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# Guideline impact analysis statement

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Title	Materiality Criteria for Related Party Transactions – Guideline impact analysis statement (2008)
Category	Prudential Limits and Restrictions
Date	August 31, 2008
Sector	Banks Life Insurance and Fraternal Companies Property and Casualty Companies Trust and Loan Companies
No	E-6

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## I. Background

Parts XI of the *Bank Act*, the *Trust and Loan Companies Act* and the *Insurance Companies Act* and Part XII of the *Cooperative Credit Associations Act* define who are related parties of federally regulated financial institutions Canadian banks, trust and loan companies, life insurance companies, property and casualty insurance companies, and cooperative credit associations incorporated or formed under an Act of Parliament (FRFIs), and set out rules for undertaking transactions with related parties. Subject to a limited number of exceptions, FRFIs cannot directly or indirectly enter into a transaction with a related party. One of these exceptions permits FRFIs to enter into a related party transaction if the value of the transaction is nominal or immaterial to the FRFI when measured by criteria established by the FRFI's Conduct Review Committee (CRC) and approved in writing by the Superintendent. The exception for nominal or immaterial value transactions is found in section 490 of the *Bank Act*, section 478 of the *Trust and Loan Companies Act*, section 522 of the *Insurance Companies Act* and section 414 of the *Cooperative Credit Associations Act*. The *Materiality Criteria for Related Party Transactions* Guidelines (the E-6 Guidelines) establish criteria for determining whether a transaction with a related party is nominal or immaterial for the purposes of the legislation.

FRFIs that adopt materiality criteria at least as stringent as the criteria set out in their respective sector Guideline are deemed to have obtained OSFI approval.

## II. Problem Identification

### 1. Clarity of the Guidelines

The need for the October 2001 Guidance Note to the life insurance Guideline suggests that the current E-6 Guidelines could be clearer with respect to the types of transactions included in each category. At the time the Guidance Note was issued, OSFI indicated that it intended to initiate a comprehensive review of the E-6 Guidelines.

Unclear guidance can pose a number of risks. First, there is a risk that FRFIs may be undertaking non-permitted self-dealing transactions. Second, FRFIs may misinterpret the Guidelines as permitting prohibited related party transactions, which could result in losses. Third, FRFIs could also be exposed to reputational risk if they undertake

inappropriate transactions because they have misinterpreted the guidance.

## 2. Relevance of the guidelines

OSFI is committed to ensuring that its guidance remains relevant. Significant legislative changes to the self-dealing regime mean that the materiality categories in the Guidelines should be reviewed and amended.

For example, prior to the 1997 legislative changes, the CRC was required to approve all related party transactions (even those permitted by the legislation), and to satisfy itself that each transaction was on terms and conditions at least as favourable to the FRFI as market terms and conditions. However, CRC approval was not required for immaterial related party transactions. Therefore, to reduce the burden on the CRC, OSFI included in the Guidelines some **permitted** related party transactions undertaken in the normal course of business. Under the current legislation the CRC is only required to review procedures for compliance with the self-dealing regime. Therefore, there is no longer a need to have materiality criteria for permitted related party transactions.

## 3. Different guidelines for the sectors

OSFI is committed to providing a level playing field for all FRFI sectors (which entails the consistent interpretation and application of FRFI legislation). While the Guidelines applicable to each financial sector achieve the same objectives, the use of different industry specific terminology and slightly different threshold values suggests that the regimes differ.

## III. Objectives

In modifying the materiality criteria, OSFI seeks to:

1. reduce the risk that FRFIs may be undertaking inappropriate or unsafe related party transactions, and
2. ensure its guidance is current, clear, relevant and supportive of OSFI's commitment to a level playing field.

## IV. Options Identification and Assessment

### Option 1— Status Quo

Under this option OSFI would continue to deal with case-by-case misinterpretations of the E-6 Guidelines through the approval and supervisory processes.

