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FINANCIERS

# CAPITAL ADEQUACY REQUIREMENTS GUIDELINE

Self-Regulatory Organizations

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## **Chapter 1. Introduction and general guidance**

### **1.1 Introduction**

#### **1.1.1 Guideline objective**

Section 182 of the *Insurers Act*, ~~S.Q. 2018, c. 23, s. 3~~, (CQLR, chapter A-32.1) (the “Act”) includes a requirement that an authorized self-regulatory organization (SRO) must, in the financial management of its insurance business, adhere to sound and prudent management practices to ensure that its insurance fund maintains:

- adequate assets to meet the liabilities charged against the fund, as and when they become due; and
- adequate capital to guarantee the sustainability of the SRO’s insurance business.

The Act also provides that the *Autorité des marchés financiers* (the “Authority” or the “AMF”) may establish guidelines applicable to SROs pertaining specifically to such sound and prudent managements practices.<sup>1</sup>

The purpose of these guidelines is to increase the transparency and predictability of the criteria used by the AMF in assessing the quality and prudence of the management practices of the financial institutions for which those criteria are intended. The ability of these institutions to meet their obligations to investors and policyholders is key to achieving this objective. This principle is reflected in the capital adequacy requirements for SROs set forth in this guideline.

The risk-based capital adequacy framework is based on an assessment of insurance risk, market risk, credit risk and operational risk through the application of various risk factors and margins. SROs are required to meet a **capital available to capital required** test. The definition of capital available to be used for this purpose is described in Chapter 3 and is calculated on a consolidated basis.

The *Capital Adequacy Requirements Guideline – Self-Regulatory Organizations* outlines the capital framework using a risk-based formula for target capital requirements and minimum capital requirements and defines the capital that is available to meet the minimum standard. The Minimum Capital Test (MCT) determines the minimum capital required and not the optimum capital required at which an SRO must carry on its insurance activities.

#### **1.1.2 Scope of application**

This guideline applies to all SROs created under the Professional Code or the *Real Estate Brokerage Act* (CQLR, c. 73.2) which are authorized to carry on insurer activities. It applies on a consolidated basis to the insurance fund’s financial statements in accordance with

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<sup>1</sup> Section 187 of the Act.

the International Financial Reporting Standards (IFRS) adopted by the Canadian Accounting Standards Board as Canadian generally accepted accounting principles (CGAAP). Accordingly, each component of capital available and capital required is calculated in such a way as to include all of the SRO's operations in connection with its insurance-related activities.

For purposes of this guideline and in order to simplify the text, the use of the generic term "SRO" should be interpreted as referring, depending on the context, to the SRO within the scope of its insurance activities or to the insurance fund belonging to the SRO.<sup>2</sup>

Moreover, in this guideline, non-qualifying subsidiaries<sup>3</sup> should be deconsolidated and accounted for using the equity method. Interests in non-qualifying subsidiaries are ~~therefore~~ excluded from capital available and capital required calculations, as are loans or other debt instruments issued to them if they are considered as capital in the entity ([Section 3.4](#)).

### 1.1.3 Effective date

This ~~updated~~ guideline ~~is effective as of January 1, 2020.~~ ~~will come into effect on June 13, 2019.~~

### 1.1.4 Clarification

Unless the context indicates otherwise, in this guideline, concepts pertaining to corporate relationships, such as subsidiaries, associates, joint ventures and related enterprises, as well as terminology, should be interpreted in accordance with CGAAP.

Assets and liabilities of subsidiaries consolidated for the purposes of this guideline are therefore subject to risk factors and asset and liability margins in the SRO's MCT.

### 1.1.5 Interpretation

This guideline sets out the AMF's capital requirements in relation to the main insurance risk management activities and other financial operations commonly carried out by an SRO.

Because the requirements set forth in this guideline are intended mainly as guidance for managers, the terms, conditions and definitions contained herein may not cover all situations arising in practice. The results of applying these requirements should therefore not be interpreted as being the sole indicator for assessing an SRO's financial position or

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<sup>2</sup> Divisions I and II of Chapter XVI of Title III of the ~~Act~~ ~~Insurers Act~~ (S.Q. 2018, c. 23, a. 3) apply, respectively, to the insurance activities of an SRO and to its insurance fund .

<sup>3</sup> ~~Under this guideline, a subsidiary that is a dissimilar regulated financial institution, such as a bank, trust company, savings company or life and health insurer, and a subsidiary that is not a legal person under section 85 of the Act, are non-qualifying subsidiaries. See Section 3.4 for the definition of "non-qualifying subsidiary".~~

the quality of its management. SROs are expected to submit to the AMF beforehand, where applicable, any situation whose treatment is not covered in this guideline or for which the recommended treatment seems inadequate. This also applies with respect to any issue arising from an interpretation of the requirements set forth in this guideline.

Furthermore, despite the stated requirements, in any case where the AMF believes that the capital treatment is inappropriate, a specific capital requirement may be determined.

## **1.2 Risk-based capital adequacy**

The AMF expects SROs to meet the MCT capital requirements at all times. To be considered capital available, capital instruments must meet certain qualifying criteria and are subject to capital composition limits and deductions and adjustments (reference Chapter 3). Under this guideline, the notion of capital encompasses capital available within any entity consolidated for the purpose of calculating the MCT ratio.

Under the MCT, capital requirements for various risks are set directly at a pre-determined target confidence level. The AMF has elected 99% of the expected shortfall (conditional tail expectation or CTE 99%) over a one-year time horizon as a target confidence level.<sup>4</sup>

As a first step, the risk factors defined in this guideline are used to compute the target capital requirements on a consolidated basis. The SRO's minimum required capital is then determined as the sum of the target capital requirements for each risk component, less the diversification credit, the result of which is divided by 1.5.

The target capital requirements are calculated as follows:

*Sum of:*

- capital required for insurance risk (reference Chapter 4):
  - margins required for unpaid claims and premium liabilities;
  - margin required for reinsurance ceded under unregistered reinsurance agreements.
- capital required for market risk (reference Chapter 5):
  - margin required for interest rate risk;
  - margin required for foreign exchange risk;
  - capital required for equity risk;
  - capital required for real estate risk;

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<sup>4</sup> As an alternative, the AMF used a value at risk (VaR) at 99.5% confidence level or expert judgement when it was not practical to use the CTE approach.

- capital required for other market risk exposures.
- capital required for credit risk (reference Chapter 6):
  - capital required for counterparty default risk for balance sheet assets;
  - capital required for counterparty default risk for off-balance sheet exposures;
  - capital required for guarantee instruments held for unregistered reinsurance (reference Section 4.3.2) and self-insured retention (reference Section 4.4).
- capital required for operational risk (reference Chapter 7).

*Less:*

- diversification credit (reference Chapter 8).

The minimum capital required is then calculated as follows:

- target capital required divided by 1.5.

The MCT ratio, expressed as a percentage, is then calculated by dividing the capital available by the minimum capital required.

### **1.3 General requirements**

#### **1.3.1 Prior approval from the AMF**

Because the AMF prefers a principles-based approach for the supervision of insurance activities, SROs have sufficient flexibility to establish the most appropriate strategies, policies and procedures that will enable them to apply the expectations and requirements set out in this guideline commensurate with their nature, scale and complexity.

Although the operations or treatments related to the MCT are all theoretically applicable to SROs, they may, in practice, not be appropriate for the SRO's reality. In this regard, the AMF prefers a prudent approach that involves greater cooperation with the SRO upstream of any operation so as to minimize the risk that an operation would result in the inadequate treatment of capital or undermine the SRO's solvency.

SROs are therefore expected to consult the AMF and seek the AMF's prior approval before applying the requirements or benefitting from the advantages afforded under this guideline:

- for any investment activity or other financial operation related to subsidiaries, associates and joint ventures (reference Section 3.4);
- for any activity or operation involving:

- the use of collateral or guarantees, except in connection with any amount for ceded reinsurance (Chapters 5 and 6);
- the use of derivatives for hedging or speculation (reference Chapters 5 and 6);
- other off-balance sheet exposures described in Section 6.2 (structured settlements, commitments, repurchase and reverse repurchase transactions, guarantees).

Moreover, the AMF expects the SRO to obtain the AMF's prior authorization in the specific cases and situations referred to elsewhere in this guideline.

The AMF, pursuant to its powers under the Act, will determine the appropriate action to take in light of the request and information sent to it. In all cases, the AMF will consider the nature, size and complexity of the SRO's activities in evaluating the request.

### **1.3.2 Considerations relating to reinsurance**

#### **1.3.2.1 Definitions**

In this guideline, the expressions "registered reinsurance" and "unregistered reinsurance" refer to Annex A of the *Reinsurance Risk Management Guideline*.

#### **1.3.2.2 Registered reinsurance**

Capital requirement calculations under the MCT reflect SROs' use of registered reinsurance in the course of their activities. Amounts receivable and recoverable under registered reinsurance agreements are subject to the risk factors described in Section 6.1.3 of this guideline.

#### **1.3.2.3 Unregistered reinsurance**

For business under an unregistered reinsurance agreement, amounts receivable and recoverable from the agreement and reported on the balance sheet are deducted from available capital, i.e., the calculations must be made as if the business were not registered, to the extent that they are not covered by amounts payable to assuming reinsurers. A ceding SRO may also ask the AMF to benefit from a credit in respect of this capital requirement if it demonstrates to the AMF that these amounts are covered by acceptable collateral obtained from assuming reinsurers that allows the SRO to guarantee the performance of its obligations in Québec.<sup>5</sup>

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<sup>5</sup> The AMF may, if deemed appropriate, require the SRO to provide the necessary documents or to observe certain formalities in order to obtain the credit. Before submitting any request, SROs are advised to consult the AMF's website to see if instructions have been issued in this regard.

Section 4.3.2 of this guideline provides additional guidance on capital deduction, the margin requirement on amounts recoverable from unregistered reinsurance and the limit on the use of guarantee instruments.

### **1.3.3 Audit**

The AMF expects the MCT ratio to be audited annually by the auditor designated and charged with the functions provided for under Chapter VII of Title II of the Act<sup>6</sup>. ~~appointed under section 117 of the Act. A report separate from the auditor's report accompanying the P&C annual return filed with the AMF should be prepared with respect to this audit, which should be conducted in accordance with the standards for audit engagements established by the Canadian Auditing and Assurance Standards Board.~~ The auditor's opinion should address compliance with this guideline as at the time the MCT ratio ~~presented on page 30.61 of the P&C – 1Q quarterly return~~ is determined.

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<sup>6</sup> Sections 115 and 130 of the Act.



## **Chapter 2. Risk and Capital Management**

### **2.1 Integrated risk management**

Risks are inherent in the conduct of a financial institution's business and can represent both opportunities and threats. Since some undesirable risks cannot be eliminated entirely, they must be managed based on their significance, i.e. the scope and frequency of the effects they are likely to have on a financial institution if they materialize.

Risk management is therefore critical to the conduct of an SRO's business. It is an ongoing, dynamic and evolving process that must be part of the SRO's corporate culture and effectively contribute to the attainment of its strategic objectives.

SROs should aspire to an integrated approach to risk management rather than one under which risks are considered separately. Thus, risks determined to be less material but that could become material when combined should also be considered. Such a management approach should be adapted to the size, nature and complexity of each SRO's insurance activities and require standardized processes and reliable information systems capable of identifying connections between risks and providing reports containing relevant, clear and adapted information in a timely manner.

While this guideline can be used to determine capital available and capital required with respect to the key risks that can be measured by a standardized approach, integrated risk management provides a more accurate assessment of risks that are more difficult to measure with the usual methods (reference Section 2.2.2.2.).

Risks associated with the use of technologies, because of their many ramifications, are good examples of risks with multiple consequences: interrupted operations, loss of data, identity theft, cyberattacks, damage to reputation, lawsuits, etc. With this in mind, resources, technologies and knowledge must be aligned to manage these risks adequately and comprehensively across the entire SRO.

Integrated risk management involves identifying, assessing, quantifying, controlling, mitigating and carefully monitoring the material risks to which an SRO is exposed. Capital management is included within integrated risk management not only because of its role in measuring capital adequacy, but also because of its role in identifying and assessing the various risks to which the SRO is exposed.

### **2.2 Capital Management**

#### **2.2.1 Role of capital management**

The ability of financial institutions to fulfill their obligations to their clients is a fundamental component of risk management practices. An SRO's capital plays an essential role in this regard insofar as one of main functions of an SRO is to ensure that commitments to the insureds are met.

Capital management is a very broad process that covers not only the measurement of capital adequacy, but also all the strategies, policies and procedures used by an SRO to determine and plan its capital. Regulatory requirements, environment, risk profile, risk appetite, strategic planning and economic imperatives must all be considered in the process. Such a management approach should be adapted to the size, nature and complexity of each SRO's insurance activities.

Capital is a crucial component of an SRO's solvency and its management is intrinsically related to the SRO's risk-taking. The AMF expects each SRO to set up a process for assessing its own risk and solvency that allows it to identify the relationships between its various activities, thereby facilitating decision-making by taking its capital level, risk appetite and insurance business strategies into account.

The SRO should also have a broad vision and take account of factors such as procyclicality, economic imperatives and regulator expectations. One of its main objectives should therefore be to achieve its business or strategic plan in a context that enables it to maintain sufficient capital to withstand the impact of a major adverse shock, thereby reducing the probability of default.

The planning process must be carried out with the objective of developing an internally consistent and coherent vision of current and future capital needs and must be supported by an adequate organizational strategy, including optimal risk management.

## **2.2.2 Levels of capital**

Under the Act, an SRO must, in the financial management of its insurance business, adhere to sound and prudent management practices to ensure that its insurance fund maintains:

- adequate assets to meet the liabilities charged against the fund, as and when they become due; and
- adequate capital to guarantee the sustainability of the organization's insurance business.

The minimum adequacy requirements for those sums are set forth in this guideline. However, as those requirements are based on standardized assumptions applicable to the entire industry, they may not perfectly reflect the specific risk profile of each SRO.

Consequently, in addition to regulatory capital requirements, an SRO should maintain additional capital levels to reflect its specific risk profile and have a margin to cover its other needs. Several incremental levels are established in accordance with the requirements for the MCT ratio calculation.

### **2.2.2.1 Regulatory capital**

Regulatory capital refers to the two levels established by the AMF, i.e., the minimum level and the intervention target level.

SROs are required to maintain, continuously and at a minimum, an MCT ratio of 100%, meaning that capital available must be equal to or greater than minimum capital required. However, in the scope of its supervisory activities, the AMF expects an MCT intervention target capital ratio, or intervention target ratio, of 210% to be maintained. These two ratios correspond to the regulatory capital requirement levels.

The 210% intervention target ratio provides a sufficient cushion above the minimum capital required and, allows, among other things, early detection of issues by the AMF as part of its usual supervisory activities. In addition, it provides the AMF with sufficient flexibility to proactively intervene if the situation requires, in accordance with the powers conferred on it by the Act, so as to minimize the impacts on the SRO. This ratio therefore enables the AMF to intervene in a timely manner if required by an SRO's situation and to be reasonably assured that the measures taken by the SRO will remedy the issues in question before they significantly affect its solvency. The intervention target ratio provides additional capacity to absorb unexpected losses in relation to the risks covered by this guideline.

