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AUTORITÉ DES MARCHÉS FINANCIERS

CAPITAL MANAGEMENT GUIDELINE

April 2015

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Preamble

The *Autorité des marchés financiers* ("AMF") establishes guidelines setting out its expectations with respect to the legal requirement of financial institutions to follow sound and prudent management practices. These guidelines therefore cover the interpretation, execution and application of this requirement.

The AMF favours a principles-based approach rather than a specific rules-based approach. As such, the guidelines provide financial institutions with the necessary latitude to determine the requisite strategies, policies and procedures for implementation of such management principles and to apply sound practices based on the nature, size and complexity of their activities. In this regard, the Guideline illustrates how to comply with the principles.

AMF Note

The AMF considers governance, integrated risk management and compliance (GRC) as the foundation stones for sound and prudent management of financial institutions and, consequently, as the basis for the prudential framework provided by the AMF.

The following guideline is part of this approach and sets out the AMF's expectations regarding sound and prudent capital management practices.

Scope

The Capital Management Guideline is intended for insurers of persons, damage insurers, and portfolio management companies controlled by an insurer, mutual insurance associations, financial services cooperatives as well as trust and savings companies, which are governed by the following Acts:

- *An Act respecting insurance*, CQLR, c. A-32;
- *An Act respecting financial services cooperatives,* CQLR, c. C-67.3;
- *An Act respecting trust companies and savings companies*, CQLR, c. S-29.01.

This guideline applies to financial institutions operating independently as well as to financial institutions operating as members of a financial group.[1] In the case of financial services cooperatives and mutual insurance associations that are members of a federation, the standards or policies adopted by the federation should be consistent with—and even converge on—the principles of sound and prudent management prescribed by law and detailed in this guideline.

The generic terms “financial institution” and “institution” refer to all financial entities covered by the scope of this guideline.

[1] For purposes of this guideline, “financial group” refers to any group of legal persons composed of a parent company (financial institution or holding company) and legal persons affiliated with it.

Coming into effect and updating

The Capital Management Guideline will come into effect on April 1, 2015.

With respect to the legal requirement of institutions to follow sound and prudent management practices, the AMF expects each institution to develop strategies, policies and procedures based on its nature, size, complexity and risk profile, to ensure the adoption of the principles underlying this guideline as soon as it comes into effect. The AMF expects an institution that has already implemented such a framework to satisfy the requirements prescribed by law.

This guideline will be updated based on developments in capital risk management and in light of the AMF's observations in the course of its supervision of financial institutions.

Introduction

The ability of financial institutions to fulfill their obligations toward their clients is a fundamental component of sound and prudent management practices. A financial institution's capital[2] plays an essential role in this regard since one of its main functions is to ensure that commitments to insureds and depositors are met.

With this in mind, the AMF issues expectations regarding capital adequacy. They are specifically described in guidelines[3] which set out in detail the regulatory capital levels according to the sector concerned, based on the risks assumed by the financial institutions. These guidelines essentially form a basis for sound and prudent capital management by establishing and comparing an institution's capital needs and its available capital to ensure they meet the requirements.

The purpose of this guideline is to set out the principles which should guide the management of capital by financial institutions more globally, before determination of the regulatory minimum level of capital. Capital management is a very broad process which covers not only capital adequacy, but also all the strategies, policies and procedures used by an institution to determine and plan its capital. Regulatory requirements, risk appetite, risk profile, economic imperatives, environment and strategic planning must all form part of this process.

This guideline discusses several important aspects of capital management, including governance and reporting practices related to capital management, the establishment of an internal capital level consistent with its risk profile, the choice of strategies for mobilization of capital, and aspects relating to the quality and composition of capital.

International standards pertaining to sound and prudent risk management, set out by bodies such as the Basel Committee on Banking Supervision[4] and the International Association of Insurance Supervisors[5], encourage regulators to provide a framework which requires institutions to adopt a forward-looking view, particularly with respect to the management of their capital. The AMF adheres to these principles and believes that the quality of capital management is essential to a financial institution's survival. Accordingly, the expectations in this guideline are based on the fundamental principles set out by these bodies.

2 For the purpose of this document, the words "capital" and "equity" are considered equivalent.

3 *The Capital Adequacy Requirements Guideline* (CAR) - insurers of persons;

The Capital Adequacy Requirements Guideline (MCT) - P&C insurers;

The Adequacy of Capital Base – financial services cooperatives and the Capital Adequacy Guideline – credit unions not members of a federation, trust companies and savings companies

4 Bank for international settlements, Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision*, September 2012

Bank for international settlements, Basel Committee on Banking Supervision, A Sound Capital Planning Process: Fundamental Elements, January 2014.

