2 Capital instruments issued by the insurer, other than those issued by consolidated subsidiaries and held by third party investors:
 - a. that meet the qualifying criteria specified in sections 2.2.1.1 to 2.2.1.3; or
 - b. that were issued prior to August 7, 2014, do not meet the criteria specified in sections 2.2.1.1 to 2.2.1.3, but meet the Tier 2 criteria specified in Appendix 2-B of the OSFI guideline *Minimum Continuing Capital and Surplus Requirements* effective January 1, 2016 (these instruments are subject to transition measures in section 2.4.1);
2. Instruments issued by consolidated subsidiaries of the insurer and held by third party investors:
 - a. that meet the criteria for classification as Tier 2, as specified in sections 2.2.1.1 to 2.2.1.3 (these instruments are subject to the conditions in section 2.2.1.4 and the transition measures in section 2.4.2); or

b. that were issued prior to August 7, 2014, do not meet the criteria specified in sections 2.2.1.1 to 2.2.1.3, but meet the Tier 2 criteria specified in Appendix 2-B of the OSFI guideline *Minimum Continuing Capital and Surplus Requirements* effective January 1, 2016 (these instruments are subject to the transition measures in sections 2.4.1 and 2.4.2);

3. Tier 2 capital elements other than capital instruments, per section 2.2.1.5.

2.2.1.1 Qualifying Criteria for Tier 2 Capital Instruments

Instruments qualify as Tier 2 if all of the following criteria are met:¹¹

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-ups¹³ 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 exercised³⁷; 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 insurer¹⁵; or
 - ii. The insurer demonstrates that its capital position is well above the supervisory target capital requirements after the call option is exercised¹⁶.

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 standing¹⁸.
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 entity¹⁹ or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 2³⁸.

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 defined as "the date specified in a letter from the Superintendent to the Company on which the instrument will no longer be recognized in full as eligible Tier 2 capital of the insurer or included as risk-based Total Available Capital 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 an amendment or variance will only be permitted with the prior approval of the Superintendent²¹.

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 (q.v. 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. However, the Superintendent may 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 should 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 an 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. Consolidated Subsidiaries having Tier 2 Third Party Investors

Tier 2 capital instruments issued by a consolidated subsidiary of the insurer and held by third party investors may receive limited recognition in the consolidated Tier 2 capital of the parent insurer.

Tier 2 capital instruments issued by a subsidiary and held by third party investors are included in consolidated Tier 2 capital if:

1. They are issued for the funding of the parent insurer and meet all of the following criteria:
 - a. The subsidiary uses the proceeds of the issue to purchase a similar instrument from the parent insurer that meets the criteria in sections 2.2.1.1 to 2.2.1.3;

- b. The terms and conditions of the issue, as well as the intercompany transfer, place the investors in the same position as if the instrument were issued by the parent insurer; and
- c. The instrument held by third party investors is not effectively secured by other assets, such as cash, held by the subsidiary.

or:

- 2. They were issued prior to September 13, 2016 and qualify for recognition in consolidated Available Capital under section 2.4.2.

The amount of Tier 2 capital instruments issued by a subsidiary and held by third party investors that do not meet the above criteria that may be included in the consolidated Tier 2 capital of the parent insurer is equal to the lowest of:

- a. The value of Tier 2 instruments issued by the subsidiary and held by third party investors that do not meet the above criteria;
- b. The difference between the Third Party Share limit calculated in section 2.1.1.5, and the amount of capital instruments and Tier 1 elements, other than capital instruments, attributable to non-controlling interests, included in consolidated Tier 1 capital that are issued by the subsidiary and held by third party investors; and
- c. 50% of the Third Party Share limit calculated in section 2.1.1.5.

2.2.1.5. Tier 2 capital elements other than capital instruments

Tier 2 capital elements other than capital instruments include:

- 1. the amounts deducted from Gross Tier 1 for:
 - a. negative reserves, excluding the amount deducted that relates to future business assumed through reinsurance contracts issued, and
 - b. offsetting and negative policy liabilities ceded under unregistered reinsurance arrangements specified in sections 10.2.2 and 10.2.4;
- 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. share premium resulting from the issuance of capital instruments included in Tier 2 capital³⁹
6. Aggregate negative Best Estimate Liabilities ceded under unregistered reinsurance arrangements eligible for recognition in Tier 2 (q.v. section 10.2.7).

For those insurers that 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 to Tier 2.

The amount subject to amortization in each period is the sum of a), b) and c) above. The amortization is made on a straight-line basis over the amortization period. The amortization period is twelve quarters and begins in the current quarter. The election will be irrevocable and the insurer will continue, in each quarter, to amortize the new impact on Available Capital in subsequent periods. The adjustment amount is 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. As these instruments approach maturity, the outstanding balances are to be amortized based on the following schedule:

Amortization Schedule of Tier 2 Capital Instruments

Years to Maturity	Included in Capital
5 years or more	100%
4 years and less than 5 years	80%
3 years and less than 4 years	60%
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 begins 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 occurs on November 1, 2020, and is reflected in the December 31, 2020 *LICAT Quarterly Return* and *LICAT Annual Supplement*. An additional 20% amortization is 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 they are 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 are deducted³² 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 (q.v. section 2.1.2.7).

