

How Secure are Canadian Life Insurance Policies?

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The idea for this report came to me in the wake of the widespread concerns caused by the economic crisis which started in 2008.

The press was having a field day reporting the beatings some major life insurance company shares were taking in the market place. Questions were being raised about the life insurance companies' ability to fulfill their obligations to their policyholders. My clients wanted to know whether their policies were still safe and secure.

During my 43 years as a financial advisor, I have always prided myself on exercising the utmost due diligence on behalf of my clients. I felt that they, as well as consumers at large, deserved more than offerings of glib, reassuring platitudes. This called for a professional and realistic response.

It is important to note that because a life insurance company's shares are down, it doesn't follow that its insurance policies are in jeopardy. When individuals buy the shares of an insurance company, they look forward to participating in the growth of the value of those shares, but they have no protection against any drop in value. A policyholder in the same company, on the other hand, benefits from the protection discussed in this report, which applies to the guaranteed features within the various insurance and investment contracts offered by the life insurance company.

Ironically, in certain circumstances, a drop in the share value of a life insurance company may be due to its actions to secure the safety of its policyholders. The protection of policyholders is paramount among an insurance company's priorities. To maintain adequate capital to meet its obligations to its policyholders, a company may take actions that will temporarily reduce its reported earnings, such as moving more assets to its reserves, issuing more shares or cutting dividends to shareholders. The shareholders may lose in the short run, but the policyholders gain security. Ultimately, this will enhance the profitability of the company and benefit policyholders and shareholders alike.

Rating Agencies

In response to their clients expressing "safety worries," the first inclination for many financial advisors was to turn to the rating agencies rankings of the financial institutions with whom they were dealing. Throughout the years these ratings had been heavily used by insurance companies to promote their competitive advantage. I am referring to Standard & Poor's, Moody's, A.M. Best, Fitch Rating and Dominion Bond Rating Service.

In the wake of the collapse of Confederation Life (on Aug 11, 1994), the Globe and Mail on September 13, 1994, admonished that "even people who follow the often repeated advice to buy policies from a top rated company need to keep abreast because companies' ratings can change drastically". It should be noted that Confederation Life received top ratings from the major rating agencies until two years prior to its demise.

In fact, whereas the policies purchased by the consumers are mostly of a permanent nature, i.e. for the lifetime of the insured, the ratings themselves can change drastically in a short period of time. This diminishes the value of these ratings as the basis for selecting a company for one's life insurance needs.

If, at the time of purchase, a client is told that his contract will be safe because the company underwriting the policy enjoys a high rating from the rating agencies, does it follow that if the company gets downgraded later on, the policy will not be safe anymore?

The safety of policies is not provided by the rating agencies. Rating agencies provide an evaluation of the current financial condition of a company. When that condition worsens, so does the rating. *Revised ratings, out of necessity, are always lagging behind the changes that trigger them.* The role of rating agencies is not to try and save a company, only to record its financial position.

The safety of policies is achieved through the cooperative efforts of two organizations that are charged with the responsibility of safeguarding the interest of Canadian policyholders, namely OSFI and Assuris.

A crucial difference between the role of the rating agencies and of the regulatory and consumer protection bodies is that the rating agencies are reactive while the latter are proactive.

OSFI and Assuris, while working closely together, have different but complementary mandates and responsibilities.

OSFI

The Office of the Superintendent of Financial Institutions Canada, created in 1987 by an Act of Parliament, is an independent government agency that reports to Parliament through the Minister of Finance. It has the responsibility for regulating and supervising federally regulated life insurance companies. In exercising this responsibility, OSFI conducts risk-based assessments of the safety and soundness of these companies. The Insurance Companies Act of Canada provides a wide range of discretionary intervention powers that allow OSFI to intervene to address concerns that may arise with federally-regulated life insurance companies.

Continuing changes in the financial markets has led OSFI to constantly review and improve its regulatory regime and supervisory practices to ensure that they remain effective. They are more sophisticated and comprehensive now than they were in the early '90s when Confederation Life was liquidated. It is a *dynamic process* where OSFI is continually challenged to adjust and improve its rules and practices as the industry keeps introducing new life products into the market.

