EXCERPT FROM THE

ANNUAL REPORT

ON FINANCIAL INSTITUTIONS

// 2015

CHALLENGES AND ISSUES FACING FINANCIAL INSTITUTIONS

REGULATORY ENVIRONMENT AND OVERSIGHT

AUTORITÉ DES MARCHÉS FINANCIERS

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INTRODUCTION

In the *2015 Annual Report on Financial Institutions, the Autorité des marchés financiers* (the "AMF") is publishing information required under the various laws it administers[1] as it relates to the following: financial services cooperatives, trust companies and savings companies, insurers of persons (life and health insurers), damage insurers (property and casualty insurers) and automobile insurers.

The AMF's status as an integrated regulator gives it a global vision of the issues and trends affecting Québec's financial sector. From this standpoint it develops and applies a prudential framework which follows best practices according to international standards.

This report is divided into two parts. The first part discusses the challenges and issues facing financial institutions, the resulting sectoral impacts and the actions taken by the AMF to adequately respond to them. The second part provides an overview backed by statistics relating to financial services cooperatives, trust companies and savings companies, insurers of persons, damage insurers and automobile insurance rates.

Table 1 presents a synopsis of changes to financial institutions between 2005 and 2015.

Table 1

Changes to financial institutions sector from 2005 to 2015

Sectors	2005	**2015**	Variation
Insurance			
Number of insurers	309	267	- 13.6%
Market share of companies incorporated in Québec			
insurance of persons (life and health insurance)	47.1%	54.0%	+ 14.7%
damage insurance (property and casualty insurance)	46.4%	43.5%	- 6.3%
Direct written premiums			
insurance of persons	$9.5B	$14.8B	+ 56.0%
damage insurance	$7.1B	$9.2B	+ 30.0%
Automobile insurance			
Number of vehicles in the "private passenger" category	4,156,906	5,017,379	+ 20.7%
Market share of Québec chartered insurers	58%	55%	5.2%
Average premium under "private passenger vehicle"	$579	$532	- 8.1%
Financial services cooperatives			
Number of financial services cooperatives in Québec	547	324	- 40.8%
Total personal deposits (ISQ)	$53.8B	$86.5B	+ 60.6%
Total hypothecary (mortgage) loans (ISQ)	$49.2B	$98.7B	+ 100.7%
Trust companies			
Number of trust companies	39	37	- 5.1%
Total deposits in Québec	$11.1B	$13.1B	+ 18.4%
Total hypothecary (mortgage) loans in Québec	$6.1B	$1.2B	- 81.0%
Savings companies			
Number of savings companies	7	8	+ 14.3%
Total deposits in Québec	$8.0B	$11.2B	+ 39.1%
Total hypothecary (mortgage) loans in Québec	$11.8B	$7.6B	- 35.1%

This document is an excerpt from the 2015 Annual Report on Financial Institutions that discusses only the challenges and issues facing financial institutions and the regulatory environment.

The full report contains a complete statistical and financial picture of the industry as well as detailed data for each financial institution. It was produced in French only and is available on the AMF's website at www.lautorite.qc.ca, as are the registers of insurers and deposit institutions.

1 *An Act respecting insurance*, CQLR, c. A-32, s. 321, *Automobile Insurance Act*, CQLR, c. A-25, s. 182, *An Act respecting financial services cooperatives*, CQLR, c. C-67.3, s. 597, *An Act respecting trust companies and savings companies*, CQLR, c. S-29.01, s. 313.

CHALLENGES AND ISSUES FACING FINANCIAL INSTITUTIONS

Québec's financial sector constitutes a key industry due to its contribution to economic activity and employment as well as the extent of its involvement with individuals and businesses.

In Québec, the finance and insurance industry[2] represents 6.4% of the GDP,[3] a contribution of $20.1B to Québec's economy. Deposit and insurance institutions alone account for 80% of that contribution.

The finance and insurance industry grew by 4.2% in 2015. Over the past five years it has grown by 2.6% annually while Québec's economy has grown by 1.4% on average. However, this industry is growing slower in Québec, which represents 17.2% of Canada's finance and insurance industry, than in the rest of the country.