5 International Association of Insurance Supervisors, *Insurance Core Principles, Standards, Guidance and Assessment Methodology*, October 2011, ICP 9 amended October 2012, ICP 22 amended October 2013.

1. Capital Management

AMF Note

The AMF expects capital management to be integrated into all risk management activities, including the stress testing program, the statement of its risk appetite and the establishment of its risk tolerance levels.

Capital is a crucial component of a financial institution's solvency and its management is intrinsically related to its risk-taking. In this regard, the AMF expects each financial institution to set up a process for assessing its risks and solvency which allows it to identify the relationships between its various activities, facilitating decision-making by taking account of its capital level, risk appetite and business strategies.

The AMF considers that an institution should attempt to integrate its activities dynamically, consistently and proactively so it can take advantage of opportunities to obtain capital on favourable terms and thus reduce the risk of adverse situations. The impacts of activities as well as their interdependence should also be considered significant variables of capital management.

The institution should also have a broad vision and take account of elements such as procyclicality, strategic targets, economic imperatives, investor perception, the expectations of regulatory organizations and, for financial groups, possible capital transfers within them. In doing so, the financial institution's main objective should be to reduce the likelihood of default and its impact in the event of a particularly adverse shock.

For institutions operating as members of a financial group, the AMF considers that capital management should be carried out at all levels of the organization:

- At the level of the financial group, it should take account of intra-group cash flow, the fungibility of capital among the various entities, contagion risk, the overlapping use of funds and possible limitations when capital is invested abroad;

- At the level of each entity, capital management should allow the establishment of target levels for such entities autonomously based on their nature, size, environment and the regulatory requirements specific to them.

Lastly, capital management should be established and supported by an adequate organizational strategy in order to manage risk optimally.

2. Governance

AMF Note

The AMF expects a financial institution's capital management to be supported by a sound governance structure allowing the roles and responsibilities of the parties involved to be clearly defined.

The board of directors is responsible for overseeing the management performed by the institution's executives. It must therefore ensure that the necessary measures are set up to achieve its objectives.

Senior management must develop the financial institution's organizational structure, strategies, plans, operational objectives and control measures and, in this sense, demonstrate to the board of directors that the strategies, policies and procedures that have been set up are adequate.

These decision-making bodies are also responsible for integrating capital management opportunities that have been identified into strategic thinking and the goal-setting process.

Roles and responsibilities of the board of directors

With regard to the expectations outlined by the AMF in the Governance Guideline[6], the board of directors has ultimate responsibility for sound and prudent capital management. In particular, it should:

- Ensure that the institution establishes and maintains an appropriate level of capital in view of regulatory requirements as well as its environment, strategic plan, risk profile and economic imperatives.
- Approve capital management strategies and policies and examine the underlying procedures, which should deal with, among other things, the target level and availability of capital the institution needs to carry on its current and planned activities as well as the strategies for recovering capital in a crisis or in the case of an unexpected shock which could require additional capital. They should also be the subject of periodic reviews.
- Remain aware of the results of the stress testing program, and more specifically, validate the proposed strategies and corrective measures in situations where the capital falls below the target level.

Roles and responsibilities of senior management and the chief risk officer

For capital management, the roles and responsibilities of senior management as well as the chief risk officer are primarily to:

6 Autorité des marchés financiers, *Governance Guideline*, April 2009.

- Develop a capital management framework adapted to the institution's risk profile and strategic plan;
- Implement, manage and ensure the monitoring of the capital management framework;
- Ensure that a process for own risk and solvency assessment[7] is designed and set up to strengthen the institution's more general integrated risk management framework;
- Establish terms of communicating with and turning to higher levels in the organization in response to major changes involving the environment, the institution's risk profile or any other element which could affect the level, quality or composition of capital.

7 This process is often called ORSA ("Own Risk and Solvency Assessment") for insurers and the ICAAP ("Internal Capital Adequacy Assessment Process") for deposit institutions. The AMF's expectations regarding these processes are indicated in section 5.

3. Capital management framework

AMF Note

The AMF expects the institution to implement a capital management framework consistent with its risk profile as well as a strategy to maintain adequate capital levels at all times and restore them in a crisis or following a major adverse shock.

The capital management framework is made up of strategies, policies and procedures which allow a financial institution to assess the quality of its capital and maintain it at an adequate level, according to its risk profile.

This framework should be efficient, permanent and evolving. It should be adapted to the institution's risk profile and be strongly based on the findings from its own risk and solvency assessment process, taking into consideration the material risks and the funds which could be required if they materialize.