The principal measure used by OSFI to assess the soundness of a life insurer's current financial position is a risk-based capital requirement known as the MCCR (Minimum Continuing Capital and Surplus Requirement). The MCCR ratio compares capital available to capital required as calculated by applying factors for specified risks. A life insurer's minimum capital requirement is the sum of the capital requirements for each of five risk components:

- the asset default risk – both from on-balance sheet asset default and in respect of off-balance sheet exposure; and the loss of market value of equities;

- the mortality/morbidity/lapse risks – resulting from wrong assumptions;
- the changes in interest rate environment risk – associated with asset depreciation arising from interest rate shifts;
- the segregated funds risk – the guaranteed values at payout time may be in excess of the account values;
- the foreign exchange risk – resulting from fluctuations in currency exchange rates.

The ratio is set at 120% rather than 100% because the calculation does not explicitly address other risks, e.g., systems, data, strategic, management, fraud, legal and other operational and business risks, nor risks not explicitly addressed by the actuary when determining policy liabilities.

Even if the minimum ratio is 120%, each life insurance company is expected to establish a target capital level which provides a cushion above minimum requirements to cope with volatility in markets and economic conditions, innovations in the industry, consolidation trends and international developments. An adequate target capital level provides additional capacity to absorb unexpected losses beyond those covered by the minimum MCCR and to address capital needs through ongoing market access. OSFI requires each institution to establish a target total MCCR ratio, at no less than the supervisory target of 150% and expects that insurers have their own target ratio of over 180 to 200%.

If OSFI sees an MCCR ratio decreasing, a number of steps are taken to increase the monitoring of the Federally Registered Life Insurers (FRLI) and OSFI requires the FRLI in question to provide OSFI with plans and actions to correct the situation, and thus improve its ratio. OSFI does not wait until a FRLI ratio is at 150% to take these steps, and OSFI can take control of the FRLI before capital reduction is too significant.

The system aims at ensuring that if and when the time comes for OSFI to take over control of a company, there are sufficient assets still in place to provide for the transfer of the remaining obligations to another insurer or run-off the remaining obligations.

All Federally Regulated Life Insurance Companies must file the MCCR return every calendar quarter. (Of note: on June 30, 2009, the combined MCCR ratio for all FRLIs stood at 232.08%).

Equally important as the Capital Surplus target levels is the quality of the assets earmarked for inclusion in the MCCR calculations. The OSFI Guidelines devote a 25 page chapter to their definition of Capital for this purpose.

The three primary considerations for defining the capital of a company for purposes of measuring capital adequacy are:

- its permanence;
- its being free of mandatory fixed charges against earnings; and
- its subordinated legal position to the rights of policyholders and other creditors of the institution.

The total capital required for MCCSR purposes will comprise two tiers. Tier 1 ("core capital") comprises the highest quality capital elements. Tier 2 ("supplementary capital") elements fall short in meeting either of the first two capital properties listed above, but contribute to the overall strength of a company as a going concern. If there can be some doubt as to the availability of capital (i.e., retraction privileges, uncertainty as to realizable values), it is classified as tier 2. Future income tax liabilities are not included in capital.

All capital instruments must be issued and fully paid for in money or, with the approval of the Superintendent, in property.

The Definition of Capital chapter in the OSFI MCCSR Guideline is highly technical and extremely comprehensive. It addresses every possible aspect of risk and security of any asset class and applies very conservative weightings when ascribing the tier 1 and tier 2 labels. All this is aimed at ensuring that the MCCSR requirements are based on a rock solid foundation.

The MCCSR returns submitted to OSFI must be verified by FRLI Auditors and FRLI Appointed Actuaries, who must sign an opinion stating that they followed these rules. These professionals are responsible under the professional code of conduct of the Canadian Institute of Chartered Accountants and the Canadian Institute of Actuaries, and OSFI may inform those Institutes of any false declarations.

OSFI's supervisory activities and responsibilities will adjust to stay in tune with the company's financial condition, policies and procedures. To this end, OSFI monitors the ratios of each FRLI regularly using an electronic file of all the data submitted in the MCCSR returns. In addition, OSFI regularly reviews other information submitted. Teams of supervisors (accountants, actuaries, investment specialists, etc.) perform on-site reviews and verifications of the FRLIs to check their processes.

These supervisory activities can, if necessary, lead OSFI to becoming progressively more directly involved in the company's affairs, depending on how successfully the company responds to OSFI's requirements. At the earliest sign of potential problems, OSFI establishes a 4 stage progressive warning system.

The Staging Process

If OSFI determines that the practices, conditions and circumstances do not indicate significant problems or control deficiencies, the company will not typically be staged. When a company is not staged, OSFI has determined that the combination of the company's overall net risk, capital and earnings makes the company resilient to most normal adverse business and economic conditions. The company's performance has been satisfactory to good, with most key indicators comparable or in excess of industry norms. The company may have access to additional capital and is able to address supervisory concerns that might arise.