Although on a slight decline since 2011, the number of people in the finance and insurance industry totalled almost 150,000, representing 4.2% of all jobs in Québec in 2015.

Certain factors can affect financial industry participants to various degrees, including continuing low interest rates, the trend toward market concentration and the increased frequency of catastrophic events.

The financial sector is also changing quickly due to the combined effect of greater globalization, facilitated by information technology, and the speed at which information now spreads. Although technological innovation provides many opportunities for all financial market players, it also brings new challenges.

This document will discuss the main challenges and issues in greater depth as well as the AMF's efforts to adequately regulate and oversee the financial sector and ensure that it functions efficiently.

MACROECONOMIC[4] AND FINANCIAL CONDITIONS RELATED TO LOW INTEREST RATES

The low interest rate environment is an important issue which the AMF is watching closely due to its potential impact on the financial institutions it oversees. On the one hand, easier access to hypothecary (mortgage) loans encourages an increase in household debt, intensifying the risks for institutions offering such credit and placing downward pressure on profits, while on the other hand, low rates affect the activities of insurers of persons by reducing the expected return on assets.

Household debt

Québec household debt reached new record levels in 2015 due in part to an easing of borrowing terms. The debt to available income ratio grew to over 150% in 2015 but remains lower than that of Canada as a whole.

Approximately 75% of household debt in Québec is made up of hypothecary (mortgage) loans and 25% personal loans. Graph 1 shows the evolution of the composition of loans of indebted Québec households for the period from 2000 to 2015.[5] Over the years, the composition of the borrowing has not shifted much. The only major change: Personal lines of credit have grown due to the rise of home equity lines of credit.

2 Corresponds to the category "Finance and insurance," as defined by the *Institut de la statistique du Québec* (ISQ). This category covers deposit institutions, insurance and securities.

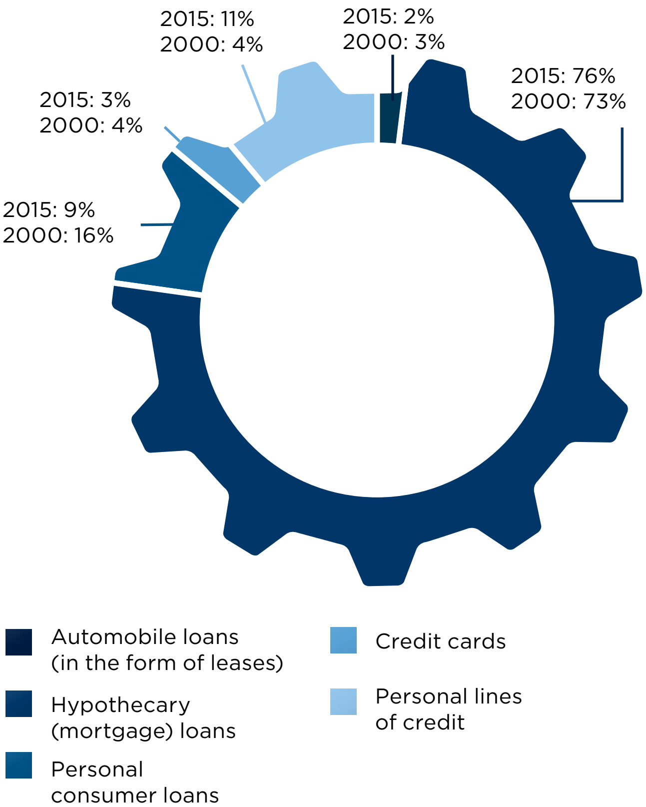
3 Gross domestic product.

4 The economic and financial context is described in detail in the Revue économique et financière trimestrielle published on the AMF's website at www.lautorite.qc.ca (in French only).

5 The data and graph were produced by the Desjardins Group, Economic Studies (Economic Viewpoint dated May 9, 2016, available at www.desjardins.com/economie).

Graph 1

Composition of loans of indebted Québec households



Despite a rise in household debt, the percentage of gross income spent on loan payments remained stable. Although Québec households still seem able to meet their financial commitments, a sharp increase in interest rates or a significant market slowdown could lead to precarious situations.