However, the minimum ratio and the intervention target ratio do not explicitly consider all risks that could occur. In fact, these ratios are based on simplifying assumptions common to a standard approach to solvency valuation. Quantifying several of these risks using a standard methodology for all SROs is not warranted at this time given that, on the one hand, the level of exposure to these risks and the risk profile vary from one SRO to the other and that, on the other hand, using a standard approach to measure them is difficult.

Consequently, the AMF asks each SRO to assess its overall capital adequacy relative to its risk profile. This assessment is made by establishing an internal capital target ratio that is higher than the 210% intervention target ratio.

#### **2.2.2.2 Internal capital target**

To establish the internal capital target ratio, an SRO must determine the target capital required to cover the risks related to its insurance operations by considering, among other things, its risk appetite and the results of sensitivity analyses based on various scenarios and simulations.<sup>7</sup> Therefore, in addition to the risks covered in the calculation of the MCT ratio, the internal capital target ratio must take into account other risks, including:

- residual credit, market and insurance risks; for example, some risks related to risk transfers are types of market risks not covered in the calculation of the MCT ratio;
- liquidity risk;
- concentration risk;
- regulatory risk;

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<sup>7</sup> In order to make sure that the internal capital target ratio is above the intervention target ratio, the level of internal target capital should be expressed as a percentage of the SRO's minimum capital requirements as set forth following this guideline, and compared to the minimum capital ratio and the intervention target ratio.

- strategic risk;
- risk related to access to market capital;
- reputation risk.

The determination of the internal capital target ratio therefore allows each SRO to take proper account of these risks. SROs can meet this requirement by drawing, for example, on adverse, but plausible, dynamic capital adequacy testing (DCAT) scenarios or on stress testing scenarios. The impact of the various scenarios should be tested on the proposed internal capital target ratio and not on the SRO's actual capital ratio.

The internal capital target ratio must be reported in the DCAT Report. SROs must provide the AMF, when the AMF requests it, with a document justifying their internal capital target ratio by means of explanations supported by an appropriate method and appropriate data. The AMF may ask an SRO to establish a new internal capital target ratio if the justification provided does not demonstrate to the AMF's satisfaction that the capital ratio submitted is relevant and sufficient.

Failure to comply with the internal capital target ratio will result in supervisory measures by the AMF commensurate with the circumstances and the corrective actions taken by the SRO to return to compliance with the established target.

### **2.2.2.3 Excess capital cushion**

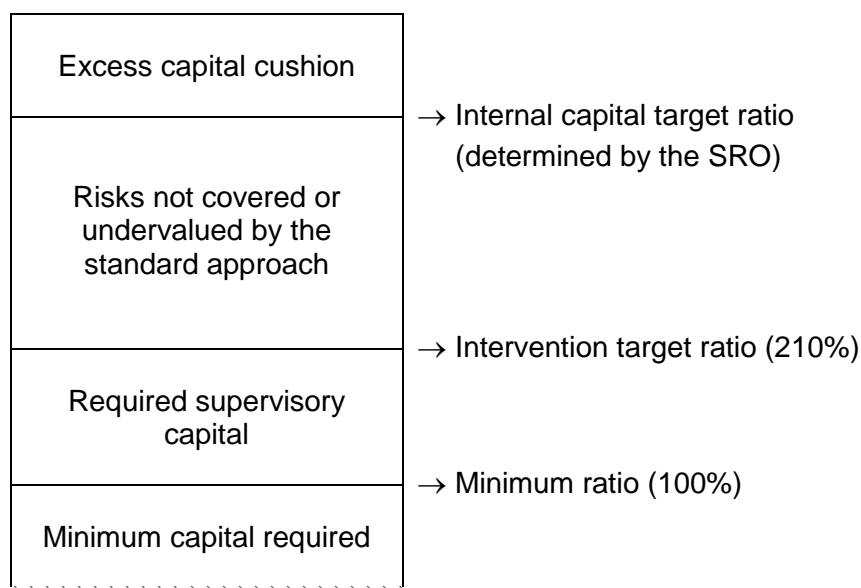
In addition, the AMF expects SROs to hold a level of capital in excess of the level of capital underlying the internal capital target ratio. This capital may be needed in order to:

- take into account the variable nature of the MCT ratio and the possibility that it will fall below their internal capital target ratio under their routine insurance-related operating conditions due, among other reasons, to normal market volatility and insurance experience;
- innovate by, for example, further developing existing products;
- be prepared for global industry-wide change, including standard-setting developments such as changes in accounting and actuarial standards.

### **2.2.2.4 Graphic representation**

The AMF's expectations are illustrated in the diagram below.

### Minimum ratio, intervention target ratio and internal capital target ratio



## 2.3 Own risk and solvency assessment

So that the SRO establishes its internal capital target in a prudent and forward-looking manner, the AMF expects the SRO to set up an own risk and solvency assessment mechanism adapted to the nature, size and complexity of its insurance activities.

### 2.3.1 Description of mechanism

The mechanism must allow the SRO to identify all material risks, whether they are easily quantifiable or not, and assess them based on its capital. The mechanism should also enable the SRO to measure individual risks that are less material but which could become material when aggregated with other risks.

An own risk and solvency assessment mechanism is a set of iterative processes designed to assess, in an ongoing and forward-looking manner, an SRO'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 an SRO'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, particularly in extreme scenarios. The analysis must include dependencies or inter-relations that cause some risks and potential impacts to be greater. SROs should document underlying assumptions, processes and key considerations with regard to drivers, the assessment, measurement and mitigants in place for each material risk. 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.

### **2.3.2 Additional capital raising**

Based on the various crisis or extreme scenarios considered in setting its internal capital target, an SRO should be able to anticipate and set up a capital raising strategy for situations in which risks could cause the capital to fall below the internal capital target.

This process is especially important in that SROs 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 could become more difficult. As a result, an SRO should act prospectively and raise additional capital in anticipation of such adverse circumstances.

The SRO should also analyze the various characteristics of its assets and liabilities and their potential impact on its solvency, taking into account the volatility of, and the potential changes in, its assets and liabilities, among other things. When it reduces its risks or obligations through reinsurance or securitization, the SRO should ensure that it captures all risks related to such transactions.

## **Chapter 3. Capital available**

This chapter establishes requirements for the adequacy and appropriateness of capital resources used to meet capital requirements, having regard to their ability to meet SROs' obligations to policyholders and creditors and to absorb losses in periods of stress. This includes the determination of the criteria for assessing the quality of capital components for inclusion in capital available and the composition of capital available, focusing on the predominance of highest quality capital.

Capital quality refers to an SRO's ability to absorb losses both in the normal course of its business and in a crisis or liquidation. This guideline distinguishes between different categories of capitalization instruments based on their nature and compliance with the criteria and limits applicable to them.

### **3.1 Capital components**

Capital available is determined on a consolidated basis, but in agreement with Section 1.1.2, which provides for the deconsolidation of non-qualifying subsidiaries<sup>8</sup>.

The four primary considerations underlying the qualifying criteria of the capital available components of a financial institution for the purpose of measuring capital adequacy are:

- its availability: the extent to which the capital element is fully paid in and available to absorb losses;
- its permanence: the period for, and extent to which, the capital element is available;
- absence of encumbrances and mandatory servicing costs: the extent to which the capital element is free from mandatory payments or encumbrances;
- subordination: the extent to which and the circumstances under which the capital element is subordinated to the rights of policyholders and other creditors of the SRO in an insolvency or winding-up of its insurance fund.

The integrity of capital elements is paramount to the protection of policyholders. Therefore, these considerations will be taken into account in the overall assessment of an SRO's financial condition.

Capital available is defined as the sum of the following components: category A capital, category B capital, and category C capital.

#### **3.1.1 Category A capital**

- retained earnings;
- general contingency reserves;

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<sup>8</sup> [See Section 3.4 for the definition of "non-qualifying subsidiary".](#)

- accumulated other comprehensive income.

Retained earnings and other comprehensive income include interim profit or loss.

For an instrument to be included in capital available under category A, it must meet all of the criteria listed in Annex 1.

### **3.1.2 Category B capital**

- instruments issued by the SRO that meet category B criteria listed in Annex 2 and do not meet the criteria for classification as category A, subject to applicable limits;
- surplus (share premium) resulting from the issuance of instruments meeting category B criteria.

For an instrument to be included in capital available under category B, it must meet all of the criteria listed in Annex 2.

Purchase for cancellation of category B capital instruments is permitted at any time with the prior approval of the AMF. For further clarity, a purchase for cancellation does not constitute a call option at the initiative of the issuer as described in the qualifying criteria for category B capital instruments laid down in Annex 2.

Tax and regulatory event calls are permitted during an instrument's life subject to the prior approval of the AMF and provided the SRO was not in a position to anticipate such an event at the time of issuance.

Stopper arrangements that stop payments on category B instruments are permissible provided the stopper does not impede the full discretion the SRO must have at all times to cancel distributions on the category B instrument, nor must it act in a way that could hinder the recapitalization of the SRO pursuant to qualifying criterion #13 of Annex 2. For example, it would not be permitted for a stopper on a category B instrument to:

- attempt to stop payment on another instrument where the payments on the other instrument were not also fully discretionary;
- prevent distributions for a period that extends beyond the point in time that distributions on the category B instrument are resumed;
- impede the normal operation of the SRO or any restructuring activity, including acquisitions or disposals.

A stopper may also act to prohibit actions that are equivalent to a payment, such as the SRO undertaking a discretionary repurchase of an instrument.



Where an amendment or variance of a category B instrument's terms and conditions affects its recognition as capital available under this guideline, such amendment or variance will only be permitted with the prior approval of the AMF.<sup>9</sup>

SROs are permitted to "re-open" offerings of capital instruments to increase the principal amount of the original issuance provided that call options will only be exercised, with the prior approval of the AMF, 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 AMF.

### **3.1.3 Category C capital**

- instruments issued by the SRO that meet category C criteria listed in Annex 3, but do not meet the category A or B criteria, subject to an applicable limit;
- surplus (share premium) resulting from the issuance of instruments meeting the category C criteria.

For an instrument to be included in capital available under category C, it must meet all of the criteria listed in Annex 3.

Category C 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 insolvency, bankruptcy, winding-up or liquidation of the issuer.

Purchase for cancellation of category C capital instruments is permitted at any time with the prior approval of the AMF. For further clarity, a purchase for cancellation does not constitute a call option at the initiative of the issuer as described in the qualifying criteria for category C capital instruments laid down in Annex 3.

Tax and regulatory event calls are permitted during an instrument's life subject to the prior approval of the AMF and provided the SRO was not in a position to anticipate such an event at the time of issuance.

Where an amendment or variance of a category C instrument's terms and conditions affects its recognition as capital available under this guideline, such amendment or variance will only be permitted with the prior approval of the AMF.<sup>10</sup>

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<sup>9</sup> Any modification of, addition to, or renewal or extension of the term of an instrument issued to a related enterprise may be subject to the provisions of the Act regarding transactions with ~~interested natural persons and/or groups that are restricted parties with respect to the SRO, with persons having ties with the directors or officers.~~

<sup>10</sup> Any modification of, addition to, or renewal or extension of the term of an instrument issued to a related enterprise may be subject to the provisions of the Act regarding transactions with ~~natural persons or groups that are restricted parties with respect to the SRO, having economic and family ties.~~

SROs are permitted to “re-open” offerings of capital instruments to increase the principal amount of the original issuance provided that call options will only be exercised, with the prior approval of the AMF, 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 AMF.

### 3.1.3.1 Amortization

Category C capital instruments are subject to straight-line amortization in the final five years prior to maturity.

Hence, as these instruments approach maturity, redemption or retraction, such outstanding balances are to be amortized based on the following schedule:

Years to maturity	Included in capital
5 years and 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%

For instruments issued prior to January 1, 2015, where the terms of the instrument include a redemption option that is not subject to prior approval of the AMF, amortization should begin five years prior to the effective dates governing such options. For example, a 20-year debenture that can be redeemed at the SRO’s option at any time on or after the first 10 years would be subject to amortization commencing in year 5. Further, where a subordinated debt was redeemable at the SRO’s option at any time without the prior approval of the AMF, the instrument would be subject to amortization from the date of issuance. For greater certainty, this would not apply when redemption requires the AMF’s approval as is required for all instruments issued pursuant to the qualifying criteria found in Annex 3.

Amortization should be computed at the end of each fiscal quarter based on the "years to maturity" schedule above. Thus, amortization would begin during the first quarter that ends within five calendar years to maturity. For example, if an instrument matures on October 15, 2020, 20% amortization of the issue would occur on October 16, 2015 and be reflected in the December 31, 2015 regulatory return. An additional 20% amortization would be reflected in each subsequent December 31 return.

### 3.1.4 Consolidated qualifying non-controlling interests

SROs are permitted to include in capital available qualifying non-controlling interests in subsidiaries that are consolidated for MCT purposes, provided that:

- the capital instruments meet the qualifying criteria under categories A, B and C;
- the capital in the subsidiary is not excessive in relation to the amount necessary to carry on the subsidiary's business;
- the level of capitalization of the subsidiary is comparable to that of the SRO as a whole.

If a subsidiary issues capital instruments for the funding of the SRO or that are substantially in excess of its own requirements, the terms and conditions of the issue, as well as the intercompany transfer, must ensure that investors are placed in the same position as if the instrument were issued by the SRO directly in order for it to qualify as capital available upon consolidation. This can only be achieved by the subsidiary using the proceeds of the issue to purchase an instrument similar to that of the SRO for its insurance fund. This treatment will only be applicable to the subordinated debt. In addition, to qualify as capital for the consolidated entity, the debt held by third parties cannot effectively be secured by other assets, such as cash, held by the subsidiary.

### 3.2 Capital composition limits

The inclusion of capital instruments qualifying under category B and category C criteria is subject to the following limits:

- The sum of capital instruments meeting the qualifying criteria under category B and category C will not exceed 40% of total capital available, excluding accumulated other comprehensive income.
- Capital instruments meeting the qualifying criteria under category C will not exceed 7% of total capital available, excluding accumulated other comprehensive income.

Category B and category C capital exceeding the allowable limits will be subject to the following treatment for capital available purposes:

- In cases where capital instruments qualifying under one of either category B or C exceed the limits, the capital in excess of the limits will not be considered in the calculation of capital available. In cases where capital instruments both under category B and category C are in excess of the prescribed limits, the greater value of the two excess amounts will be excluded from capital available. In doing so, SROs must first fully exclude excess capital under category C, followed by excess capital under category B.
- Under certain exceptional circumstances and subject to the AMF's approval, an SRO may be permitted to continue to include such excess amounts in capital available temporarily, upon providing the AMF with a satisfactory plan outlining its strategy to achieve compliance with the limits as soon as possible. Typically, only

those excesses arising after issuance and as a result of operating losses or extraordinary events beyond the control of management will normally be eligible for temporary inclusion in capital available. In most other circumstances, excesses resulting from, for example:

- purchases or redemptions of capital instruments;
- new issuances of capital instruments within the same fiscal quarter;
- foreseeable events;

could not be included in capital available.