Taking into account the size, nature, complexity of the activities, and risk profile of each financial institution, the capital management framework should provide, among other things:

- Identification of the roles and responsibilities relating to the implementation of capital requirement strategies and policies;
- Policies setting the target capital level and stating the capital adequacy objectives based on:
    - Risk appetite and risk tolerance levels;
    - Risk profile;
    - Economic imperatives;
    - Strategic plan.
- Measures for identifying and declaring material risks which could require capital;
- Procedures allowing the assessment of the level of overall capital adequacy based on risk and the strategic plan;
- Internal control, review and validation mechanisms to ensure adequate capital taking into account regulatory requirements and the financial institution's needs;
- Limits and restrictions regarding the quality and composition of capital;
- Strategies to be preferred in terms of capital mobilization according to circumstances;
- Corrective measures which could be taken by senior management in a crisis or following a major shock;
    - The frequency of approval processes and the review of decisions.

4. Regulatory, target and excess capital

The AMF expects the financial institution to not only meet the capital requirements but also to establish target capital levels reflecting its situation considering a range of risks and more comprehensive strategic considerations.

Under the laws the AMF administers, financial institutions are required to maintain adequate capital to ensure sound and prudent management[8].

The minimum regulatory capital requirements corresponding to this obligation are established by the different capital guidelines issued by the AMF[9]. Since those requirements are based on standardized assumptions applicable to the entire industry, they cannot perfectly reflect the particular risk profile of each institution. The guidelines therefore state that a financial institution should maintain additional capital levels to reflect its specific risk profile and have a margin to cover its other needs.

There are several incremental levels of capital:

Regulatory capital:

This level refers to the different levels established by the AMF, namely the minimum and, where applicable, target level established for oversight purposes, in accordance with the framework provided for capital adequacy. An additional requirement may be added to these levels to reflect an institution's systemic nature.

Target capital[10]:

This level refers to the required level of capital determined by the institution in connection with its activities, its stress testing scenarios and the establishment of its risk appetite. It takes into account the institution's strategic plan as well as all the risks it could face in connection with its current and planned activities, such as reputation risk, strategic risk and risk related to access to market capital.

Since the target capital should consider a broader range of risks, the AMF expects its level to exceed that of regulatory capital requirements.

Excess capital:

This level refers to the available capital exceeding the target capital as established by the institution. It is normally maintained for strategic purposes. For example, additional capital could be maintained to carry out acquisitions and projects, achieve or maintain a credit rating or simply absorb annual variations in the financial results.

8 *An Act respecting insurance*, CQLR, c. A-32, section 275; *An Act respecting financial services cooperatives*, CQLR, c. C-67.3, sections 441 and 451; *An Act respecting trust companies and savings companies*, CQLR, c. S-29.01, section 195.

9 See footnote 3.

10 For insurers, the term “internal target capital" is mainly used in one or more contexts in which internal models are used to establish the capital level. The term "economic capital" is more commonly used for deposit institutions.

5. Own risk and solvency assessment

The AMF expects the financial institution to establish its internal target capital level in a prudent and forward-looking manner, setting up an own risk and solvency assessment mechanism adapted to its nature, size and the complexity of its activities.

It is up to each financial institution to set up a mechanism allowing it to identify its material risks and assess them based on its capital.

An own risk and solvency assessment mechanism is a set of iterative processes designed to assess, in an ongoing and forward-looking manner, a financial institution's material risks and the capital required to support them. This tailored alignment of risks with capital is key to and an indispensable part of a financial institution's integrated risk management.

In concrete terms, this mechanism may be seen as a set of activities carried out jointly, iteratively and consistently according to a process with risk appetite as the starting point. It includes all steps of a normal risk management process, from risk identification and monitoring through the deployment of the business strategy and an analysis of risk conduct in extreme scenarios. The results of this analysis could trigger a reconsideration of the appetite for certain risks, coming full circle back to the beginning of the iterative process.

In addition to the close relationship of this mechanism with the Integrated Risk Management Guideline[11], some of the AMF's expectations set forth in the governance[12], stress testing[13] and capital adequacy[14] guidelines are also closely associated with it.

The added value of this mechanism therefore lies in formally and continually taking into account existing relationships between the institution's solvency, risk profile and strategic goals as well as the impacts they may have on each other.

The AMF expects the application of the own risk and solvency assessment mechanism to be the subject of an official report to the board of directors at least once a year, or more often if the financial institution's risk profile changes significantly. The report should contain enough information to allow the board to assess the institution's results based on its risk profile and factors which could jeopardize its capital and solvency.