> *The AMF is closely monitoring the changing patterns of household indebtedness in accordance with its framework for sound and prudent management practices and sound commercial practices (market conduct). This will help it ensure that financial institutions remain solvent through sound management and that their commercial practices do not lead to the unfair treatment of consumers.*

By associating household debt with weakness in the financial system, the Bank of Canada[6] believes that an adverse shock could lead to an increase in borrower defaults by one category of households and result in losses for lending institutions, weakening their financial position.

> *The AMF asks financial institutions to conduct regular stress testing which incorporate macroeconomic variables projecting changes in household debt and an increase in interest rates.*

Real estate market

The unwinding of imbalances in Québec's real estate market continued in 2015 as prices stabilized, construction start-ups slowed and property sales recovered compared with the previous year.

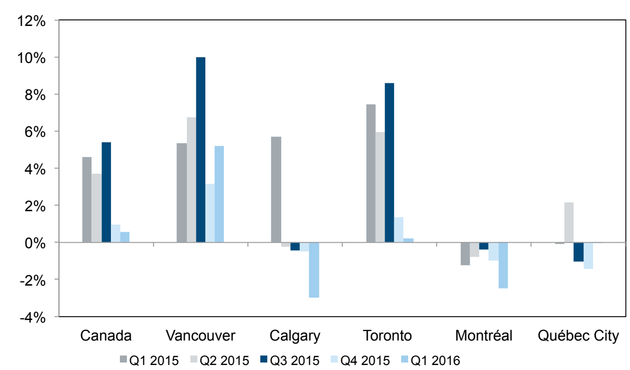
Driven by low mortgage rates, the average increase in sales during 2015 was 5% for all properties and 4% for condominiums, the first such increase in four years.

Housing starts decreased slightly in 2015, continuing the trend of the past few years. This decline could eventually help absorb the glut of properties for sale in certain market segments, particularly the condominium market, where excess supply remains a weakness.

The surplus of properties for sale in Québec has put downward pressure on prices. Although prices remained stable overall in 2015, in certain sectors they were slightly lower. As illustrated in Graph 2, this vulnerability runs counter to certain large Canadian cities where prices continued to rise during the year.

Graph 2

Annual variation of housing prices in Canada



Sources: Teranet and the AMF

Housing prices in Montréal and Québec City seem to rule out the idea of a real estate bubble and indicate a possible soft landing for Québec's real estate market.

6 Bank of Canada, *Financial System Review*, December 2015.

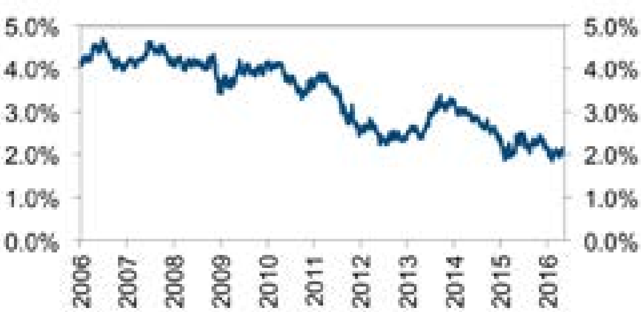
The AMF is increasing its monitoring of real estate transactions due to their potential impact on the financial health of the institutions it oversees, particularly in the case of the Desjardins Group.[7] Its Residential Hypothecary Lending Guideline sets out its expectations regarding sound and prudent management practices for financial institutions that are active in this market. The AMF is also strengthening its stress testing framework to include more diversified macroeconomic and financial variables, particularly those which could rapidly affect hypothecary (mortgage) loan portfolios.

Insurance of persons

With the long-term nature of life insurance products, insurers prefer bonds with longer maturities so they can match their investments to their commitments. In 2015, interest rates for long-term (30-year) Canadian bonds dropped once again to 2.15% as of December 31 compared with 2.33% a year earlier.

Graph 3

Interest rates of Canadian long-term (30-year) bonds



Even a slight drop in current interest rates could have a significant effect on insurers' liabilities. In calculating actuarial policy liability, insurers must make assumptions about interest rates for future years. In addition to having a negative impact on current investments, persistent low rates could eventually lower their forecasts and lead to an increase in actuarial liabilities.