### 3.3 Deductions/adjustments

#### 3.3.1 Deductions

The following amounts must be deducted from the capital available:

- interests in non-qualifying subsidiaries<sup>11</sup>, associates and joint ventures<sup>12</sup> in which the SRO holds more than a 10% ownership interest (reference Section 3.4);
- loans or other forms of lending provided to non-qualifying subsidiaries, associates and joint ventures in which the SRO holds more than a 10% ownership interest which are considered as capital (reference Section 3.4);
- amounts receivable and recoverable from unregistered reinsurance agreements to the extent that they are not covered by amounts payable to assuming reinsurers or by acceptable collateral from assuming reinsurers (reference Section 4.3.2);
- self-insured retentions, included in other recoverables on unpaid claims, where the AMF requires acceptable collateral to ensure collectability of recoverables, and no collateral has been received (reference Section 4.4);
- accumulated other comprehensive income on cash flow hedges. The amount of cash flow hedge reserve that relates to the hedging of items that are not fair valued on the balance sheet (including projected cash flows) must be derecognized in the calculation of capital available. This includes items that are not recognized on the balance sheet but excludes items that are fair valued on the balance sheet. Positive amounts should be deducted from capital available and negative amounts should be added back. This treatment specifically identifies the element of the cash flow hedge reserve that is to be derecognized for prudential purposes. It removes the element that gives rise to artificial volatility in capital available, as in this case the reserve only reflects one half of the picture (the fair value of the derivative, but not the changes in fair value of the hedged future cash flow);

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<sup>11</sup> [See section 3.4 for the definition of “non-qualifying subsidiaries”.](#)

<sup>12</sup> Interests in limited partnerships that are reported using the equity method of accounting are subject to the same capital treatment as joint ventures.

- defined benefit pension fund assets and liabilities. For each defined benefit pension fund that is in a surplus position and reported as an asset on the SRO's balance sheet, the amounts reported as a surplus asset on the balance sheet must be deducted from capital available, net of any amount of available refunds of defined benefit pension fund surplus assets to which the SRO has unrestricted and unfettered access. SROs can only reduce this deduction by an amount of available refunds of defined benefit pension fund surplus assets if they obtain prior written supervisory authorization from the AMF;<sup>13</sup>
- net impacts of shadow accounting if the SRO has elected to use the shadow accounting option within IFRS;
- accumulated unrealized gains and losses that have resulted from changes in the fair value of an SRO's financial liabilities that are due to changes in the SRO's own credit risk. In addition, with regard to derivative liabilities, all accounting valuation adjustments arising from the SRO's own credit risk should also be deducted on an after-tax basis. The offsetting between valuation adjustments arising from the SRO's own credit risk and those arising from its counterparties' credit risk is not permitted.
- goodwill and other intangible assets:
  - Goodwill related to consolidated subsidiaries and subsidiaries deconsolidated for regulatory capital purposes and the proportional share of goodwill in joint ventures subject to the equity method of accounting must be deducted from capital available. The full amount reported on the balance sheet is to be deducted.
  - The full amount of all other intangible assets<sup>14</sup> must be deducted from capital available. This includes intangible assets related to consolidated subsidiaries and subsidiaries deconsolidated for regulatory capital purposes, and the proportional share of intangible assets in joint ventures subject to the equity method of accounting.

No risk factor is applied to items that are deducted from capital available.

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<sup>13</sup> To obtain the AMF written supervisory authorization, the SRO must demonstrate, to the AMF's satisfaction, that it has clear entitlement to the surplus and that it has unrestricted and unfettered access to the surplus pension assets including, among other things, having obtained an acceptable independent legal opinion and the prior authorization from the pension plan members and the pension regulator, where applicable.

<sup>14</sup> This includes computer software intangibles.

### 3.3.2 Adjustments

The following amounts must be reversed from the total of capital available:

- owner-occupied property:<sup>15</sup>
  - for owner-occupied property accounted for using the cost model and where the deemed value of the property was determined at conversion to IFRS by using fair value, unrealized fair value gains (losses) must be reversed from the SRO's reported retained earnings for capital adequacy purposes. The amount determined at conversion is an on-going deduction from capital available and can only be changed as a result of a sale of owner-occupied properties (owned at the time of IFRS conversion) and the resulting realization of actual gains (losses);
  - accumulated revaluation losses in excess of gains accounted for using the revaluation model must be reversed from retained earnings. Revaluation gains must be reversed from accumulated other comprehensive income included in capital available.

### 3.4 Interests in and loans to subsidiaries, associates and joint ventures

The equity method of accounting is used for all interests of an SRO in non-qualifying subsidiaries, associates and joint ventures.<sup>11</sup> These interests remain unconsolidated for MCT purposes.

Under this guideline, a non-qualifying subsidiary is a dissimilar regulated financial institution, such as a bank, trust company, savings company or insurer of persons, or any subsidiary other than a subsidiary:

- that is a P&C insurer;
- that carries on only activities similar to those the insurer is authorized to carry on;
- whose principal activity is the purchase, management, sale or leasing of immovables;
- whose principal activity is the offering of shares in investment portfolios, the making of loans and investments, factoring, leasing, the offering of computing services or actuarial advisory services;
- whose principal activity is complementary to the distribution of certain insurance products such as travel assistance, legal assistance and road assistance;
- whose activities are those of a firm within the meaning of the *Act respecting the distribution of financial products and services* (CQLR, chapter D-9.2) or that offers financial products and services outside Québec; or

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<sup>15</sup> No adjustments are required for investment properties, as fair value gains (losses) are allowed for capital purposes.

- that operates a residential and long-term care centre.

#### **3.4.1 Qualifying consolidated subsidiaries**

The assets and liabilities of these subsidiaries are fully consolidated in the SRO's regulatory financial statements and are included in the calculation of capital available and required; they are therefore subject to risk factors and liability margins in the SRO's MCT.

#### **3.4.2 Joint ventures with less than or equal to 10% ownership interest**

Where an SRO holds less than or equal to a 10% ownership interest in a joint venture, the investment is included in capital available. The investment is reported under capital required for equity risk and is subject to the risk factor applicable to investments in common shares (reference Section 5.3).

#### **3.4.3 Non-qualifying subsidiaries, associates and joint ventures with more than a 10% ownership interest**

Interests in non-qualifying subsidiaries, associates and joint ventures in which the SRO holds more than a 10% ownership interest are excluded from capital available. Loans or other forms of lending provided to these entities are also excluded from capital available of the SRO if they are considered as equity in the entity.

Loans or other forms of lending provided to these entities that are not considered as equity in the entity are subject to a risk factor of 45% (or higher for higher risk loans). SROs should contact the AMF to discuss higher risk factors.

Insurance receivables from registered reinsurers that are associates of the SRO will attract a risk factor of 0.7%. Other receivables from these entities will attract a risk factor of 5% or 10% depending on how long the balances are outstanding (reference Section 6.1.3).

#### **3.4.4 Ownership interest in a limited partnership**

Investments of the SRO held and managed by a limited partnership on behalf of the SRO are treated as direct investments of the SRO, provided that the SRO can demonstrate to the AMF's satisfaction that these investments are not used to capitalize such a partnership under the laws and regulations governing it. Consequently, the capital required for such investments is calculated using a "look-through" approach to the underlying assets held by the limited partnership, by applying the risk factors in Chapters 4 and 5 to the limited partnership investments.<sup>16</sup>

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<sup>16</sup> In such circumstances, requirements regarding limited partnerships using the equity method of accounting do not apply.

## **Chapter 4. Insurance risk**

### **4.1 Description of insurance risk**

Insurance risk is the risk arising from the potential for claims or payouts to be made to policyholders or beneficiaries. Exposure to this risk results from the present value of losses being higher than the amounts originally estimated.

Insurance risk includes uncertainties around:

- the ultimate amount of net cash flows from premiums, commissions, claims, payouts, and related settlement expenses;
- the timing of the receipt and payment of these cash flows.

The “insurance risk” component of the MCT reflects the SRO’s consolidated risk profile by individual classes of insurance and results in specific margin requirements for insurance risk. For the MCT, the risk associated with insurance exposure is divided into three parts:

- reserving risk associated with variation in claims provisions (unpaid claims);
- underwriting risk including catastrophe risk (premium liabilities);
- risk associated with unregistered reinsurance.

### **4.2 Margins for unpaid claims and premium liabilities**

Given the uncertainty that provisions will be sufficient to cover underlying liabilities, margins are added to cover the potential shortfall.

From the AMF’s perspective, these margins are included to take into account possible unexpected negative variations in the provision amounts, given the fact that the margins added by actuaries in their valuations are primarily intended to cover expected variations.

The margin on unpaid claims is calculated by class of insurance, by multiplying the net amount at risk (i.e., net of reinsurance, salvage and subrogation, and SIRs) less the provision for adverse deviations (PfAD), by the applicable risk factors.

The margin for premium liabilities is calculated by class of insurance, by multiplying the applicable risk factors by the greater of the net premium liabilities (i.e., net of reinsurance) less the PfAD, and 30% of the net written premiums for the past 12 months.

The insurance risk factors are as follows:



Class of insurance	Risk factor unpaid claims	Risk factor premium liabilities
Fidelity	20%	25%
Liability	25%	30%

### 4.3 Risk mitigation and risk transfer mechanisms - reinsurance

The risk of default for amounts recoverable from reinsurers arises from both credit and actuarial risk. Credit risk relates to the risk that the reinsurer will fail to pay the ceding SRO what it is owed. Actuarial risk relates to the risk associated with the misassessment of the amount of the required provision.

#### 4.3.1 Registered reinsurance

The risk factor applied to unpaid claims and unearned premiums recoverable from registered reinsurance agreements is treated as a combined weight under the MCT, reflecting both the credit risk and the risk of variability or insufficiency of unpaid claims and unearned premiums (reference Section 6.1.3).

The balance sheet values used to calculate the risk requirement for reinsurance assets arising from registered reinsurance agreements may be reduced to a minimum of zero by:

- the funds held by the ceding SRO for its exclusive benefit (e.g., funds withheld reinsurance) to secure the payment to the ceding SRO by the reinsurer of the reinsurer's share of any loss or liability for which the reinsurer is liable under the reinsurance agreement; and
- any other liabilities of the ceding SRO due to the reinsurer for which the ceding SRO has a legal and contractual right of setoff against the amount recoverable from the reinsurer.

Total reinsurance assets by reinsurer cannot be negative. Acceptable collateral posted by a reinsurer under a registered reinsurance agreement may be recognized provided the conditions under Section 4.3.2.3 are met.

#### 4.3.2 Unregistered reinsurance

##### 4.3.2.1 Deduction from capital available

Rather than being applied a risk factor to cover the risk of default of the reinsurers, amounts receivable and recoverable from unregistered reinsurance agreements, as reported on the balance sheet, are deducted from capital available to the extent that they are not covered by amounts payable to assuming reinsurers or acceptable collateral. Acceptable collateral is defined as guarantee instruments from assuming reinsurers and funds held to secure payment from assuming reinsurers. Section 4.3.2.3 outlines further conditions for using collateral to obtain credit for unregistered reinsurance agreements. Amounts payable to assuming reinsurers may be deducted from amounts receivable and

recoverable only where there is a legal and contractual right of setoff against the assuming reinsurer.

The deduction is calculated in the unregistered reinsurance exhibit of the P&C Returns. The amount is the sum, for each of the unregistered reinsurance agreements, of the following calculation where the result is positive:

$$A + B + C - D - E - F - G$$

where:

- A: is the amount of unearned premiums ceded to the assuming reinsurer
- B: is the amount of outstanding losses recoverable from the assuming reinsurer
- C: is the amount of receivables from the assuming reinsurer
- D: is the amount of payables to the assuming reinsurer
- E: is the amount of non-owned deposits or other assets held as security from the assuming reinsurer as a guarantee instrument for reinsurance
- F: is the amount of funds held to secure payment from the assuming reinsurer
- G: is the amount of acceptable letters of credit held as security from the assuming reinsurer

#### **4.3.2.2 Required margin**

The margin for unregistered reinsurance is calculated in the unregistered reinsurance exhibit of the P&C Returns and reported on the “Reinsurance Ceded to Unregistered Insurers” line on the MCT calculation page of the Returns.

The margin is 20% of the ceded unearned premiums under unregistered reinsurance agreements and of the outstanding losses recoverable from such agreements (collectively, “ceded policy liabilities”). The margin requirement for each unregistered reinsurance agreement may be reduced to a minimum of zero by payables to the reinsurer and acceptable collateral that are in excess of the amount of ceded policy liabilities and receivables from unregistered reinsurance agreements.

#### **Transition period**

Policy liabilities ceded under unregistered reinsurance agreements on or before December 31, 2019 (or March 31, 2020) and any associated new claims or development on incurred claims are subject to a 15% margin required until December 31, 2022 (or March 31, 2023), the end of the transition period. During the transition period, any ceded policy liabilities on business from direct policies, or assumed business with underlying direct policies, with an effective date of January 1, 2020 (or April 1, 2020) or later are subject to the 20% margin required. After the transition period, starting January 1, 2023 (or April 1, 2023), all ceded policy liabilities for all unregistered reinsurance agreements, including any remaining ceded policy liabilities that were subject to transition, are subject to the 20% margin required.

#### 4.3.2.3 Collateral

A ceding SRO is given credit for unregistered reinsurance where the SRO obtains and maintains a valid and enforceable guarantee interest that has priority over any other security interest in assets of an unregistered reinsurer that are held in Canada, to secure the payment to the ceding SRO by the reinsurer of the reinsurer's share of any loss or liability for which the reinsurer is liable under the reinsurance agreement.

The collateral used to obtain credit for a specific unregistered reinsurance agreement must materially reduce the risk arising from the credit quality of the reinsurer. In particular, the instruments used may not be related party obligations of the unregistered reinsurer (i.e., obligations of the reinsurer itself, its parent, or one of its subsidiaries or associates). With respect to the above three sources available to obtain credit, this implies that:

- to the extent that a ceding SRO is reporting obligations due from a related party of the reinsurer as assets in its annual return, the ceding SRO is precluded from taking credit for funds held to secure payment from the unregistered reinsurer;
- reinsurer's assets located in Canada in which a ceding SRO has a valid and perfected first priority security interest under applicable law may not be used to obtain credit if they are obligations of a related party of the unregistered reinsurer;
- a letter of credit is not acceptable if it has been issued by a related party of the unregistered reinsurer.

Collateral must be available to the SRO for a period of not less than the remaining term of the ceded liabilities in order to be valid towards obtaining credit for unregistered reinsurance. In cases where an arrangement contains a renewal provision for the ceding SRO to maintain collateral for a part or the whole of the remaining term of ceded liabilities (e.g., additional fees or higher interest rate), the renewal provision should be included when determining the ceded reserves.

Letters of credit held as guarantee against unregistered reinsurance are considered a direct credit substitute and are subject to risk factors based on the credit rating of the issuing/confirming bank and the term of ceded liabilities (reference Section 6.2). Where a letter of credit is issued or confirmed by a related enterprise of a ceding insurer, no reduction in capital required is permitted.

Guarantee instruments other than letter of credits, such as non-owned deposits, held as guarantee against unregistered reinsurance, are subject to the same risk factors as those applied to similar assets owned by the SRO (reference Sections 5.3 and 6.1).

Capital requirements for collateral associated with unregistered reinsurance are calculated on an aggregate basis using applicable risk factors, on the total amount of acceptable collateral from each reinsurer.

However, acceptable collateral that is greater than the unregistered reinsurance requirements is considered excess collateral and is not subject to capital requirements.

Where appropriate, the total amount of capital required for the collateral is pro-rated in order to exclude capital otherwise required on the excess portion of collateral.

Two steps are required to compute excess collateral and arrive at a reduction in capital required for excess collateral.