11 Autorité des marchés financiers, *Integrated Risk Management Guideline*, April 2015.

12 Autorité des marchés financiers, *Governance Guideline*, April 2009.

13 Autorité des marchés financiers, *Stress Testing Guideline*, June 2012.

14 See footnote 3.

The AMF therefore considers that an institution that is able to integrate its own risk and solvency assessment processes dynamically, consistently and proactively in connection with its capital needs and all the expectations stemming from AMF governance, integrated risk management, stress testing and capital adequacy guidelines, is able to establish a prudent and forward-looking internal target capital level.

6. Mobilization of additional capital

AMF Note

The AMF expects the financial institution to set up an informed, prudent and forward-looking capital mobilization strategy which takes into account the risks and limitations which could prevent it from accessing its capital during a crisis.

Based on different crisis scenarios, the institution should be able to anticipate and set up a capital mobilization strategy for situations in which risks could cause the capital to fall below the target level.

This process is especially important in that institutions should not assume that capital will be easily accessible when they need it, but should consider instead the fact that in certain circumstances, access to capital on the markets could become more difficult. As a result, an institution should act in a forward-looking manner and mobilize additional capital in anticipation of such adverse circumstances.

The financial institution should also analyze the different characteristics of its assets and liabilities and their potential impact on its solvency taking into account their volatility and potential evolution, among other things. When it reduces its risks or obligations through intragroup transactions, reassurance or securitization, the institution should ensure that it captures all risks related to such transactions. Where appropriate, the financial institution should also ensure that it meets the expectations set forth in the Reinsurance Risk Management Guideline[15] and the Securitization Risk Management Guideline[16]. The Liquidity Risk Management Guideline[17] also sets forth the AMF's expectations in connection with financing and capitalization to facilitate the institution's access to capital so that it is able to meet its obligations without disturbing current operations.

More generally, the institution should:

- Give particular importance to relationships with its capital providers, as the quality of those relationships could be crucial in a crisis period;
- Identify the main capital mobilization risks resulting from its financial structure, internal operations, risk profile and market conditions;
- If it is a member of a financial group, take into account the capital interdependencies between the different entities of the group and the impacts of those relationships on its ability to mobilize additional capital.

15 Autorité des marchés financiers, *Reinsurance Risk Management Guideline*, July 2013.

16 Autorité des marchés financiers, *Securitization Risk Management Guideline*, April 2009.

17 Autorité des marchés financiers, *Liquidity Risk Management Guideline*, April 2009.

7. Quality and composition of capital

AMF Note

The AMF expects a financial institution to be particularly mindful of the quality and composition of its capital. Accordingly, the institution should take into consideration the specific characteristics of its capitalization instruments and the risks inherent in their use while ensuring that it complies with applicable regulatory capitalization criteria and limits.

Capital quality refers to a financial institution's ability to absorb losses both in its normal course of business and in a crisis or liquidation. The capital should therefore include subordination in the rights of insureds or depositors if the institution is in a crisis or being liquidated.

The AMF's capital adequacy guidelines thus distinguish different categories of capitalization instruments. The highest quality capital usually includes instruments with the capacity to absorb losses under all circumstances and that are ultimately subordinated to the rights of insureds and depositors.

Capitalization instruments which do not qualify as being in the highest quality category may be divided into sub-categories based on their nature and compliance with the criteria and limits applicable to them. Contrary to higher category instruments, the criteria used in such cases are less restrictive, and thus of lower quality in the case of liquidation.

There are also instruments that are not eligible for the categories provided or have limited recognition in calculating regulatory capital. The institution could consider some of these financial instruments for the purpose of determining its excess or strategic capital, although it should be sure to identify the main risks potentially related to such instruments and provide adequate disclosure of their use to all interested parties.

Given these categories and the criteria associated with them, each institution could ensure it diversifies its capital instruments and establishes its own limits and ratios to ensure it maintains adequate levels of capital in the desired proportions. This will help maintain public confidence in the financial institution and facilitate access to capital in the future.

Supervision of sound and prudent management practices

To foster the establishment of sound and prudent management practices within financial institutions, the AMF, acting within the scope of its oversight activities, intends to assess the degree of compliance with the principles set forth in this guideline. Consequently, it will examine the effectiveness and relevance of the procedures implemented as well as the quality of the oversight and control exercised by the board of directors and senior management.

Capital management practices are constantly evolving. The AMF therefore expects decision makers at financial institutions to keep abreast of best practices in this area and to adopt them, to the extent that they address their needs.