Insurers have changed their investment portfolios in response to the low interest rates that have persisted for several years. Since the latest financial crisis, the capital required to cover the risk of counterparty insolvency or a decline in real estate or stock market returns has more than doubled. Insurers are therefore trying to generate a better return on assets tied to their commitments. They are investing less in low-risk government bonds for instance, and more in equity, real estate and corporate bonds.

The current environment of low interest rates favours the development of new products and increased risk-taking with investments by insurers. The AMF is constantly monitoring products offered by insurers on the basis of sound commercial practices and continued solvency.

MARKET CONCENTRATION

Chartered banks and financial services cooperatives are the key players in Québec's deposit institution sector, with trust companies and savings companies present to a lesser degree.[8]

Desjardins Group

Almost all financial services cooperatives are part of the Desjardins Group, which remains geographically concentrated in the Province of Québec and has been designated by the AMF as a domestic systemically important financial institution. This analysis of concentration among deposit institutions is therefore focused on the Desjardins Group.

The Desjardins Group diversified its activities oriented primarily toward the insurance sector through the acquisition of all the Canadian insurance activities of State Farm[9] on January 1, 2015, although it still has extensive operations in financial intermediation.

7 The Desjardins Group holds a large share of the residential mortgage market in Québec. In 2015, 64% of its credit portfolio consisted of residential mortgage loans.

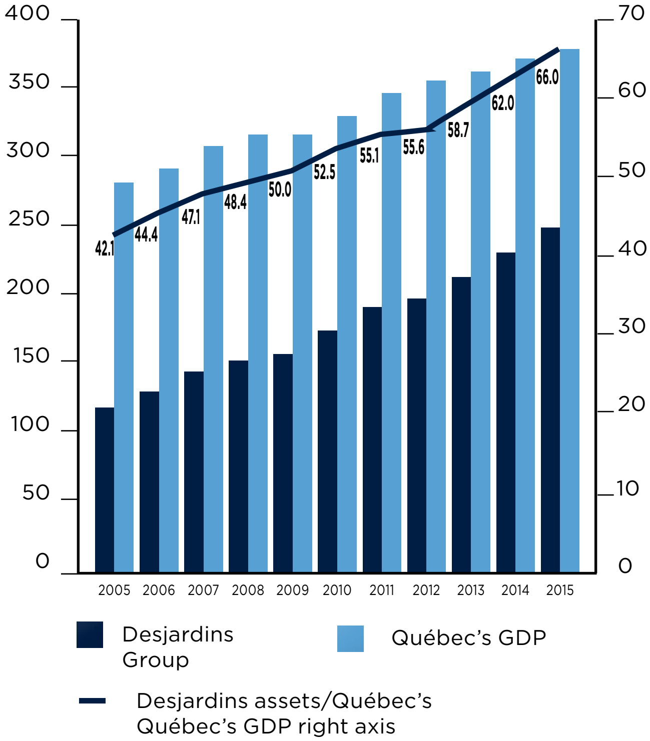
8 Since 18 of the 37 trust companies and 6 of the 8 savings companies carrying on business in Québec are bank subsidiaries and their results are consolidated in the banks' balance sheets, our analysis will be limited to a comparison of financial services cooperatives and federal chartered banks.

9 Following this transaction, the Desjardins Group set up Desjardins Financial Corporation Inc., a new holding company with interests in several of its other companies. Under an AMF decision issued on August 1, 2015, this new company was subject to certain provisions of *An Act respecting insurance and An Act respecting the Autorité des marchés financiers*, in accordance with section 478 of *An Act respecting financial services cooperatives*.

Graph 4 illustrates the evolution of the value of the Desjardins Group's assets as a proportion of Québec's GDP from 2005 to 2015. Despite episodes of financial turmoil,[10] this proportion has continued to grow from just over 42% in 2005 to 66% in 2015.

Graph 4

Evolution of value of the Desjardins Group's assets as a proportion of Québec's GDP (in billions of dollars)*



* Sources: Institut de la statistique du Québec and the AMF.