### Step 1: Computation of excess collateral

Reinsurance ceded under unregistered reinsurance agreements	Amount (\$)
Unearned premiums ceded to assuming reinsurer	100
Outstanding losses recoverable from assuming reinsurer	500
20% margin on ceded policy liabilities <sup>17</sup>	120
Receivable from assuming reinsurer	40
Payable to assuming reinsurer	(20)
<b>Unregistered reinsurance exposure</b>	<b>740</b>
Collateral required to reduce margin required to 0 (500 + 100) x 120% + 40 - 20	740
Non-owned deposits	1,000
Funds held	100
Letters of credit	100
<b>Total collateral</b>	<b>1,200</b>
<b>Excess collateral</b> (no capital required on this amount) <del>1,100</del> <u>1,200</u> – <del>710</del> <u>740</u>	<b>460</b>

The amount of excess collateral should be calculated separately for each individual reinsurer and then added together.

### Step 2: Reduction in capital required for excess collateral

Using the above example, the ratio of 0.38 x (460/1,200) should be applied to the total amount of capital required for collateral, in order to calculate the capital requirement for collateral excluding the excess portion. The calculation is provided in the following table.

<sup>17</sup> For ceded policy liabilities that are subject to the transition under Section 4.3.2.2, a margin of 15% will apply until December 31, 2022 (or March 31, 2023).

	<b>Collateral amount</b>	<b>Risk factor</b>	<b>Total capital required</b>	<b>Proportional allocation of excess collateral</b>	<b>Reduction in capital required for excess collateral</b>
	(01)	(02)	(03) = (01) x (02)	(04)	(05) = (03) x (04)
<b>Letters of credit</b> (AA rating ≤1 year)	\$100	0.25%	\$0.25		
<b>Non-owned deposits</b> (AAA bonds ≤1 year)	\$500	0.25%	\$1.25		
<b>Non-owned deposits</b> (AA bonds >1 year ≤5 years)	\$500	1.00%	\$5.00		
<b>Funds held</b> (demand deposits)	\$100	0.25%	\$0.25		
<b>Total</b>	\$1,200		\$6.75	0.38	\$2.57

The capital requirements for acceptable collateral, less the excess, are reported as part of capital required for credit risk (reference Chapter 6).

### Letters of credit

The limit on the use of letters of credit to obtain capital credit for unregistered reinsurance is 30% of ceded unearned premiums under unregistered reinsurance agreements and of the outstanding losses recoverable from such agreements. This limit is applied in the aggregate and not against individual reinsurance exposures.

### Non-owned deposits from reinsurers received as security

Deposits from reinsurers received under unregistered reinsurance agreements and that are “not owned” by the SRO, including deposits held in trust on behalf of reinsurers, are not to be reported on the SRO’s balance sheet. Details of these deposits must also be reported in the unregistered reinsurance exhibit of the P&C Returns.

Non-owned deposits held as security on behalf of an unregistered reinsurer must be valued at market value as at the end of the statement year, including the amount of investment income due and accrued respecting these deposits.

## **Funds held as security against unregistered reinsurance**

Cash and securities received to secure payment from unregistered reinsurance agreements that have been co-mingled with the SRO's own funds should be reported on the SRO's balance sheet in the appropriate asset categories and will be subject to the corresponding risk factors. Funds held include the reinsurance premiums withheld by the ceding SRO, as specified in the reinsurance agreement. Details of funds held must be reported in the unregistered reinsurance exhibit of the P&C Returns. The reinsurance agreement must clearly provide that, in the event of the ceding SRO's or reinsurer's insolvency, the funds withheld must form part of the property of the ceding SRO's general estate.<sup>18</sup>

In order for a ceding SRO to obtain credit for funds held under a funds withheld reinsurance agreement, the agreement must not contain any contractual provision that would require payment of funds withheld to the reinsurer, other than those funds that, together with other forms of acceptable collateral, if any, are in excess of the ceded policy liabilities and the margin required for unregistered reinsurance, before all subject policies have expired and all claims settled. (e.g., an acceleration clause). Furthermore, the ceding SRO may not provide non-contractual or implicit support, or otherwise create or sustain an expectation that any funds withheld could be paid to the reinsurer, other than those funds that, together with other forms of acceptable collateral, if any, are in excess of the ceded policy liabilities and the margin required for unregistered reinsurance, before all subject policies have expired and all claims settled.

### **4.4 Self-insured retentions**

Self-insured retentions (SIRs) represent the portion of a loss that is payable by the policyholder. In some cases, SIRs may be included in the policy declaration or in an endorsement to the policy, stipulating that the policy limit applies in excess of the SIR.

To admit SIRs recoverable for regulatory capital purposes, the AMF must be satisfied with the collectability of recoverables, and may require collateral to ensure collectability. For example, collateral may be required when it is deemed that there is an excessive concentration of SIRs owed by any one debtor.

Letters of credit and other acceptable securities may be used as collateral for SIRs. Collateral used may not be related party obligations of the policyholder (i.e., obligations of the policyholder itself, its parent, or one of its subsidiaries or associates); in such cases, no reduction in capital required is permitted.

Letters of credit for SIRs are considered a direct credit substitute and are subject to a risk factor based on the credit rating of the issuing/confirming bank and the term of ceded liabilities (subject to the provision for excess guarantees) (reference Section 6.2). Risk factors for collateral other than letters of credit are the same as those applied to similar assets owned by the SRO (reference Chapters 5 and 6).

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<sup>18</sup> This requirement only applies to reinsurance agreements coming into force on or after January 1, 2018, or that will be renewed after that date.

## **Chapter 5. Market risk**

Market risk arises from potential changes in rates or prices in various markets such as for interest rates, foreign exchange rates, equities, real estate, and other market risk exposures. Exposure to this risk results from trading, investing, and other business activities, which create on- and off-balance sheet positions.

Investments in mutual funds or other similar assets must be broken down by type of investment (bonds, preferred shares, common shares, etc.) and assigned the appropriate risk factor relating to the investment. If the information available on an investment is not broken down, then the factor of the riskiest asset held in the fund is assigned to the entire investment.

### **5.1 Interest rate risk**

Interest rate risk represents the risk of economic loss resulting from market changes in interest rates and the impact on interest rate sensitive assets and liabilities. Interest rate risk arises due to the volatility and uncertainty of future interest rates.

Assets and liabilities whose value depends on interest rates are affected. Interest rate sensitive assets include fixed income assets. Interest rate sensitive liabilities include those for which the values are determined using a discount rate.

To compute the interest rate risk margin, a duration and an interest rate shock factor are applied to the fair value of interest rate sensitive assets and liabilities. The interest rate risk margin is the difference between the change in the value of interest rate sensitive assets and the change in the value of interest rate sensitive liabilities, taking into account the change in the value of recognized interest rate derivative contracts, as appropriate.

The components used to calculate the interest rate risk margin are as follows.

#### **5.1.1 Interest rate sensitive assets**

The interest rate sensitive assets to be included in the calculation of the interest rate margin requirement are those for which their fair value will change with movements in interest rates. Although certain assets, for example loans and bonds held to maturity, may be reported on the balance sheet on an amortized cost basis, their economic value, and changes in that value, are to be considered for interest rate risk margin purposes. Interest rate sensitive assets include the following:

- term deposits and other similar short-term securities (excluding cash);
- bonds and debentures;
- commercial paper;
- loans;
- mortgages (residential and commercial);
- mortgage-backed and asset-backed securities (MBS and ABS);

- preferred shares;
- interest rate derivatives held for other than hedging purposes.

Assets in mutual funds and other similar assets that are interest rate sensitive are to be included in the determination of the fair value of the SRO's total interest rate sensitive assets.

Other assets, such as cash, investment income due and accrued, common shares and investment properties, are not to be included in the determination of the value of interest rate sensitive assets. Such assets are assumed for interest rate risk margin determination purposes to be insensitive to movements in interest rates.

### **5.1.2 Interest rate sensitive liabilities**

The interest rate sensitive liabilities to be included in the calculation of the interest rate risk margin are those for which their fair value will change with movements in interest rates. The following liabilities are considered sensitive to interest rates and are to be included:

- net unpaid claims and adjustment expenses;
- net premium liabilities;
- liabilities owing to reinsurers under a funds withheld reinsurance arrangement.

The SRO must obtain the AMF's approval in order to be able to consider other liabilities in the calculation of the interest rate risk margin.

Net unpaid claims and adjustment expenses, which include PfAD, are net of reinsurance, salvage and subrogation, and self-insured retentions. Net premium liabilities, which also include PfAD, are after reinsurance recoverables.

### **5.1.3 Allowable interest rate derivatives**

Interest rate derivatives are those for which the cash flows are dependent on future interest rates. They may be used to hedge an SRO's interest rate risk and as such may be recognized in the determination of the margin required for interest rate risk, subject to the conditions below.

Only plain-vanilla interest rate derivatives that clearly serve to offset fair value changes in an SRO's capital position due to changes in interest rates may be included in the interest rate risk calculation. Plain-vanilla interest rate derivative instruments are limited to the following:

- interest rate and bond futures;
- interest rate and bond forwards;
- single-currency interest rate swaps.



Other interest rate derivatives, including interest rate options, caps and floors are not considered plain-vanilla and may not be recognized in the determination of the interest rate risk margin.

SROs must understand the interest rate hedging strategies that they have in place and be able to demonstrate to the AMF, upon request, that the underlying hedges decrease interest rate risk exposure and that the addition of such derivatives does not result in overall increased risk. For example, SROs are expected to be able to demonstrate that they have defined the hedging objectives, the class of risk being hedged, the nature of the risk being hedged and the hedge horizon and have considered other factors, such as the cost and liquidity of hedging instruments. In addition, the ability to demonstrate an assessment, retrospectively or prospectively, of the performance of the hedge would be appropriate. If the SRO cannot demonstrate that the derivatives result in decreased overall risk, then additional capital may be required. SROs that are in this situation should contact the AMF for details.

Derivatives used for hedging an SRO's interest rate risk are subject to credit risk requirements. Refer to Section 6.2 for further details.

#### **5.1.4 Duration of interest rate sensitive assets and liabilities**

SROs are required to calculate the duration of the interest rate sensitive assets and liabilities for the purpose of the interest rate risk capital requirement calculation. The duration of an asset or a liability is a measure of the sensitivity of the value of the asset or liability to changes in interest rates. More precisely, it is the percentage change in an asset or liability value given a change in interest rates.

The calculation of duration for an asset or liability will depend on the duration measure chosen and whether the cash flows of the asset or liability are themselves dependent on interest rates. Modified duration is a duration measure in which it is assumed that interest rate changes do not change the expected cash flows. Effective duration is a duration measure in which recognition is given to the fact that interest rate changes may change the expected cash flows.

An SRO may use either modified duration or effective duration to calculate the duration of its assets and liabilities. However, the duration methodology chosen should apply to all interest rate sensitive assets and liabilities under consideration and the same methodology must be used consistently from year to year (i.e., "cherry-picking" is not permitted).

The cash flows associated with interest rate derivatives are sensitive to changes in interest rates and therefore the duration of an interest rate derivative must be determined using effective duration. In particular, if an SRO has interest rate derivatives on its balance sheet that lie within the scope of Section 5.1.3, then it must use effective duration for all of its interest rate sensitive assets and liabilities.

The portfolio duration (modified or effective) can be obtained by calculating the weighted average of the duration of the assets or the liabilities in the portfolio.

The dollar duration of an asset or liability is the change in dollar value of an asset or liability for a given change in interest rates.

#### 5.1.4.1 Modified duration

Modified duration is defined as the approximate percentage change in the present value of cash flows for a 100 basis point change in the annually compounded yield rate, assuming that expected cash flows do not change when interest rates change.

Modified duration can be written as:

$$\text{Modified duration} = \frac{1}{(1+\text{yield}/k)} \times \frac{\sum t \times \text{PVCF}_t}{k \times \text{Market Value}}$$

where:

*k*: number of periods, or payments, per year (e.g., *k* = 2 for semi-annual payments and *k* = 12 for monthly payments)

yield: periodically compounded yield to maturity of the cash flows

PVCF<sub>*t*</sub>: present value of the cash flow at time *t* discounted at the yield rate

#### 5.1.4.2 Effective duration

Effective duration is a duration measure in which recognition is given to the fact that interest rate changes may change the expected cash flows. Although modified duration will give the same estimate of the percentage fair value change for an option-free series of cash flows, the more appropriate measure for any series of cash flows with an embedded option is effective duration.

Effective duration is determined as follows:

$$\text{Effective duration} = \frac{\text{fair value if yields decline} - \text{fair value if yields increase}}{2 \times (\text{initial price}) \times (\text{change in yield in decimal})}$$

Denoting:

Δ*y*: change in yield in decimal

*V*<sub>0</sub>: initial fair value

*V*<sub>-</sub>: fair value if yields decline by Δ*y*

*V*<sub>+</sub>: fair value if yields increase by Δ*y*

Then, effective duration is as follows:

$$\frac{V_- - V_+}{2 \times (V_0) \times (\Delta y)}$$

#### **5.1.4.3 Portfolio duration**

The duration of a portfolio of interest rate sensitive assets or liabilities is to be determined by calculating the weighted average of the duration of the assets or liabilities in the portfolio. The weight is the proportion of the portfolio that a security comprises. Mathematically, a portfolio's duration is calculated as follows:

$$w_1D_1 + w_2D_2 + w_3D_3 + \dots + w_KD_K$$

where:

$w_i$ : fair value of security  $i$  / fair value of the portfolio

$D_i$ : duration of security  $i$

$K$ : number of securities in the portfolio

#### **5.1.4.4 Dollar fair value change**

Modified and effective duration are related to percentage fair value changes. The interest rate risk capital requirements depend on determining the adjustment to the fair value of interest rate sensitive assets and liabilities for dollar fair value changes. The dollar fair value change can be measured by multiplying duration by the dollar fair value and the number of basis points (in decimal form). In other words:

$$\text{Dollar fair value change} = \text{Dollar fair value} \times \text{duration} \times \text{interest rate change (in decimal)}$$

#### **5.1.5 Duration of allowable interest rate derivatives**

Effective duration is the appropriate measure that should be used when assets or liabilities have embedded options. For portfolios with eligible plain-vanilla interest rate derivatives, SROs should be using effective dollar duration<sup>19</sup> because they are hedging the dollar interest rate risk exposure.

#### **Example 5-1: Effective dollar duration of a swap**

Assuming an SRO has a longer duration for its interest rate sensitive assets and a shorter duration for its interest rate sensitive liabilities, the current dollar duration position of the

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<sup>19</sup> Effective dollar duration is the fair value change in dollars for a unit change in the yield (per one percentage point or per one basis point).

SRO, prior to taking into consideration any interest rate derivatives, is effectively as follows:

$$\text{Effective dollar duration of the SRO} = \text{dollar duration of assets} - \text{dollar duration of liabilities} > 0$$

The SRO enters into a single-currency interest rate swap in which it pays fixed-rate and receives floating-rate. The dollar duration of a swap for a fixed-rate payer can be broken down as follows:

$$\text{Effective dollar duration of a swap for a fixed-rate payer} = \text{effective dollar duration of a floating-rate bond} - \text{effective dollar duration of a fixed-rate bond}$$

Assuming the dollar duration of the floater is near zero, then:

$$\text{Effective dollar duration of a swap for a fixed-rate payer} = 0 - \text{effective dollar duration of a fixed-rate bond}$$

The dollar duration of the swap position is negative; therefore, adding the swap position reduces the SRO's dollar duration of assets and moves the SRO's overall dollar duration position closer to zero.