A credit risk factor will not be applied to equity investments or other facilities provided to controlled non-life financial corporations where these have been deducted from Available Capital.

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.

2.2.3.4 Negative reserve tax adjustments and amounts recoverable on surrender ceded under unregistered reinsurance

Any tax adjustments and amounts recoverable on surrender related to policy-by-policy negative reserves ceded under unregistered reinsurance that are included in Gross Tier 1 (qq.v. sections 10.2.5 and 10.2.6) are fully deducted from Gross Tier 2.

2.2.4. Net Tier 2 and Tier 2

Net Tier 2 is equal to Gross Tier 2 minus the deductions from Gross Tier 2 set out in section 2.2.3. However, Net Tier 2 capital may not be lower than zero. If the total of all Gross Tier 2 deductions exceeds Gross Tier 2, the excess is deducted from Net Tier 1 capital (q.v. section 2.1.3).

Since Tier 2 capital may not exceed Net Tier 1 capital, Tier 2 Capital is defined to be the lower of Net Tier 2 or Net Tier 1.

2.3. Capital Composition and Limitations

The following capital composition requirements and limitations apply to capital elements after all specified deductions and adjustments. In addition, for purposes of calculating the limitations set out below, Tier 1 Capital Instruments Other than Common Shares and Tier 2 instruments should exclude instruments subject to transition set out in sections 2.4.1 and 2.4.2.

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 issued by the insurer that meet the criteria specified in section 2.1.1.1;
 - b. Instruments issued by consolidated subsidiaries of the insurer and held by third party investors that meet the criteria for classification as Common Shares as specified in section 2.1.1.1, subject to section 2.1.1.5;
 - c. 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 capital for joint stock companies) excluding any share premium resulting from the issuance of capital instruments not included within this limit;
 - d. Adjusted Retained Earnings;
 - e. Adjusted Accumulated Other Comprehensive Income (AOCI);
 - f. Participating account;³
 - g. Non-participating account (mutual companies);⁴
 - h. Tier 1 elements, other than capital instruments, attributable to non-controlling interests, subject to section 2.1.1.5.
2. An insurer's Tier 2 capital (net of amortization) shall not exceed 100% of Net Tier 1 capital.

3. The amount of Tier 1 Capital Instruments Other than Common Shares recognized in Net Tier 1 capital is limited to 25% of Net Tier 1. Tier 1 Capital Instruments Other than Common Shares in excess of 25% of Net Tier 1 may be included in Tier 2 capital, subject to the Tier 2 limit in the preceding item.

2.4. Transition

2.4.1 Instruments issued prior to August 7, 2014

Capital instruments issued prior to August 7, 2014 that do not meet the qualifying criteria specified in sections 2.1.1.1, 2.1.1.2 to 2.1.1.4 and 2.2.1.1 to 2.2.1.3 but meet the Tier 1 or Tier 2 criteria specified in Appendix 2-B and Appendix 2-C of the OSFI guideline *Minimum Continuing Capital and Surplus Requirements* effective January 1, 2016, will be treated as follows:

1. Instruments will continue to be recognized as Available Capital until the earlier of the instrument's first par call date or the effective date of any feature constituting an incentive to redeem (i.e., the effective maturity date).
2. Regulatory event calls, if any, will not be permitted to be exercised until the end of the recognition period for the instrument.
3. If a Tier 2 instrument has an effective maturity date within the recognition period and the issuer elects not to exercise the call option despite the incentive to redeem, that instrument will continue to be recognized as Available Capital, provided it meets the qualifying criteria specified in sections 2.2.1.1 to 2.2.1.3.
4. Tier 2 amortization rules will continue to apply to Tier 2 instruments in their final 5 years to maturity.
5. During the recognition period, SPVs associated with Tier 1 and Tier 2B innovative instruments should continue to not, at any time, hold assets that materially exceed the aggregate amount of the innovative instruments. For Asset-Based Structures, OSFI will consider the excess to be material if it exceeds 25% of the innovative instrument(s) and, for Loan-Based Structures, the excess will be considered to be material if it exceeds 3% of the innovative instrument(s). Amounts in excess of these thresholds require Superintendent approval.

The above provisions apply equally to instruments issued directly by insurers as well as those issued by consolidated subsidiaries to third party investors.