An analysis of the risks covered by the capital ratio shows that credit risk is by far the most important risk facing the Desjardins Group according to the Adequacy of Capital Base Guideline. It represents over 80% of risk-weighted assets.

> *To assess the Desjardins Group's resiliency, the AMF keeps a close watch on its regulatory ratios, which take account of other risks inherent in its activities.*

Desjardins Group's resilience

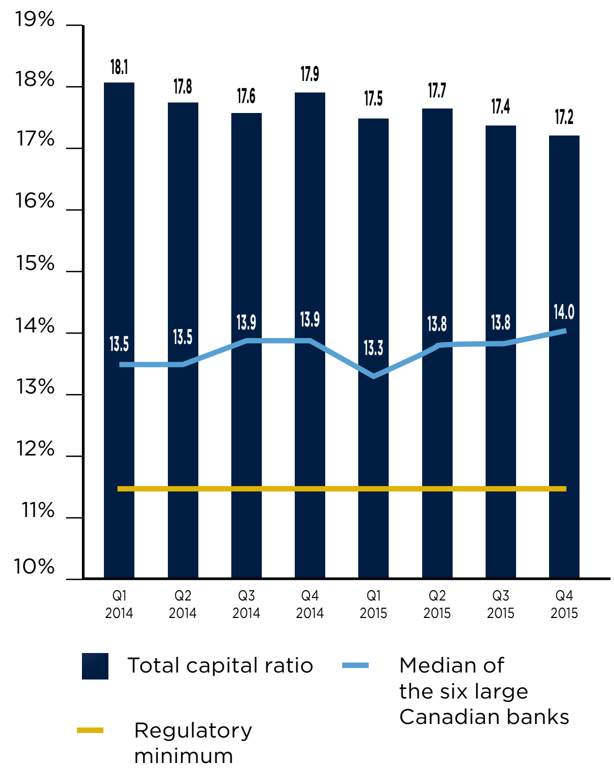
The main regulatory requirements recommended by the Basel Committee, which are adapted and applied to the Desjardins Group by the AMF, are the capital ratio, the leverage ratio and the liquidity ratios.

Capital ratio

In 2015, the total amount of the Desjardins Group's regulatory capital was $18.7B compared with $17.4B in 2014, and the total capital ratio was 17.2% compared with 17.9% in 2014. The value of these ratios is well above the regulatory minimum of 11.5%[11] and the median of the ratios for the six large Canadian banks, which stands at 14%.

Graph 5

Evolution of total capital ratio of the Desjardins Group compared with the six large Canadian banks



10 In particular the subprime crisis (2007 to 2009) and the sovereign debt crisis in Europe (2012).

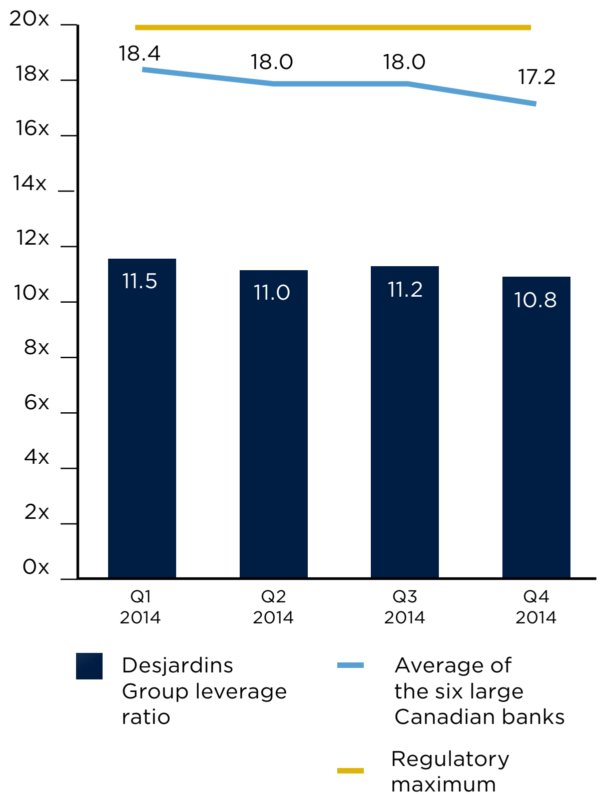
11 Including the capital surcharge due to its systemic nature, this requirement which was initially set at 10.5% increased to 11.5%.