### 5.1.6 Interest rate risk margin

The interest rate risk margin is determined by measuring the economic impact on the SRO of a  $\Delta y$  change in interest rates. The  $\Delta y$  interest rate shock factor is 1.25% ( $\Delta y = 0.0125$ ).

(A) The estimated change in the interest sensitive asset portfolio for an interest rate increase of  $\Delta y$  is determined as follows:

$$\text{Dollar fair value change of the interest rate sensitive asset portfolio} = (\text{Duration of interest rate sensitive asset portfolio}) \times \Delta y \times (\text{Fair value of interest rate sensitive asset portfolio})$$

(B) The change in the interest rate sensitive liabilities for an interest rate increase of  $\Delta y$  is determined as follows:

$$\text{Dollar fair value change of the interest rate sensitive liabilities} = (\text{Duration of interest rate sensitive liabilities}) \times \Delta y \times (\text{Fair value of interest rate sensitive liabilities})$$

(C) The change in the allowable interest rate derivatives for an interest rate increase of  $\Delta y$  is determined as follows:

$$\text{Effective dollar duration of the allowable interest rate derivatives portfolio} = \text{Sum of the effective dollar duration of the allowable interest rate derivatives for a } \Delta y \text{ increase in interest rates}$$

- (D) The capital requirement for an interest rate increase of  $\Delta y$  is determined as the greater of zero and  $A - B + C$ .
- (E) Steps A through C are repeated for an interest rate decrease of  $\Delta y$  (i.e.,  $-\Delta y$ ) and the capital requirement for an interest rate decrease of  $\Delta y$  is the greater of zero and  $A - B + C$ .
- (F) The interest rate risk margin is then determined as the maximum of D or E.

## **5.2 Foreign exchange risk**

The foreign exchange risk margin is intended to cover the risk of loss resulting from fluctuations in currency exchange rates and is applied to the entire insurance activity of the SRO.

### **5.2.1 General requirements**

Two steps are necessary to calculate the foreign exchange risk margin. The first is to measure the exposure in each currency position. The second is to calculate the capital requirement for the portfolio of positions in different currencies.

The foreign exchange risk margin is 10% of the greater of:

- the aggregate net long positions in each currency, adjusted by effective allowable foreign exchange rate hedges if any are used;
- the aggregate net short positions in each currency, adjusted by effective allowable foreign exchange rate hedges if any are used.

Effective allowable foreign exchange rate hedges are limited to plain-vanilla foreign currency derivatives such as futures and forward foreign currency contracts and currency swaps.

Assets in mutual funds and other similar assets that are denominated in a foreign currency are to be included in the calculation to determine the capital requirement for each currency position. In cases where a claim liability is recorded in Canadian dollars but the settlement of the claim will be made in a foreign currency, the liability must be included in the foreign exchange risk margin.

### **5.2.2 Foreign exchange risk margin**

#### **Step 1: Measuring the exposure in a single currency**

The net open position for each currency is calculated by summing:

- the net spot position, defined as all asset items less all liability items denominated in the currency under consideration, including accrued interest and accrued expenses if they are subject to exchange rate fluctuations;

- the net forward position (i.e., all net amounts under forward foreign exchange transactions, including currency futures and the principal on currency swaps), valued at current spot market exchange rates or discounted using current interest rates and translated at current spot rates;
- guarantees (and similar instruments) that are certain to be called and are likely to be irrecoverable;
- net future income/expenses not yet accrued but already fully hedged (at the discretion of the reporting institution); and
- any other item representing a profit or loss in foreign currencies.

### **Carve-out**

An SRO with a net open long position in a given currency may reduce the amount of the net exposure, to a maximum of zero, by the amount of a carve-out, which is equivalent to a short position of up to 25% of the liabilities denominated in the corresponding currency.

### **Step 2: Calculating the capital requirement for the portfolio**

The nominal amount (or net present value) of the net open position in each foreign currency calculated in Step 1 is converted at a spot rate into Canadian dollars. The gross capital requirement is 10% of the overall net open position, calculated as the greater of:

- the sum of the net open long positions; and
- the absolute value of the sum of the net open short positions.

### **Example 5-2**

An SRO has \$100 of U.S. assets and \$50 of U.S. liabilities and the spot exchange rate is 1.000.

- the net spot position, defined as assets less liabilities, is a long position of \$50;
- the carve-out, using 25% of liabilities, is:  
= 25% x \$50  
= \$12.50

- therefore, the foreign exchange risk margin is:  
= 10% x MAX<sup>20</sup> ((net spot position - carve-out), 0)  
= 10% x MAX ((\$50 – \$12.50), 0)  
= 10% x \$37.50  
= \$3.75

### **5.2.2.1 Allowable foreign currency hedges**

Foreign currency derivatives are those for which the cash flows are dependent on future foreign exchange rates. They may be used to hedge an SRO's foreign exchange risk and as such, may be recognized in the determination of the capital requirement for foreign exchange risk, subject to the following requirements.

Only effective hedges that offset the changes in fair value of the hedged item may be included in the foreign exchange risk calculation. The SRO must be able to demonstrate to the AMF the effectiveness of its foreign exchange hedges.

SROs with foreign currency derivatives on their balance sheet must be able to demonstrate that the addition of such derivatives does not result in increased risk. If they cannot demonstrate that the derivatives do not result in increased risk, then the AMF may require additional capital.

Only plain-vanilla foreign currency derivatives may be recognized in the calculation of the foreign exchange capital requirement. Plain-vanilla foreign currency derivative instruments are limited to the following:

- futures foreign currency contracts;
- forward foreign currency contracts;
- currency swaps.

Other foreign currency derivatives, including options on foreign currencies, are not considered plain-vanilla and are not to be recognized in the determination of the foreign exchange risk margin.

Derivatives used for hedging an SRO's foreign exchange risk are subject to credit risk requirements. Refer to Section 6.2 for further details.

### **5.2.2.2 Measurement of forward currency positions**

Forward currency positions should be valued at current spot market exchange rates. It would not be appropriate to use forward exchange rates since they partly reflect current

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<sup>20</sup> The carve-out can be used to reduce the net open long currency position to a minimum of zero.

interest rate differentials. SROs that base their normal management accounting on net present values are expected to use the net present values of each position, discounted using current interest rates and translated at current spot rates, for measuring their forward currency positions.

### **5.2.2.3 Accrued and unearned interest income and expenses**

Accrued interest, accrued income and accrued expenses should be treated as a position if they are subject to exchange rate fluctuations. Unearned but expected future interest, income or expenses may be included, provided the amounts are certain and have been fully hedged by allowable forward foreign exchange contracts. SROs must be consistent in their treatment of unearned interest, income and expenses and must have written policies covering the treatment. The selection of positions that are only beneficial to reducing the overall position will not be permitted for capital purposes.

### **5.2.2.4 Unregistered reinsurance**

A separate component calculation must be performed for each group of liabilities ceded under an unregistered reinsurance agreement to a reinsurer that is backed by a distinct pool of assets, where the defining characteristic of the pool is that any asset in the pool is available to pay any of the corresponding liabilities.

Each calculation should take into consideration the ceded liabilities, the assets supporting them, and deposits placed by the reinsurer to cover the capital requirement for the ceded liabilities, if the deposits are in a currency different from the currency in which the ceded liabilities are payable to policyholders.

If some of the assets supporting the liabilities ceded under an unregistered reinsurance agreement are held by the ceding SRO (e.g., funds withheld), the SRO's corresponding liability should be treated as an asset in the calculation of the open positions for the ceded business.

Excess deposits placed by an unregistered reinsurer within a pool of supporting assets may be used to reduce the foreign exchange risk requirement for the corresponding ceded business to a minimum of zero. Any requirements not covered by excess deposits must be added to the ceding SRO's own requirement.

## **5.3 Equity risk**

Equity risk is the risk of economic loss due to fluctuations in the value of common shares and other equity securities.

### **5.3.1 Common shares and joint ventures**

A 30% risk factor applies to investments in common shares and joint ventures in which an SRO holds less than or equal to 10% ownership interest.



### 5.3.2 Futures, forwards and swaps

Equity futures, forwards, and swaps attract a 30% risk factor, which is applied to the market value of the underlying equity security or index. Where a swap exchanges a return on an equity security or index for a return on a different equity security or index, a 30% risk factor applies to the market value of both equity securities and indices for which the returns are being exchanged.

#### Example 5-3

An SRO has entered into a one-year swap during which it will pay the 3-month Canadian Dollar Offered Rate (CDOR) plus fees, and receive the total return on a notional index of equities that was worth \$100 at the time of inception. The index of equities is currently worth \$110. A 30% equity risk capital charge will apply to \$110 for the long position in the index, but no capital will be required on the short position in the bond because such a position is not subject to a capital charge.

In addition to the capital requirements set out in this section, futures, forwards, and swaps are subject to credit risk requirements. Refer to Section 6.2 for further details.

### 5.3.3 Short positions

The capital requirements for short positions in common shares, equity futures, forwards, and swaps that do not wholly or partially offset a long equity position are determined by assuming the instrument is held long and then applying the corresponding risk factor. Common shares, futures, forwards, and swaps eligible for offset recognition and the corresponding capital treatment are described in Section 5.3.4.

### 5.3.4 Recognition of equity hedges

Equity futures, forwards, and swaps, as well as common shares can be used to wholly or partially hedge an equity exposure. SROs may recognize qualifying equity hedges in the calculation of the capital requirements in accordance with Sections 5.3.4.1 and 5.3.4.2.

SROs must document the equity hedging strategies employed and demonstrate that the hedging strategies decrease the overall risk. The documentation must be available for review, upon request. If the SRO cannot demonstrate, to the AMF's satisfaction, that the hedging strategies result in decreased overall risk, then additional capital above that calculated per Sections 5.3.4.1 and 5.3.4.2 may be required, at the discretion of the AMF.<sup>21</sup>

For hedges to qualify, the instruments which make them up must be issued by an entity that:

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<sup>21</sup> An SRO may contact the AMF to discuss the adequacy of its documentation and/or risk assessment to assess the likelihood or amount of potential additional capital that may be required.

- issues obligations which attract a 0% factor under Section 6.1.3; or
- is rated A- or higher (including clearing houses rated A- or higher).

#### **5.3.4.1 Identical equity securities or indices**

Long and short positions in exactly the same underlying equity security or index may be considered to be offsetting so that the capital requirements are calculated for the net exposure only. Individual instruments of portfolios that qualify for the capital treatment under Section 5.3.4.2 cannot be carved out of the portfolios to receive the capital treatment of Section 5.3.4.1.

Only common shares and plain-vanilla equity futures, forwards, and swaps can obtain the capital treatment under this section. Options and other exotic equity derivatives do not qualify for this treatment.<sup>22</sup>

#### **5.3.4.2 Closely linked equity securities or indices**

A portfolio of common shares and equity futures, forwards, and swaps can be used to partially hedge the equity exposure of another portfolio of similar instruments. When the instruments contained in both portfolios are closely linked, instead of following the capital requirements set out in Sections 5.3.1, 5.3.2, and 5.3.3, SROs may calculate the capital requirements for the combined portfolios in the following manner:

$$(1 - \text{Correlation Factor}) \times 1.5 \times \text{MIN}(\text{market value of the portfolio of hedging instruments}, \text{market value of the portfolio of instruments being hedged})$$

The capital requirements set out above are capped at 60% of the minimum market value of both portfolios.

The difference between the market value of the two portfolios is not considered a hedged position and is subject to a 30% risk factor.

The Correlation Factor (CF) is derived by using:

$$CF = A \times (B/C)$$

where:

- A: represents the historical correlation between the returns on the portfolio of instruments being hedged and the returns on the portfolio of hedging instruments
- B: represents the minimum of (standard deviation of returns on the portfolio of instruments being hedged, standard deviation of returns on the portfolio of hedging instruments)

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<sup>22</sup> An example of an exotic derivative would be one that has a discontinuous payoff structure.

- C: represents the maximum of (standard deviation of returns on the portfolio of instruments being hedged, standard deviation of returns on the portfolio of hedging instruments)

The historical correlations and standard deviations must be calculated on a weekly basis, covering the previous 52-week period. The returns on each portfolio of hedging instruments used to calculate the components of the CF must be determined by assuming that the portfolio is held long. The returns on each portfolio must be measured net of additional capital injections, and must include the returns on each component of the portfolio. For example, the returns on both the long and short legs of a total return swap included in a portfolio must be reflected in the calculation of the CF.

The CF for the previous 52 weeks is required to be calculated for each of the past four quarters. The correlation factor is the lowest of the four CFs calculated and is used to calculate capital requirements.

In order for the portfolios to obtain the capital treatment set out in this section, the following conditions must be met:

- the instruments in both portfolios are limited to exchange-traded common shares, and plain-vanilla equity futures, forwards, and swaps where the underlying asset is an exchange-traded common share or an equity index. Options and other exotic equity derivatives do not qualify for this treatment. Portfolios that contain instruments other than those specified in this section will be subject to the capital treatment under Sections 5.3.1, 5.3.2, and 5.3.3;
- the CF is determined at the portfolio level. Individual instruments cannot be carved out of the portfolios and receive the capital treatment as per Section 5.3.4.1;
- the portfolios that are part of a hedging strategy must have been established at least two years prior to the reporting date. In addition, the hedging strategy and the active management strategy on which both portfolios are based must not have changed in the past two years prior to the reporting date.<sup>23</sup> Portfolios that have been established for at least two years but have undergone a change in the hedging strategy or active management strategy will attract a 30% risk factor.

#### **Example 5-4**

Suppose a portfolio of instruments is valued at \$200 and is paired with another portfolio of instruments as part of a qualifying equity hedge. Assuming that the second portfolio is worth \$190 and that the correlation factor between the two portfolios is 0.95, the total capital charge for both portfolios will be  $\$190 \times 5\% \times 1.5 + \$10 \times 30\% = \$17.25$ .

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<sup>23</sup> For the purposes of this section, the hedging strategy and active management strategy together are deemed to be unchanged if the ex-ante equity risk profile of the combined portfolios is maintained. For example, the ex-ante equity risk profile is maintained if the combined beta is continuously targeted to be 0 (the hedging strategy), and if instrument selection is continuously based on the price-earnings ratio (the active management strategy).

**Portfolios recently established**

Portfolios that were established less than two years prior to the reporting date attract the following capital treatment:

- no recognition of the equity hedge in the first year following the establishment of the portfolios (i.e., a 30% factor is applied to both portfolios); and
- in the second year, the sum of:
  - T x capital requirements for the combined portfolios using the correlation factor approach described in this section<sup>24</sup>; and
  - (1-T) x capital requirements without recognition (as set out above).

where T equals 20%, 40%, 60%, and 80% in the first, second, third, and fourth quarter, respectively, of the second year following the establishment of the portfolios.

**Example 5-5**

Two portfolios (as part of an equity hedge), each equal to \$100, are established on April 1, 2016. On March 31, 2017, the capital charge for both portfolios will be  $(30\% \times \$100 + 30\% \times \$100) = \$60$ . On June 30, 2017, assuming that the Correlation Factor is 0.90, the combined portfolios will be subject to a capital charge of  $(20\% \times 10\% \times 1.5 \times \$100 + 80\% \times 30\% \times 2 \times \$100) = \$51$ .