2.4.2 Consolidated subsidiaries having third party investors

Tier 1 and Tier 2 capital instruments issued by a subsidiary of the insurer and held by third party investors:

1. prior to August 7, 2014 and that meet the Tier 1 or Tier 2 criteria specified in Appendix 2-B and Appendix 2-C of the OSFI guideline *Minimum Continuing Capital and Surplus Requirements* effective January 1, 2016, subject to the treatment outlined in section 2.4.1; or
2. prior to September 13, 2016 and that meet the qualifying criteria specified in sections 2.1.1.1, 2.1.1.2 to 2.1.1.4 and 2.2.1.1 to 2.2.1.3

qualify for recognition in consolidated Available Capital, subject to the following conditions:

1. The instrument has not matured or been redeemed.
2. The instrument's first par call date on or after September 13, 2016 has not passed.
3. For instruments that do not mature and that do not have par call dates, the reporting date is prior to January 1, 2028.

Appendix 2-A Information Requirements for Capital Confirmations

Given the potential impact of OSFI finding that a capital instrument does not meet certain criteria, insurers are encouraged to seek confirmations of capital quality from OSFI prior to issuing instruments. 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 (e.g., Prospectus, Offering Memorandum, Debt Agreement, and Share Terms).
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 purposes⁴⁰.
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 statements⁴¹.
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, 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.

- 1 Where repayment of the premium is subject to the Superintendent's approval.
- 2 An approximation may be used under section 1.4.5.
- 3 For non-stock companies, this refers to residual interest reported either as equity or as a liability in the LIFE return. For joint stock companies, this refers to i) contributions to participating surplus reported as liabilities in the LIFE return and ii) amounts reported as Participating Account Policyholders' Equity in the LIFE return. Expected shareholder transfers from the participating account included within the contractual service margins are excluded from the participating account, as contractual service margins are included in the determination of Adjusted Retained Earnings below.
- 4 This also includes residual interest reported as a liability in the LIFE return.
- 5 For fraternal benefit societies, the amount of retained earnings reported for LICAT purposes should be the lower of the insurance fund surplus or the total surplus. For other non-stock companies without reported retained earnings, reversals should be made from surplus, which includes amounts attributable to Participating Policyholders/Certificate holders, and Residual Interest Policyholders, as reported in the LIFE return.
- 6 Excluding contractual service margins attributable to non-controlling interests in subsidiaries (q.v. section 2.1.1.5).
- 7 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.
- 8 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.
- 9 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.

- 10** 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.
- 11** 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.
- 12** 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 this criterion.
- 13** 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 does not constitute a step-up.
- 14** A call option combined with a requirement or an investor option to convert the instrument into common shares if the call is not exercised constitutes an incentive to redeem.
- 15** Replacement issuances may be made concurrently when the instrument is called, but not subsequently.
- 16** For the definition of the Supervisory Target, refer to Guideline A-4 [*Regulatory Capital and Internal Capital Targets*](#).
- 17** 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.

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

- 18** 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.
- 19** An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.
- 20** 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.
- 21** 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.
- 22** Tier 1 elements, other than capital instruments, attributable to non-controlling interests associated with a consolidated subsidiary is the amount of Tier 1 elements of non-controlling interest related to the subsidiary that meet Tier 1 eligibility criteria (including contractual service margin), less any amount of Tier 1 and Tier 2 capital instruments issued by the subsidiary and held by third party investors included therein.
- 23** If an insurer's consolidated financial statements include an unleveraged mutual fund entity that is not subject to deduction from Available Capital, and a portion of the fund's units are exempt from the requirements of section 5.4, all non-controlling interests in the mutual fund entity should be excluded from the insurer's Available Capital.
- 24** 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.
- 25** 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.

- 26** As defined in section 10 of the *Insurance Companies Act*.
- 27** 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.
- 28** 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.
- 29** 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.
- 30** The defining characteristic of a pool is that any asset in the pool is available to pay any of the corresponding liabilities.
- 31** 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.
- 32** Investments in non-life solvency regulated corporations are deducted where an insurer cannot carry on the business directly. Non-life solvency regulated financial corporations include those that are engaged in the business of banking, trust and loan business, or the business of co-operative credit societies. They also include corporations that are primarily engaged in the business of dealing in securities, including portfolio management and investment counselling. Investments in corporations that are engaged exclusively in property and casualty insurance business are deducted, but investments in composite insurance subsidiaries (q.v. section 1.3) are not.
- 33** 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.

- 34** Although the facility has not been called upon, if it were drawn, the resources would not be available to cover the capital requirements of the insurer.
- 35** Negative reserves include those that an insurer has assumed under modified coinsurance arrangements, and exclude those that the insurer has ceded under both registered and unregistered modified coinsurance arrangements.
- 36** This reduction may not be applied to negative reserves for policies that constitute future business.
- 37** 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 act in any way to create an expectation that the call will be exercised at this point.
- 38** 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.
- 39** 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.
- 40** OSFI may require a Canada Revenue Agency advance tax ruling to confirm the tax opinion if the tax consequences are subject to material uncertainty.
- 41** OSFI may require the accounting opinion to be an external opinion of a firm acceptable to OSFI if the accounting consequences are subject to material uncertainty.