Stage 1 – Early warning – If a company is categorized as Stage 1, OSFI has identified deficiencies in the company's financial condition, policies or procedures or the existence of other practices, conditions and circumstances that could lead to the development of problems at Stage 2 if they are not promptly addressed.

The following conditions could lead to OSFI categorizing a company as Stage 1:

- the combination of the company's overall net risk and its capital and earnings compromises the company's resilience.
- the company has issues in its risk management or control deficiencies, although not serious enough to present a threat to financial viability or solvency which could deteriorate into more serious problems if not addressed.

In addition, to its normal activities, at Stage 1, OSFI's activities/responsibilities may involve:

- Formally notify management, board of directors and external auditor of the company by way of a supervisory letter that the company is at stage 1 and required to take measures to mitigate or rectify the identified deficiencies.
- Meeting with management, board of directors (or a committee of the board) and/or the external auditor of the company to outline concerns and discuss remedial actions.
- Sending a notice of the assessment surcharge to the company.
- Monitoring the company on an escalating basis by increasing the frequency of reporting requirements and/or expanding the level of detail of information that the company is required to submit.
- Conducting enhanced or more frequent supervisory reviews, or directing the company's internal specialists to conduct reviews that focus on particular areas of concern such as asset valuations or policy liability valuations.
- Entering into a prudential agreement with the company for the purposes of implementing any measure designed to maintain or improve the safety and soundness of the company.
- Requiring the company to increase its capital.
- Imposing business restrictions on the company in appropriate circumstances and/or issuing a direction of compliance in appropriate circumstances.

Stage 2 -- Risk to financial viability or solvency – At Stage 2, the company poses material safety and soundness concerns and is vulnerable to adverse business and economic conditions.

One or both of the following conditions would likely lead OSFI to classify a company as Stage 2:

- The combination of the company's overall net risk and its capital and earnings may pose a serious threat to its financial viability or solvency unless effective corrective action is implemented.
- OSFI has identified issues in the company's risk management that, although not serious enough to present an immediate threat to financial viability or solvency, could deteriorate into more serious problems if not addressed promptly.

In addition to its activities at the preceding stages, OSFI's activities/responsibilities may involve:

- Enhanced monitoring of remedial measures through imposing more frequent reporting requirements.
- Conducting follow-up supervisory reviews more frequently and/or enlarging their scope.
- Requiring the company to incorporate in the business plan appropriate remedial measures aimed at rectifying problems within a specified time frame.
- Requiring the company's external auditor to enlarge the scope of the review of the financial statements and/or to perform other procedures and prepare a report thereon. Note - OSFI may assign the cost of the external auditor's work to the company.
- Requiring the company to conduct a special audit to be performed by an auditor other than the company's external auditor. Note - OSFI may assign the cost of the auditor's work to the company.
- Requiring the appointed actuary to provide policy liabilities calculated using alternate assumptions or methods.
- Requiring an external actuary to perform a special review of the company's actuarial reserves.
- Developing a contingency plan to enable OSFI to be ready to take control of the assets of the company or the company itself in case of rapid deterioration.

Stage 3 -- Future financial viability in serious doubt – If a company is categorized as Stage 3, OSFI has identified that the company has failed to remedy the problems that were identified at Stage 2 and the situation is worsening. One or both of the following conditions pose a serious threat to the company's financial viability or solvency unless effective correction action is promptly undertaken.

- The combination of the company's overall net risk and its capital and earnings makes it vulnerable to adverse business and economic conditions.
- The company has serious issues in risk management or control deficiencies.

In addition to its activities at the preceding stages, OSFI's activities/responsibilities may involve:

- Directing external specialists or professionals to assess certain areas such as quality of assets, liquidity, sufficiency of reserves, sufficiency of policy liabilities, reliability of reinsurance arrangements, etc.
- Enhancing the scope of business restrictions that have already been imposed on the company and/or expanding the level of detail of information that the company is required to submit to OSFI.

- OSFI staff being present at the company to monitor the situation on an ongoing basis.
- Expanding contingency planning. Communicating to management and the board of directors of the company the importance of considering resolution options such as restructuring the company or seeking out a prospective purchaser.

Stage 4 – Non-viability/ insolvency imminent – If a company is categorized as Stage 4, OSFI has determined that it is experiencing severe financial difficulties and has deteriorated to such an extent that the statutory conditions for taking control have been met.