**5.4 Real estate risk**

Real estate risk is the risk of economic loss due to changes in the value of a property or in the amount and timing of cash flows from investments in real estate.

Risk factor	Real estate
10%	Owner-occupied properties
20%	Held for investment purposes

For owner-occupied properties, the risk factor is applied to the value using the cost model, excluding any unrealized fair value gains (losses) resulting from the conversion to IFRS, or subsequent unrealized fair value gains (losses) due to revaluation.

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<sup>24</sup> For the purposes of this calculation, the CF must be determined based on actual portfolio returns (i.e., portfolio returns up to the reporting date). Projected (simulated) returns cannot be used. The CF must be determined as the lowest of available 52 week CF given the actual history of portfolio returns. During the second year, the number of available 52 week CF will increase from one to four as time elapses.

## **5.5 Right-of-use assets**

The risks associated with right-of-use assets are related to fluctuating market lease rates and contingent changes in the amount and timing of cash flows arising from early cancellation penalties and the costs associated with renegotiating or finding a new lease.

A 10% risk factor is applied to right-of-use assets, determined in accordance with applicable accounting principles and associated with leased ~~buildings~~ properties occupied by the SRO and ~~to~~ with leased assets that fall into the “Other assets” category, for example, equipment.

A 20% risk factor is applied to right-of-use assets, determined in accordance with applicable accounting principles and associated with leases on ~~buildings~~ properties used for investment purposes.

## **5.6 Other market risk exposures**

Other market risk exposures include assets that fall into the “Other assets” category, for example, equipment, that are exposed to asset value fluctuations that may result in the value realized upon disposal being less than the balance sheet carrying value. A 10% risk factor applies to other assets as part of the total capital requirements for market risk.

## **Chapter 6. Credit risk**

Credit risk is the risk of loss arising from a counterparty's potential inability or unwillingness to fully meet its contractual obligations due to the SRO. Exposure to this risk occurs any time funds are extended, committed, or invested through actual or implied contractual agreements. Components of credit risk include loan loss/principal risk, pre-settlement/replacement risk and settlement risk. Counterparties covered by this guideline include issuers, debtors, borrowers, brokers, policyholders, reinsurers and guarantors.

All on- and off-balance sheet exposures are subject to a specific risk factor that either:

- corresponds to the external credit rating of the counterparty or issuer; or
- represents a prescribed factor determined by the AMF.

To determine the capital requirements for balance sheet assets, factors are applied to the balance sheet values or other specified values of these assets. To determine the capital requirements for off-balance sheet exposures, factors are applied to the exposure amounts determined according to Section 6.2. Collateral and other forms of credit risk mitigators may be used to reduce the exposure. No risk factors are applied to assets deducted from capital available (reference Section 3.3.1). The resulting amounts are summed to arrive at the credit risk capital requirements.

### **6.1 Capital requirements for balance sheet assets**

For the purpose of calculating the capital requirements for credit risk, balance sheet assets should be valued at their balance sheet carrying amounts, with the following exceptions:

- loans carried at fair value under the fair value option, fair value hedge accounting, or available-for-sale accounting, which should be valued at amortized cost; and
- off-balance sheet exposures, which should be valued in accordance with Section 6.2.

#### **6.1.1 Use of ratings**

Many of the risk factors in this guideline depend on the external credit rating assigned to an asset or an obligor. In order to use a factor that is based on a rating, an SRO must meet all of the conditions specified below.

SROs may recognize credit ratings from the following rating agencies for MCT purposes:

- DBRS;
- Moody's Investors Service;
- Standard and Poor's (S&P);
- Fitch Rating Services;
- Kroll Bond Rating Agency (KBRA).

An SRO must choose the rating agencies it intends to rely on and then use their ratings for MCT purposes consistently for each type of asset or obligation. SROs are not authorized to select the assessments provided by different rating agencies with the sole intent to reduce their capital requirements.

Any rating used to determine a factor must be publicly available, i.e., the rating must be published in an accessible form and included in the rating agency's transition matrix. Ratings that are made available only to the parties to a transaction do not satisfy this requirement.

If an SRO is relying on multiple rating agencies and there is only one assessment for a particular claim, that assessment should be used to determine the capital requirement for the claim. If there are two assessments from the rating agencies used by an SRO and these assessments differ, the SRO should apply the risk factor corresponding to the lower of the two ratings. If there are three or more assessments for a claim from an SRO's chosen rating agencies, the SRO should exclude one of the ratings that corresponds to the lowest risk factor, and then use the rating that corresponds to the lowest risk factor of those that remain (i.e., the SRO should use the second-highest rating from those available, allowing for multiple occurrences of the highest rating).

Where an SRO holds a particular securities issue that carries one or more issue-specific assessments, the capital requirement for the claim will be based on these assessments. Where an SRO's claim is not an investment in a specifically rated security, the following principles apply:

- In circumstances where the borrower has a specific rating for an issued debt security, but the SRO's claim is not an investment in this particular security, a rating of BBB- or higher on the rated security may only be applied to the SRO's unrated claim if this claim ranks pari passu or senior to the rated claim in all respects. If not, the credit rating cannot be used and the SRO's claim must be treated as an unrated obligation.
- In circumstances where the borrower has an issuer rating, this assessment typically applies to senior unsecured claims on that issuer. Consequently, only senior claims on that issuer will benefit from a BBB- or higher issuer assessment. Other unassessed claims on the issuer will be treated as unrated. If either the issuer or one of its issues has a rating of BB+ or lower, this rating should be used to determine the risk factor for an unrated claim on the issuer.
- Short-term assessments are deemed to be issue-specific. They can only be used to determine capital requirements for claims arising from the rated security. They cannot be generalized to other short-term claims, and in no event can a short-term rating be used to support a risk factor for an unrated long-term claim.
- Where the capital requirement for an unrated exposure is based on the rating of an equivalent exposure to the borrower, foreign currency ratings should be used for exposures in foreign currency. Canadian currency ratings, if separate, should only

be used to determine the capital requirements for claims denominated in Canadian currency.

The following additional conditions apply to the use of ratings:

- External assessments for one entity within a corporate group may not be used to determine the risk factor for other entities within the same group. This condition does not apply to assets held with a credit union that is a member of a federation within the meaning of the *Act respecting financial services cooperatives* (CQLR, chapter C-67.3).<sup>25</sup>
- No rating may be inferred for an unrated entity based on assets that the entity possesses.
- In order to avoid the double counting of credit enhancement factors, SROs may not recognize credit risk mitigation if the credit enhancement has already been reflected in the issue-specific rating.
- An SRO may not recognize a rating if the rating is at least partly based on unfunded support (e.g., guarantees, credit enhancement or liquidity facilities) provided by the SRO itself or one of its associates.
- Any assessment used must take into account and reflect the entire amount of credit risk exposure an SRO has with regard to all payments owed to it. In particular, if an SRO is owed both principal and interest, the assessment must fully take into account and reflect the credit risk associated with repayment of both principal and interest.
- SROs may not rely on unsolicited ratings in determining the risk factor for an asset, except where the asset is a sovereign exposure and a solicited rating is not available.

### **6.1.2 Variable credit risk factors**

Various risk factors are applied to invested assets depending on the external credit ratings and the remaining term to maturity as outlined below.

Investments in mutual funds or other similar assets must be broken down by type of investment (bonds, preferred shares, etc.) and assigned the appropriate risk factor relating to the investment. If the information available on an investment is not broken down, then the factor of the riskiest asset held in the fund is assigned to the entire investment.

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<sup>25</sup> To qualify for this exception, the SRO must refer to a rating assigned to a financial services cooperative by a rating agency duly recognized under this guideline, which rating should be closely linked to the evaluation of the quality of the financial condition and the risk assessment of the credit unions that are members of the federation. If more than one financial services cooperative is assessed, the SRO must apply the risk factor corresponding to the lowest rating.



**6.1.2.1 Long-term obligations**

- Long-term obligations, including term deposits, bonds, debentures and loans that are not eligible for a 0% risk factor, and that are not Canadian municipal bonds, have risk factors according to the following table:

Rating	Remaining term to maturity		
	One year or less	Greater than 1 year up to and including 5 years	Greater than 5 years
AAA	0.25%	0.5%	1.25%
AA+ to AA-	0.25%	1%	1.75%
A+ to A-	0.75%	1.75%	3%
BBB+ to BBB-	1.5%	3.75%	4.75%
BB+ to BB-	3.75%	7.75%	8%
B+ to B-	7.5%	10.5%	10.5%
Unrated	6%	8%	10%
Below B-	15.5%	18%	18%

- Bonds of Canadian municipalities only <sup>26</sup> have risk factors according to the following table:

Rating	Remaining term to maturity		
	One year or less	Greater than 1 year up to and including 5 years	Greater than 5 years
AAA	0.125%	0.25%	0.625%
AA+ to AA-	0.125%	0.5%	0.875%
A+ to A-	0.375%	0.875%	1.5%
BBB+ to BBB-	0.75%	1.875%	2.375%
BB+ to BB-	1.875%	3.875%	4%
B+ to B-	3.75%	5.25%	5.25%
Unrated	3%	4%	5%
Below B-	7.75%	9%	9%

- Long-term obligations generally have an original term to maturity at issue of 1 year or more.
- Remaining term to maturity denotes the number of years from the reporting date until the maturity date.
- SRO may use effective maturity as an option for determining risk factors for investments in long-term obligations subject to a determined cash flow schedule. The following formula may be used to calculate effective maturity:

$$\text{Effective maturity (M)} = \frac{\sum t \times CF_t}{\sum CF_t}$$

where  $CF_t$  denotes the cash flows (principal, interest payments and fees) contractually payable by the borrower in period  $t$ .

- In cases where an SRO elects not to calculate an effective maturity or if it is not feasible to do so using the above formula, the SRO is required to use the maximum remaining time (in years) that the borrower is permitted to fully discharge its contractual obligation (principal, interest and fees) under the terms of the loan agreement. Normally, this would correspond to the nominal maturity or term to maturity of the instrument;

<sup>26</sup> For other municipal bonds, refer to the risk factors of the other long-term obligations.

- Where information is not available to determine the redemption/maturity of an asset, SROs must use the “Greater than 5 years” category for that asset.

**6.1.2.2 Short-term obligations**

- Short-term obligations, including commercial paper, that are not eligible for a 0% risk factor, have risk factors assigned according to the following table:

Rating	Factor
A-1, F1, P-1, R-1 or equivalent	0.25%
A-2, F2, P-2, R-2 or equivalent	0.5%
A-3, F3, P-3, R-3 or equivalent	2%
Unrated	6%
All other ratings, including non-prime and B or C ratings	8%

- Short-term obligations generally have an original term to maturity at issue of no more than 365 days.

**6.1.2.3 Asset-backed securities**

The category of asset-backed securities encompasses all securitizations, including mortgage-backed securities and collateralized mortgage obligations, as well as other exposures that result from the stratification or tranching of an underlying credit exposure. For exposures that arise as a result of securitizations, SROs should refer to Chapter 6 (rules related to securitization) of the capital base adequacy requirements guideline published by the AMF for financial services cooperatives, in order to determine whether there are functions provided (e.g., credit enhancement or liquidity facilities) that require capital for credit risk.

**NHA residential mortgage-backed securities**

Mortgage-backed securities that are guaranteed by the Canada Mortgage and Housing Corporation (CMHC) under the *National Housing Act* (NHA) carry a risk factor of 0% in recognition of the fact that CMHC commitments are legal obligations of the Government of Canada.

**Other asset-backed securities**

The capital requirements for all other asset backed securities are based on their external credit ratings. In order to use external credit ratings to determine capital requirements, the SRO must satisfy all operational requirements for use of the ratings set out in the capital base adequacy requirements guideline published by the AMF for financial services cooperatives.

For asset-backed securities (other than resecuritizations) rated BBB or higher, the capital requirement is the same as the requirement specified in section 6.1.2.1 for a long-term obligation having the same rating and maturity as the asset-backed security. If an asset-backed security is rated BB, the SRO may recognize the rating only if it is a third-party investor in the security. The credit risk factor for an asset-backed security (other than a resecuritization) rated BB in which the SRO is a third-party investor is 300% of the requirement for a long-term obligation rated BB having the same maturity as the security.

The credit risk factors for short-term asset-backed securities (other than resecuritizations) rated A-3 or higher are the same as those in section 6.1.2.2 for short-term obligations having the same rating.

The credit risk factor for any resecuritization rated BBB or higher is 200% of the risk factor applicable to an asset-backed security having the same rating and maturity as the resecuritization.

The credit risk factor for all other asset-backed security not mentioned above (including unrated securities) is 60%.

#### 6.1.2.4 Preferred shares

- Preferred shares risk factors should be assigned according to the following table:

Rating	Factor
AAA, AA+ to AA-, Pfd-1, P-1 or equivalent	3%
A+ to A-, Pfd-2, P-2 or equivalent	5%
BBB+ to BBB-, Pfd-3, P-3 or equivalent	10%
BB+ to BB-, Pfd-4, P-4 or equivalent	20%
B+ or lower, Pfd-5, P-5 or equivalent or unrated	30%

#### 6.1.3 Fixed credit risk factors

##### 0% Risk factor

- Cash held on the SRO's own premises.
- Obligations of federal, provincial and territorial governments in Canada.<sup>27</sup>

<sup>27</sup> Including securities, loans and accounts receivable.

- Obligations of agents of the federal, provincial or territorial governments in Canada whose obligations are, by virtue of their enabling legislation, direct obligations of the parent government.
- Obligations of sovereigns rated AA- or higher and their central banks.<sup>28</sup>
- Obligations that have been explicitly, directly, irrevocably and unconditionally guaranteed by a government Grade entity eligible for a 0% risk factor including, for example, residential mortgages insured under the NHA or equivalent provincial mortgage insurance program, and NHA mortgage-backed securities that are guaranteed by the Canada Mortgage and Housing Corporation.
- DPAA, including DPAA on commissions, premium taxes, etc.
- Instalment premiums receivable (not yet due).
- Any deductions from capital, including goodwill, intangible assets and interests in non-qualifying subsidiaries, associates, and joint ventures with more than 10% ownership interest.

#### **0.25% Risk factor**

- Demand deposits, certificates of deposit, drafts, cheques, acceptances and similar obligations that have an original maturity of less than three months, and that are drawn on regulated deposit-taking institutions subject to the solvency requirements of the Basel Framework.<sup>29</sup>

#### **0.70% Risk factor**

- Insurance receivables from registered reinsurers.

#### **2.5% Risk factor**

- Investment income due and accrued.
- Unearned premiums recoverable from registered reinsurers (reference Section 4.3.1).
- Unpaid claims and adjustment expenses recoverable from registered reinsurers (reference Section 4.3.1).

#### **4% Risk factor**

- First mortgages on one- to four-unit residential dwellings.

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<sup>28</sup> Sovereign obligations rated lower than AA- may not receive a factor of 0%, and are instead subject to the factor requirements in Section 6.1.2.

<sup>29</sup> Where the maturity of the asset is longer than three months, the risk factor related to the credit rating of the regulated deposit-taking institution would apply instead.

**5% Risk factor**

- Accounts receivable, not yet due and outstanding less than 60 days, from non-qualifying subsidiaries, associates, joint ventures and policyholders, including other receivables.
- Instalment premiums outstanding less than 60 days.