This option would not address the objectives listed above, which poses a potential cost to FRFIs and depositors or policyholders. Under this option there would be no additional benefits to FRFIs, depositors, policyholders or OSFI.

### Option 2 – Guidelines remain unchanged with an increase in on-site examination

Under this option, OSFI supervisors would be required to conduct supervisory reviews of each FRFI to ensure that the policy intent of the regime and the application of the E-6 Guidelines are being correctly followed by the FRFIs. These focused reviews could identify specific common misinterpretations of the Guidelines that could be addressed through the issuance of further guidance notes.

Under this option, depositors and policyholders would benefit because FRFIs that were misinterpreting the Guidelines and, as a consequence, possibly undertaking inappropriate related party transactions, would be identified and appropriate remedial actions taken. Moreover, this option would benefit FRFIs because they would be receiving specific tailored input from OSFI regarding their procedures.

However, this option would require OSFI to devote additional time and resources to complete on-site examination work. The reduced reliance OSFI would be placing on FRFI management and boards for ensuring compliance with applicable legislation and guidelines runs counter to its overall reliance-based regime. Further, the introduction of mandatory supervisory reviews would deviate from OSFI's risk-based supervisory approach, with the result that supervisory focus could be diverted from large risk issues to compliance issues. This option would result in additional costs to OSFI that would be passed on to the FRFIs.

Finally, this approach would likely lead to the issuance of additional guidance, which would require additional OSFI resources to produce.

### Option 3 - Clarify, update and harmonize the guidelines

The revised Guidelines would be clarified and updated with respect to changes in the FRFI legislation. This would cause some categories to be eliminated and, to improve clarity, some new, more descriptive categories to be introduced. The industry specific Guidelines would be consolidated into a single Guideline and harmonized for all institutions, which would create some minor changes for each sector.

This option would require FRFIs to modify their procedures to varying degrees to comply with the new regime. OSFI is of the view that these costs should be minimal.

This option will benefit the interests of depositors and policyholders of FRFIs that have been misinterpreting the Guidelines by reducing the likelihood of undetected inappropriate related party transactions that could affect the safety and soundness of the FRFI.

The materiality criteria would be clarified while maintaining OSFI's risk-based supervisory approach and reliance-based regulatory regime. Moreover, FRFIs would benefit from a level playing field, as each industry sector would be subject to the same criteria.

## V. Consultations

OSFI sought the views of selected FRFIs representing all industry sectors and having various sizes and ownership structures prior to preparing an initial Draft Guideline. These discussions provided insights into the areas of common misunderstanding that required additional clarity. The initial Draft Guideline was discussed with the same group on an informal basis and appropriate changes were made. Subsequently, broad industry consultation was undertaken through industry associations. The industry associations consulted were the Canadian Bankers Association, the Canadian Life and Health Insurance Association, and the Insurance Bureau of Canada. . . . Appropriate changes were made to the Guideline as a result of these consultations.

## VI. Recommendation

Option 3 addresses all objectives outlined above and provides the most effective means of safeguarding depositor and policyholder interests while permitting FRFIs to undertake limited nominal or immaterial related party transactions. This option would be less resource intensive than Option 2 and would more appropriately align with OSFI's framework of risk-based supervision and reliance-based regulation.

## VII. Implementation and Evaluation

Directors of FRFIs are required to report to OSFI annually on the CRC's activities during the year with respect to carrying out its responsibilities to establish and review procedures for complying with the self-dealing regime/*CA S.204(6), BA S.195(6), TLCA S.199(6), CCAA S.200(6)*. . When the revised Guideline is issued, OSFI will recommend that it be referred to the CRCs of FRFIs for review. The CRC's review would be evident in its annual report to OSFI and would be further evidenced in the minutes of the CRC. Through examination of the CRC annual report to OSFI as well as selected CRC minutes, OSFI would be able to evaluate if FRFIs have taken into consideration the revised E-6 Guideline and to ensure that appropriate revised procedures have been implemented.