These statutory conditions are listed in section 679 (1.1) of the Insurance Companies Act. It states that control by the Superintendent may be taken where

- the company, has failed to pay its liabilities or, in the opinion of the Superintendent, will not be able to pay its liabilities as they become due and payable;
- the assets of the company, are not, in the opinion of the Superintendent, sufficient to give adequate protection to its policyholders and creditors;
- any asset appearing on the books or records of the company, held under its administration is not, in the opinion of the Superintendent, satisfactorily accounted for;
- the regulatory capital of the company has in the opinion of the Superintendent, reached a level or is eroding in a manner that may detrimentally affect its policyholders or creditors;
- the company has failed to comply with an order of the Superintendent to increase its capital or with an order of the Superintendent to transfer all or any portion of its policies to, or cause itself to be reinsured, against all or any portion of the risks undertaken under its policies, by any company, society, foreign company or body corporate that is authorized to transact the class of insurance to be so transferred or reinsured.
- in the opinion of the Superintendent, any other state of affairs exists in respect of the company, that may be materially prejudicial to the interests of the company's policyholders or creditors or the owners of any assets under the company's administration.

Once the Superintendent has taken control of the company it can request that the Attorney General of Canada apply for a winding-up order in respect of the company.

If, after thirty days of having taken control the Superintendent has not made a request to the Attorney General of Canada to apply for a winding-up order, the board of directors of the company can request the Superintendent to relinquish control.

The Superintendent must, not later than twelve days after receipt of this request,

- (a) comply with the request, if the Superintendent is of the opinion that the circumstances leading to the taking of control by the Superintendent have been substantially rectified and that the company can resume control of its business and affairs; or

- (b) request the Attorney General of Canada to apply for a winding-up order in respect of the company where the assets of the company or the company itself is under the control of the Superintendent.

At this point, OSFI will have completed its regulatory and supervisory duties and will hand the responsibility of protecting the policyholders to Assuris.

Assuris

Assuris, formally known as Comcorp, was founded in 1989. It is a not for profit organization, funded by the life insurance industry and endorsed by the Government of Canada. Its mission is to mitigate the impact on Canadian policyholders of the financial failure of a member life insurance company. Its role is to protect policyholders by minimizing loss of benefits and ensuring a quick transfer of their policies to a solvent company where the contractual benefits will continue to be honoured.

In May of this year, at a convention of financial brokers in Toronto, Josee Rheault, an Assuris vice-president of communications, confirmed that Assuris has access to an immediate liquidity fund of \$120,000,000 to fund insolvency claims and it has the legal authority to collect \$4.5 billion from its members to deal with insolvency claims.

She went on to explain that in a worst-case scenario, Canadian policyholders would have 85% coverage for guaranteed values in excess of prescribed minimum amounts. As was the case in insolvencies in the past, such as Confederation Life, policyholders will usually get 100% of their value returned to them since it's Assuris' mandate to ensure that the solvent insurer can acquire the policies of a failed competitor and continue coverage.

Assuris and the Staging Process

Although there are no regular supervisory interactions between Assuris and member companies, Assuris will closely follow any concerns that come to light through OSFI's supervisory activities. Should a situation reach the point where a company has become insolvent, Assuris will step up to carry out its consumer protection mandate, once the company has been placed under the control of OSFI.

Assuris is at all times working hand in hand with OSFI in keeping track of the financial condition and operating performance of the company.

When a company is classified as **Stage 2** (see page 5), Assuris may:

- Request and analyzing information from OSFI including:
 - Business plan obtained from the company reflecting its remedial measures;
 - Reports and results of OSFI regulatory and special examinations;
 - Mandate, scope and results of work done by auditors; and
 - Mandate, scope and results of work completed by actuaries.
- Hire consultants to provide in-depth analysis of critical areas. Note - OSFI will treat these consultants in the same manner as senior Assuris management so long as appropriate confidentiality agreements are in place.

- Develop a preliminary restructuring plan.

When a company is categorized as **Stage 3**, Assuris' activities/responsibilities may involve:

- Declare the company to be a “troubled member”.
- Develop a detailed restructuring plan.
- Estimate its coverage exposure.
- Evaluate whether to make a financial commitment to support the restructuring plan depending on the circumstances in order to reduce its potential exposure.
- Formulate a detailed contingency plan for managing liquidation and funding its coverage commitments.

At **Stage 4**, OSFI has determined that the company will become non-viable on an imminent basis.