**10% Risk factor**

- Accounts receivable, outstanding 60 days or more, from non-qualifying subsidiaries, associates, joint ventures and policyholders, including instalment premiums and other receivables.
- Commercial mortgages and other residential mortgages that do not qualify as first mortgages on one- to four-unit residential dwellings.
- The amount of available refunds of defined benefit pension plan surplus assets included in capital available.
- Other investments not specified in this section or Section 5.5 as part of other market risk exposures, excluding derivative-related amounts. Capital requirements for derivative-related amounts included in other investments are set out in Section 6.2.
- Other assets not specified in this section or Section 5.5 as part of other market risk exposures, excluding other investments.

**15% Risk factor**

- Mortgages secured by undeveloped land (e.g., construction financing), other than land used for agricultural purposes or for the production of minerals. A property recently constructed or renovated will be considered as “under construction” until it is completed and 80% leased.

**20% Risk factor**

- Other recoverables (mainly salvage and subrogation) on unpaid claims.
- SIR recoverables not deducted from capital (reference Section 4.4).
- Assets held for sale (other than financial).<sup>30</sup>

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<sup>30</sup> 1) Alternatively, assets classified as held for sale may be re-consolidated (look-through approach) at the option of the SRO. If this method is selected, any write-down made as a result of re-measuring the assets classified as held for sale at the lower of carrying amount and fair value less costs to sell should be reflected in the MCT after re-consolidation. Any asset within a consolidated group that is deducted from capital available for MCT purposes should continue to be deducted from capital when it becomes an asset held for sale.

2) If the SRO has elected to apply a 20% risk factor to assets held for sale instead of using the look-through approach, associated liabilities held for sale should be subject to the usual MCT treatment of liabilities as per Chapter 4.

## **45% Risk factor**

- Loans or other forms of lending (bonds, debentures, mortgages, etc.) provided to non-qualifying (non-consolidated) subsidiaries, associates and joint ventures with more than a 10% ownership interest which are not considered as capital;

## **6.2 Capital requirements for off-balance sheet exposures**

The capital required for off-balance sheet exposures such as structured settlements, letters of credit or non-owned deposits, derivatives and other exposures is calculated in a manner similar to the on-balance sheet assets in that the credit risk exposure is multiplied by a counterparty risk factor to arrive at the capital required. However, unlike most assets, the face amount of an off-balance sheet exposure does not necessarily reflect the true credit risk exposure. To approximate this exposure, a credit equivalent amount is calculated for each exposure. This amount, net of any collateral or guarantees, is then multiplied by a credit conversion factor. For letters of credit and non-owned deposits, the credit equivalent amount is the face value. The determination of the counterparty credit risk categories and the approach for determining the eligibility of collateral and guarantees is the same as it is for other assets. For letters of credit and non-owned deposits, the counterparty credit risk is found under Section 4.3.2.3.

The risk to an SRO associated with structured settlements, letters of credit, non-owned deposits, derivatives and other exposures and the amount of capital required to be held against this risk is:

- the credit equivalent amount of the instrument at the reporting date;
- less: the value of eligible collateral securities or guarantees (reference Section 6.3);
- multiplied by: a factor reflecting the nature and maturity of the instrument (Credit Conversion Factors); and
- multiplied by: a factor reflecting the risk of default of the counterparty to a transaction (Risk Factors).

### **6.2.1 Credit equivalent amount**

The credit equivalent amount related to off-balance sheet exposures varies according to the type of instrument.

#### **6.2.1.1 Structured settlements**

The credit equivalent amount for a “Type 1” structured settlement is the current replacement cost of the settlement, which is gross of the coverage provided by Assuris.

“Type 1” structured settlements are not recorded as liabilities on the balance sheet and have the following characteristics:

- An annuity is purchased by an SRO that is named as the owner. There is an irrevocable direction from the SRO to the annuity underwriter to make all payments directly to the claimant.
- Since the annuity is non-commutable, non-assignable and non-transferable, the SRO is not entitled to any annuity payments and there are no rights under the contractual arrangement that would provide any current or future benefit to the SRO.
- The SRO is released by the claimant indicating settlement of the claim amount.
- The SRO remains liable to make payments to the claimant in the event and to the extent the annuity underwriter fails to make payments under the terms and conditions of the annuity and the irrevocable direction given.

Under this type of structured settlement arrangement, the SRO is not required to recognize a liability to the claimant, nor is it required to recognize the annuity as a financial asset. However, the SRO is exposed to some credit risk by guaranteeing the obligation of the annuity underwriter to the claimant and, consequently, must set aside additional capital.

For details on the types of structured settlements, SROs should refer to Special Topics, Section IV of the Instructions to the P&C Returns.

#### **6.2.1.2 Derivatives**

The credit equivalent amount for derivatives is the positive replacement cost (obtained by marking to market) plus an amount for potential future credit exposure (an “add-on” factor).

Derivatives include forwards, futures, swaps, purchased options, and other similar contracts. SROs are not exposed to credit risk for the full face value of these contracts (notional principal amount), only to the potential cost of replacing the cash flow (on contracts showing a positive value) if the counterparty defaults. The credit equivalent amounts are assigned the risk factor appropriate to the counterparty in order to calculate the capital requirement.

The credit equivalent amount depends on the maturity of the contract and the volatility of the underlying instrument. It is calculated by adding:

- the total replacement cost (obtained by marking to market) of all contracts with positive values; and
- an amount for potential future credit exposure (or “add-on”). This is calculated by multiplying the notional principal amount by the following “add-on” factors.



<b>Residual Maturity</b>	<b>Interest Rate</b>	<b>Exchange Rate and Gold</b>	<b>Equity</b>	<b>Precious Metals except Gold</b>	<b>Other Instruments</b>
	<b>(01)</b>	<b>(02)</b>	<b>(03)</b>	<b>(04)</b>	<b>(05)</b>
One year or less	0%	1%	6%	7%	10%
One year to five years	0.5%	5%	8%	7%	12%
Over five years	1.5%	7.5%	10%	8%	15%

**Notes**

- Instruments traded on exchanges do not require capital for counterparty credit risk where they are subject to daily margining requirements.
- For contracts with multiple exchanges of principal, the factors are to be multiplied by the number of remaining payments in the contract.
- For contracts that are structured to settle outstanding exposures following specified payment dates, and where the terms are reset so that the market value of the contract is zero on these specified dates, the residual maturity is considered to be the time until the next reset date. In the case of interest rate contracts with residual maturities of more than one year and that also meet the above criteria, the add-on factor is subject to a floor of 0.5%.
- Contracts not covered by columns 01 to 04 in the above table are to be treated as “Other Instruments” for the purpose of determining the “add-on” factor.
- No potential credit exposure would be calculated for single currency floating/floating interest rate swaps; the credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value.
- The add-ons are based on effective rather than stated notional amount. In the event that the stated notional amount is leveraged or enhanced by the structure of the transaction, SROs must use the actual or effective notional amount when determining potential future exposure. For example, a stated notional amount of \$1 million with payments calculated at two times LIBOR would have an effective notional amount of \$2 million.
- Potential credit exposure is to be calculated for all over-the-counter (OTC) contracts (with the exception of single currency floating/floating interest rate swaps), regardless of whether the replacement cost is positive or negative.

No add-on for potential future exposure is required for credit derivatives. The credit equivalent amount for a credit derivative is equal to the greater of its replacement cost or zero.

### **6.2.1.3 Other exposures**

#### **Commitments**

A commitment involves an obligation (with or without a material adverse change clause or similar clause) of the SRO to fund its customer in the normal course of business should the customer seek to draw down the commitment. This includes:

- extending credit in the form of loans or participations in loans, lease financing receivables, mortgages or loan substitutes; or
- purchasing loans, securities, or other assets.

Normally, commitments involve a written contract or agreement and a commitment fee or some other form of consideration.

The maturity of a commitment should be measured from the date when the commitment was accepted by the customer, regardless of whether the commitment is revocable or irrevocable, conditional or unconditional, until the earliest date on which:

- the commitment is scheduled to expire; or
- the SRO can, at its option, unconditionally cancel the commitment.

#### **Repurchase and reverse repurchase agreements**

A securities repurchase (repo) is an agreement whereby a transferor agrees to sell securities at a specified price and repurchase the securities on a specified date and at a specified price. Since the transaction is regarded as a financing transaction for accounting purposes, the securities remain on the balance sheet. Given that these securities are temporarily assigned to another party, the factor accorded to the asset should be the higher of the factor of the security and the factor of the counterparty to the transaction (net of any eligible collateral).

A reverse repo agreement is the opposite of a repo agreement, and involves the purchase and subsequent sale of a security. Reverse repos are treated as collateralized loans, reflecting the economic reality of the transaction. The risk is therefore to be measured as an exposure to the counterparty. Where the asset temporarily acquired is a security that attracts a lower factor, this would be recognized as collateral and the factor would be reduced accordingly.

#### **Guarantees provided in securities lending**

In securities lending, SROs can act as principal to the transaction by lending their own securities or as agent by lending securities on behalf of customers. When the SRO lends its own securities, the risk factor is the higher of:

- the risk factor related to the instruments lent; or

- the risk factor for an exposure to the borrower of the securities. The exposure to the borrower may be reduced if the SRO holds eligible collateral (reference Section 6.3.1). Where the SRO lends securities through an agent and receives an explicit guarantee of the return of the securities, the SRO may treat the agent as the borrower subject to the conditions in Section 6.3.2.

When the SRO, acting as agent, lends securities on behalf of a client and guarantees that the securities lent will be returned or the SRO will reimburse the client for the current market value, the SRO should calculate the capital requirement as if it were the principal to the transaction. The capital requirements are those for an exposure to the borrower of the securities, where the exposure amount may be reduced if the SRO holds eligible collateral (reference Section 6.3.1).

For details on how to record these and other such exposures, contact the AMF.

### **6.2.2 Credit conversion factors**

Separate credit conversion factors exist for structured settlements, letters of credit, non-owned deposits, derivatives and other exposures.

For other exposures, the weighted average of the credit conversion factors, described below, for all of these instruments held by the SRO, should be used.

#### **100% Conversion factor**

- Direct credit substitutes (general guarantees of indebtedness and guarantee-type instruments, including standby letters of credit and non-owned deposits serving as financial guarantees for, or supporting, loans and securities)
- Derivatives such as forwards, futures, swaps, purchased options (including options purchased over the counter) and other similar derivative contracts, including:
  - interest rate contracts (single currency interest rate swaps, basis swaps, forward rate agreements and derivative contracts with similar characteristics, interest rate futures, interest rate options purchased, and similar derivative contracts based on specific parameters or on indices, etc.);
  - equity contracts (forwards, swaps, purchased options, and similar derivative contracts based on specific parameters or on indices, etc.);
  - exchange rate contracts (gold contracts, cross-currency swaps, cross-currency interest rate swaps, outright forward foreign exchange contracts, currency futures, currency options purchased, and similar derivative contracts based on specific parameters or on indices, etc.);
  - precious metals (except gold) and other commodity contracts (forwards, swaps, purchased options, and similar derivative contracts based on specific parameters or on indices, etc.);
  - other derivative contracts based on specific parameters or on indices (such as catastrophe insurance options and futures).

- Forward agreements (contractual obligations) to purchase assets
- Sale and repurchase agreements
- All other exposures not contemplated elsewhere (provide details)

**50% Conversion factor**

- Structured settlements that are not recorded as liabilities on the balance sheet (refer to Type 1 characteristics and to Section IV, Special Topics, of the Instructions to the P&C Returns)
- Transaction-related contingencies (for example, warranties and standby letters of credit related to a particular transaction)
- Commitments with an original maturity exceeding one year

**20% Conversion factor**

- Commitments with an original maturity of one year or less

**0% Conversion factor**

- Commitments that are unconditionally cancellable at any time without prior notice<sup>31</sup>

**6.2.3 Risk factors**

Off-balance sheet exposures are assigned a risk factor consistent with Section 6.1. All criteria in Section 6.1 around the use of ratings are applicable to off-balance sheet exposures.

Risk factors for structured settlements, which are considered long-term exposures, are based on the credit rating of the counterparty from which the annuity is purchased.

The risk factors to be applied are:

Rating	Factor
Rated A- or higher	2%
Rated BBB+ to B-	8%
Unrated	10%
Below B-	18%

<sup>31</sup> Other than any notice required under legislation or court rulings that require notice.

If the structured settlement is not rated by one of the four rating agencies listed in Section 6.1.1, an SRO may use a credit rating from another reputable rating agency. The use of an alternative rating agency must comply with all the criteria around the use of ratings specified in Section 6.1.1, including a consistent use of the same rating agency in order to assign a risk factor based on the credit rating of the annuity underwriter.

### **6.3 Capital treatment of collateral and guarantees**

#### **6.3.1 Collateral**

A collateralized transaction is one in which:

- an SRO has a credit exposure or potential credit exposure; and
- the credit exposure or the potential credit exposure is hedged in whole or in part by collateral posted by a counterparty or by a third party on behalf of the counterparty.

Recognition of collateral in reducing the capital requirements is limited to cash or securities rated A- or higher. Any collateral must be held throughout the period for which the exposure exists. Only that portion of an exposure that is covered by eligible collateral will be assigned the risk factor given to the collateral, the uncovered portion retains the risk factor of the underlying counterparty. Only collateral securities with a lower risk factor than the underlying exposure will lead to reduced capital requirements. All criteria in Section 6.1 around the use of ratings are applicable to collateral. Where a rating is not available for the collateral asset, exposure, or counterparty where applicable, no reduction in capital required is permitted.

The effects of collateral may not be double counted. Therefore, SROs may not recognize collateral on claims for which an issue-specific rating is used that already reflects that collateral.

Collateral securities used to reduce capital requirements must materially reduce the risk arising from the credit quality of the underlying exposure. In particular, collateral used may not be related party obligations of the issuer of the underlying exposure (i.e., obligations of the underlying counterparty itself, its parent, or one of its subsidiaries or associates).

#### **6.3.2 Guarantees**

Investments (principal and interest) or exposures that have been explicitly, directly, irrevocably and unconditionally guaranteed by a guarantor whose long-term issuer credit rating is A- or higher, may attract the risk factor allocated to a direct claim on the guarantor where the desired effect is to reduce the risk exposure. Thus only guarantees issued by entities with a lower risk factor than the underlying counterparty will lead to reduced capital requirements.<sup>32</sup>

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<sup>32</sup> Letters of credit for which a company is the beneficiary are included within the definition of guarantees, and receive the same capital treatment.

Where the recovery of losses on a loan, financial lease agreement, security or exposure is partially guaranteed, only the part that is guaranteed is to be weighted according to the risk factor of the guarantor (see following examples). The uncovered portion retains the risk factor of the underlying counterparty.

All criteria in Section 6.1 around the use of ratings remain applicable to guarantees. Where a rating is not available for the investment, exposure, or guarantor where applicable, no reduction in capital required is permitted.

An SRO may not recognize a guarantee provided by a related enterprise (parent, subsidiary or associate). This treatment follows the principle that guarantees within a corporate group are not a substitute for capital.

The effects of credit protection may not be double counted. Therefore, no capital recognition is given to credit protection on claims for which an issue-specific rating is used that already reflects that protection.

To be eligible, a guarantee must cover the full term of the exposure, i.e., no recognition will be given to a guarantee if there is a maturity mismatch,<sup>33</sup> and be legally enforceable.