When a company is categorized as Stage 4, Assuris' activities/responsibilities may involve:

- Obtaining board commitment to provide coverage in the event of liquidation.
- Proceeding with planning an assessment to raise funds required to meet coverage obligations in anticipation of the *Winding-up Order* being issued.
- Where appropriate, planning for an orderly commencement to liquidation with the assistance of the appointed liquidator, including:
 - preparing a closure manual designed to assist with issues and procedures arising immediately upon liquidation;
 - training information officers to handle public inquiries;
 - establishing funding and reporting arrangements during liquidation; and
 - developing strategies with the liquidator for operating the company in liquidation.

Past Insolvencies

Shortly after Assuris came into being in 1990 they were called upon to deal with the only three insolvencies in the life insurance industry in Canada – Les Coopérants, (Jan 3, 1992), Sovereign Life, (Jan 18, 1993), and Confederation Life, (August 11, 1994). In addition to financial support, Assuris quickly developed expertise to resolve the unique and largely unprecedented issues in a life insurance company insolvency affecting Canadian policyholders. *In all three cases, all the Canadian policies were ultimately transferred to solvent life insurance companies.*

When Confederation Life Insurance Company was seized by regulators on August 11, 1994, it was the single largest life insurance company to fail on the North American continent. What led to its demise makes a compelling narrative in Rod McQueen's extensively researched book – *Who Killed Confederation Life? The Inside Story*, published in 1996.

With operations in Canada, the United States and the United Kingdom, Confederation Life was an internationally complex liquidation. In Canada alone it had obligations to 260,000 individual policyholders and another 1.5 million people who participated in group insurance plans.

The troubles at Confederation Life were rooted in its insatiable appetite for real estate. By 1989, 73.8% of Confederation's assets were invested in real estate or mortgages. At that time, the real estate market was beginning to sour, with Confed's portfolio at a dangerously high level. According to a 1989 survey by rating agency Duff & Phelps, holdings in real estate and mortgages by Confed, in that year, were 28.5% of total assets at Manulife - 32.1% at SunLife - 35.9% at Canada Life and 42.2% at Great West, which had already begun to decrease its portfolio.

Duff & Phelps also supplied another ominous comparison in its 1989 report: debt financing as a percentage of surplus. Again, Confed was out of whack at 141.3%, compared with the more conservative SunLife at 3.5%.

The warnings went unheeded. Pat Burns, Chairman and CEO at the time, realized that "we had gradually been consuming our available capital.....the funds that we deem over and above those necessary to meet our obligations and therefore free for developmental investing".

Unfortunately, the company leadership was so wrapped up in their culture of fast growth and reckless acquisitions that they were unable to reverse the course. As early as 1989, OSFI Superintendent Michael Mackenzie issued his first warning that Confed was sailing perilously to the edge of the world.

In October of 1991, Superintendent Mackenzie delivered the Confed board its second wake up call declaring that poor real estate and insufficient financial controls were weakening financial strength.

By 1993, Confederation Life started to negotiate strategic alliances with other insurers in the hope of securing substantial capital injections. By July 1994, efforts were directed through OSFI and the department of Finance to see how Ottawa could help.

On August 10, 1994, in light of the general failure to raise capital, then Superintendent Labarge informed Confederation Life president Paul Cantor that she will recommend that the government invoke the Winding-Up Act.

On August 11, 1994, the liquidation of Confederation Life began. Secretary of State Doug Peters orders OSFI to take control of Confederation Life Insurance Co. and Confederation Trust.

Superintendent Labarge tells the Confed board that time is up; Peat Marwick Inc. is appointed agent of OSFI and an application is made to the attorney general of Canada to wind-up the company. Liquidators arrive at 10:40 p.m., Confed is out of business. Compcorp (now Assuris) announces that it will protect Confed policyholders up to its published limits.

The process, supervised by Assuris, to transfer various Confed blocks of business to solvent companies took roughly 1.5 years. In the meantime, *all annuity and disability payments continued without interruption* and in the end, the result was full recovery for all policyholders. Canada's enviable record of protecting Canadian policyholders' benefits remained intact.

Conclusion

In the wake of the Confederation Life experience, OSFI has been tightening its regulatory and supervisory practices to the point that it is highly unlikely that a federally regulated life insurer will ever again be allowed to deteriorate to the level that Confederation Life did.

No one truly knows how well a system works, until it is tested. Through the great trial Confederation Life presented to our regulators, we have had, here in Canada, the opportunity to develop one of the most rigorously regulated financial service industries in the world.

I am confident that the OSFI rules and processes combined with the protective role played by Assuris are appropriate to safeguard Canadian policyholders from the possibility of losing any guaranteed benefits from a Federally Regulated Life Insurance Company.