### **6.3.2.1 Additional requirements for guarantees**

The following conditions must be satisfied in order for a guarantee to be recognized:

- on the qualifying default/non-payment of the counterparty, the SRO may in a timely manner pursue the guarantor for any monies outstanding under the documentation governing the transaction. The guarantor may make one lump sum payment of all monies under such documentation to the SRO, or the guarantor may assume the future payment obligations of the counterparty covered by the guarantee. The SRO must have the right to receive any such payments from the guarantor without first having to take legal action in order to pursue the counterparty for payment;
- the guarantee is an explicitly documented obligation assumed by the guarantor;
- except as noted in the following sentence, the guarantee covers all types of payments the underlying obligor is expected to make under the documentation governing the transaction, for example notional amount, margin payments, etc. Where a guarantee covers payment of principal only, interest and other uncovered payments should be treated as an unsecured amount in accordance with Section 6.1.

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<sup>33</sup> A maturity mismatch occurs when the residual maturity of the credit protection is less than that of the underlying exposure.

### 6.3.3 Examples

#### Example 6-1: Credit risk exposure

To record a \$100,000 bond rated AAA due in 10 years that has a government guarantee of 90%, the SRO would report a balance sheet value of \$90,000 ( $\$100,000 \times 90\%$ ) in the 0% risk weighted category and a balance sheet value of \$10,000 ( $\$100,000 - \$90,000$ ) in the AAA category under “Term Deposits, Bonds and Debentures - Expiring or redeemable in more than five years”. The capital required in the 0% risk weighted category is \$0 ( $\$90,000 \times 0.0\%$ ). The capital required in the AAA category is \$125 ( $\$10,000 \times 1.25\%$ ) for a total capital requirement of \$125.

An example of the calculation, assuming no other assets, is provided in the table below:

	Risk factor (%)	Balance sheet value	Capital required
<b>Investments:</b>			
Term Deposits, Bonds and Debentures:			
Expiring or redeemable in more than five years:			
0% Risk factor	0%	\$90,000	\$0
Rating: AAA	1.25%	\$10,000	\$125
<b>Total</b>		<b>\$100,000</b>	<b>\$125</b>

#### Example 6-2: Type 1 structured settlement

To record a \$300,000 Type 1 structured settlement rated BBB+ to B-, backed by collateral or by a guarantee of \$200,000 from a counterparty rated A- or higher, the SRO would report a credit equivalent amount of \$300,000 and collateral and guarantees of negative \$200,000 in the BBB+ to B- category, and collateral and guarantees of \$200,000 in the A- or higher category.

The capital required in the BBB+ to B- category is \$4,000 ( $(\$300,000 - \$200,000) \times 50\% \times 8\%$ ). The capital required in the A- or higher category is \$500 ( $\$200,000 \times 50\% \times 0.5\%$ ) for a total capital requirement of \$4,500.

An example of the calculation, assuming no other exposures, is provided in the following table.

	Credit equivalent amount	Collateral and guarantees	Credit conversion factor (%)	Risk factor (%)	Capital required
<b>Structured settlements</b>					
0% Risk factor					
Rating: A- or higher		\$200,000	50%	0.5%	\$500
Rating: BBB+ to B-	\$300,000	(\$200,000)	50%	8%	\$4,000
<b>Total</b>					<b>\$4,500</b>



## **Chapter 7. Operational risk**

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The definition includes legal risk,<sup>34</sup> but excludes strategic and reputation risk.

Exposure to operational risk results from either day-to-day operations or a specific, unanticipated event.

### **7.1 Operational risk formula**

The two risk drivers used to determine the operational risk margin are capital required and premiums, subject to a cap.

$$\text{Operational risk margin} = \text{MIN} \{30\% \text{ CR}_0, (8.50\% \text{ CR}_0 + 2.50\% \text{ P}_d + 1.75\% \text{ P}_a + 2.50\% \text{ P}_c + 2.50\% \text{ P}_\Delta)\}$$

where:

**CR<sub>0</sub>:** is the total capital required for the reporting period, before the operational risk margin and diversification credit

**P<sub>d</sub>:** is the direct premiums written in the past 12 months

**P<sub>a</sub>:** is the assumed premiums written in the past 12 months arising from third party reinsurance<sup>35</sup>

**P<sub>c</sub>:** is the premiums ceded in the past 12 months arising from third party reinsurance<sup>35</sup>

**P<sub>Δ</sub>:** is the growth in gross premiums written in the past 12 months above a 20% threshold

### **7.2 Components of operational risk margin**

#### **7.2.1 Capital required**

A portion of the operational risk margin is based on total capital required, reflecting the overall riskiness of an SRO. An 8.50% risk factor applies to total capital required, before the operational risk margin and diversification credit.

#### **7.2.2 Premium volume**

The following risk factors apply to insurance premiums:

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<sup>34</sup> Legal risk includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements.

<sup>35</sup> Includes reinsurance arrangements with insurers within the same group that do not qualify as intra-group pooling arrangements.

- 2.50% for direct premiums written;
- 1.75% for assumed premiums written arising from third party reinsurance;
- 2.50% for ceded premiums arising from third party reinsurance;

The 2.50% risk factor for direct premiums and 1.75% risk factor for assumed premiums from third party reinsurance capture an SRO's operational risk exposure on new business and renewals.

The 2.50% risk factor for ceded premiums from third party reinsurance captures the operational risk remaining with the ceding SRO. While the SRO cedes a portion of its insurance risk exposure through reinsurance, the operational risk remains with the ceding SRO. Because the capital requirements for insurance liabilities (reference Section 4.2) are calculated on the net amount of risk (net of reinsurance), the portion of operational risk requirement calculated as 8.50% of capital required does not account for the operational risk on the entire insurance business of the SRO.

### **7.2.3 Year-over-year premium growth beyond a threshold**

Rapid growth, which is linked to the acquisition of another entity, the acquisition of a block of business through assumption reinsurance, new lines of business or changes to existing products or underwriting criteria, can create additional pressures on people and systems. SROs with premium growth beyond a 20% threshold are subject to additional capital requirements for operational risk.

The premium growth requirement is calculated using gross premiums written, i.e., direct premiums written plus assumed premiums written. A 2.50% risk factor applies to the total amount of gross premiums written in the past 12 months above the 20% growth threshold compared to the gross premiums written for the same period in the previous year. For example:

- assume that as a result of rapid growth, gross premiums written increase by 50% from \$100 to \$150;
- then, the amount above the 20% increase (\$30) is subject to an additional risk factor of 2.50%.

### **7.2.4 Cap on operational risk margin**

A 30% cap serves to dampen the operational risk margin. The 30% cap is calculated in relation to total capital required, before the operational risk margin and diversification credit.

## **Chapter 8. Diversification credit**

Because losses arising across some risk categories are not perfectly correlated with each other, an SRO is not likely to incur the maximum probable loss at a given level of confidence from each type of risk simultaneously. Consequently, an explicit credit for diversification is permitted between the sum of credit and market risk requirements and the insurance risk requirement so that the total capital required for these risks is lower than the sum of the individual requirements for these risks.

### **8.1 Risk aggregation and diversification credit**

The diversification credit is calculated using the following formula:

$$\text{Diversification credit} = A + I - \sqrt{A^2 + I^2 + 2 \times R \times A \times I}$$

where:

- A: is the asset risk margin, which is the sum of capital required for:
- credit risk, including requirements for balance sheet assets, off-balance sheet exposures and collateral for unregistered reinsurance and SIRs;
  - market risk, including interest rate risk, foreign exchange risk, equity risk, real estate risk and other market risk exposures.
- I: is the insurance risk margin, which is the sum of capital required for:
- unpaid claims and premium liabilities;
  - margin required for unregistered reinsurance exposures.
- R: is the correlation factor between *A* and *I*, determined as 50% for the diversification credit calculation.

## **Annex 1. Qualifying criteria for category A capital instruments<sup>36</sup>**

For an instrument to be included in capital available under category A, it must meet all of the following criteria:

1. The instrument represents the most subordinated claim in liquidation of the SRO.
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 is allowable under relevant law and subject to the prior approval of the AMF).
4. The SRO 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 promotional material and 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 SRO is unable to pay distributions that exceed the level of distributable items or to the extent that distribution 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.

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<sup>36</sup> The application of the criteria should preserve the quality of the instruments by requiring that they are deemed fully equivalent to common shares in terms of their capital quality as regards loss absorption and do not possess features that could cause the condition of the SRO to be weakened as a going concern during periods of market stress.

10. It is directly issued and paid-in<sup>37</sup> and the SRO cannot directly or indirectly have funded the purchase of the instrument.
11. The paid-in amount is neither secured nor covered by a guarantee of the issuer or related enterprise<sup>38</sup> or 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 SRO, either given directly by the owners or, if permitted by applicable law, given by the Board of Directors or by other persons duly authorized to represent it in connection with the SRO's insurer activities.
13. It is clearly and separately disclosed on the SRO's balance sheet, prepared in accordance with the relevant accounting standards.

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<sup>37</sup> Paid-in capital generally refers to capital that has been received with finality by the SRO, is reliably valued, fully under the SRO's control and does not directly or indirectly expose the SRO to the credit risk of the investor.

<sup>38</sup> A related enterprise can include a subsidiary or any other affiliate. A holding company held by the SRO is also a related enterprise.

## **Annex 2. Qualifying criteria for category B capital instruments**

For an instrument to be included in capital available under category B, it must meet all of the following criteria:

1. The instrument is issued and paid-in in cash or, subject to the prior approval of the AMF, in other means.
2. The instrument is subordinated to policyholders, general creditors, and subordinated debt holders of the SRO.
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 SRO's policyholders and creditors.<sup>39</sup>
4. The instrument is perpetual, i.e., there is no maturity date and there are no step-ups<sup>40</sup> or other incentives to redeem.<sup>41</sup>
5. The instrument may be callable at the initiative of the issuer only after a minimum of five years:
  - i. To exercise a call option, an SRO must receive prior approval from the AMF.
  - ii. An SRO must not do anything that creates an expectation that the call will be exercised.
  - iii. An SRO must not exercise the call unless:
    - a) It replaces the called instrument with capital of the same or higher 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 SRO;<sup>42</sup>
    - b) It demonstrates that its capital position is above the internal capital target ratio after the call option is exercised.
6. Any repayment of principal (e.g., through repurchase or redemption) must require approval of the AMF, and SROs should not assume or create market expectations that such approval will be given.

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<sup>39</sup> Further, where an SRO 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 criterion #3 above.

<sup>40</sup> 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 would not constitute a step-up.

<sup>41</sup> Other incentives to redeem include a call option combined with a requirement or an investor option to convert the instrument if the call is not exercised.

<sup>42</sup> Replacement issuances can be concurrent with, but not after, the instrument is called.

7. The dividend/coupon payments must be discretionary.
  - i. The SRO must have full discretion at all times to cancel distributions/payments.<sup>43</sup>
  - ii. Cancellation of discretionary payments must not be an event of default or credit event;
  - iii. The SRO must have full access to cancelled payments to meet obligations as they fall due;
  - iv. Cancellation of distributions/payments must not impose restrictions on the SRO except in relation to distributions to the members.
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 credit standing of the SRO.<sup>44</sup>
10. The instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of applicable insolvency law.
11. Other than preferred shares, category B instruments included in capital available must be classified as equity per relevant accounting standards.
12. Neither the SRO nor a related enterprise over which the SRO exercises control or significant influence can have purchased the instrument, nor can the SRO directly or indirectly have funded the purchase of the instrument.
13. The instruments cannot have any features that hinder recapitalization, 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 directly by the SRO (e.g., it is issued out of an SPV), proceeds must be available immediately without limitation to the SRO in a form that meets or exceeds all of the criteria for inclusion specified under category B. For greater certainty, the only assets the SPV may hold are intercompany instruments issued by the SRO or a related enterprise with terms and conditions that meet or exceed the above category B criteria. Put differently, instruments issued to the SPV have to fully meet or exceed all of the eligibility criteria under category B as if the SPV itself was an end investor – i.e., the SRO cannot issue a lower quality capital

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<sup>43</sup> 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 SRO to make a dividend/coupon payment on the instrument if it has made a payment on another (typically more junior) capital instrument or share. Such an obligation is inconsistent with the requirement for full discretion to cancel distributions/payments at all times. Furthermore, the term “cancel distributions/payments” means to forever extinguish these payments. It does not permit features that require the SRO to make distributions/payments in kind at any time.

<sup>44</sup> SROs may use a broad index as a reference rate in which the issuing SRO is a reference entity; however, the reference rate should not exhibit significant correlation with the SRO’s credit standing. If an SRO plans to issue capital instruments where the margin is linked to a broad index in which the SRO is a reference entity, the SRO should ensure that the dividend/coupon is not credit-sensitive.

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 qualifying capital under category B.



### **Annex 3. Qualifying criteria for category C capital instruments**

For an instrument to be included in capital available under category C, it must meet all of the following criteria:

1. The instrument is issued and paid-in in cash or, with the prior approval of the AMF, in other means.
2. The instrument is subordinated to policyholders and general creditors of the SRO.
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 SRO's policyholders and/or general creditors.
4. Maturity:
  - i. minimum original maturity of at least five years;
  - ii. recognition in capital available in the remaining five years before maturity will be amortized on a straight line basis;
  - iii. there are no step-ups or other incentives to redeem.<sup>45</sup>
5. The instrument may be callable at the initiative of the issuer only after a minimum of five years:
  - i. To exercise a call option, an SRO must receive prior approval from the AMF.
  - ii. An SRO must not do anything that creates an expectation that the call will be exercised.
  - iii. An SRO must not exercise a call unless:<sup>46</sup>
    - a) It replaces the called instrument with capital of the same or higher 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 SRO;<sup>47</sup>
    - b) It demonstrates that its capital position is above the internal capital target ratio after the call option is exercised.

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<sup>45</sup> 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 would not constitute a step-up.

<sup>46</sup> 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 SRO does not do anything that creates an expectation that the call will be exercised at this point.

<sup>47</sup> Replacement issuances can be concurrent with, but not after, the instrument is called.

6. The investor must have no rights to accelerate the repayment of future scheduled payments (interest or principal), except in bankruptcy, insolvency, wind-up or liquidation.
7. 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 credit standing of the SRO.<sup>48</sup>
8. Neither the SRO nor a related enterprise over which the SRO exercises control or significant influence can have purchased the instrument, nor can the SRO directly or indirectly have funded the purchase of the instrument.
9. If the instrument is not issued directly by the SRO (e.g., it is issued out of an SPV), proceeds must be available immediately without limitation to the SRO in a form that meets or exceeds all of the criteria for inclusion specified under category C. For greater certainty, the only assets the SPV may hold are intercompany instruments issued by the SRO or a related enterprise with terms and conditions that meet or exceed the above category C criteria. Put differently, instruments issued to the SPV have to fully meet or exceed all of the eligibility criteria under category C as if the SPV itself was an end investor – i.e., the SRO 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 qualifying capital under category C.

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<sup>48</sup> SROs may use a broad index as a reference rate in which the issuing SRO is a reference entity; however, the reference rate should not exhibit significant correlation with the SRO's credit standing. If an SRO plans to issue capital instruments where the margin is linked to a broad index in which the SRO is a reference entity, the SRO should ensure that the dividend/coupon is not credit-sensitive.