Leverage ratio

Until December 31, 2014, the AMF required that the Desjardins Group maintain a regulatory asset to equity ratio of less than 20. This helped determine globally whether the Desjardins Group had adequate capital given the significance of its total assets adjusted by certain off-balance sheet items. Graph 6 shows the evolution of this ratio, which is calculated according to the AMF's requirements based on Basel II.

Graph 6

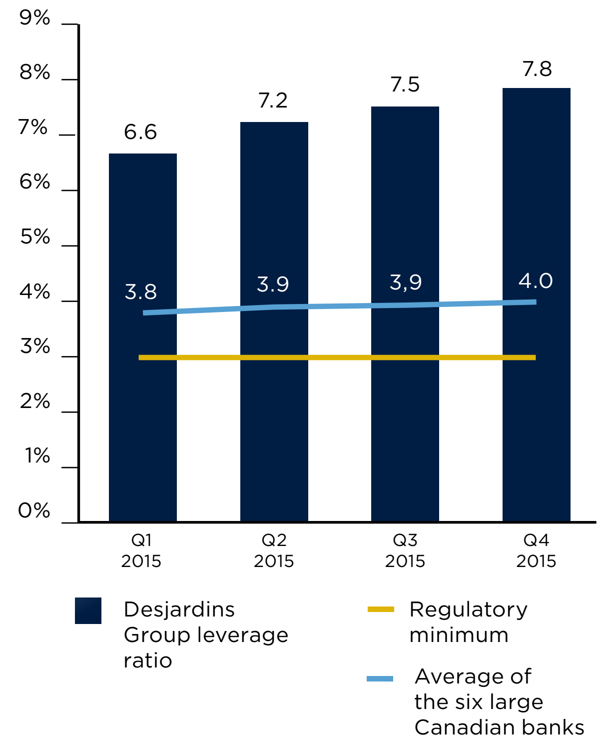
Evolution of the Desjardins Group's asset to equity ratio (former leverage ratio) compared with the six large Canadian banks



On January 1, 2015, this ratio was replaced by a leverage ratio expressed as a percentage. It is now computed based on Tier 1 equity divided by the exposure measure (on-balance sheet assets, exposure relating to equity financing transactions, derivatives exposure and off-balance sheet items). The minimum leverage ratio is 3% according to the AMF's Adequacy of Capital Base Guideline.

Graph 7

Evolution of the Desjardins Group's asset to equity ratio (new leverage ratio) compared with the six large Canadian banks



As the last two graphs indicate, the Desjardins Group has better leverage than do the banking institutions.

Liquidity ratios

In January 2015, the liquidity coverage ratio (LCR) and net cumulative cash flow (NCCF) were incorporated in the AMF's liquidity adequacy framework. Although these measures are computed by financial institutions, they are not yet publicly disclosed. The AMF nonetheless requires that they be filed and disclosed by the Desjardins Group on a regular basis. So far, it has always met the minimum requirements.

After the Desjardins Group was designated a domestic systemically important financial institution, the AMF tightened its requirements and increased its supervision of the group as a whole. For example, in connection with the designation, the AMF is pursuing its work to develop a plan for the orderly resolution of the Desjardins Group in the event of default in order to limit any adverse effects on Québec's financial system.

Insurers

Mergers and acquisitions are gradually transforming the market and necessarily have an impact on product offerings. Following a wave of recent transactions, the AMF is particularly interested in changes to the market concentration rate and the impact it could have on consumers.

Table 2

Québec market share[12] held by the largest insurers or insurer groups by insurance class

	Number of insurers or insurer groups							
	1		4		7		10	
Year	Insurance of persons	Damage insurance	Insurance of persons	Damage insurance	Insurance of persons	Damage insurance	Insurance of persons	Damage insurance
2013	17.5%	25.3%	60.0%	54.7%	83.7%	68.6%	89.4%	77.0%
2014	17.3%	24.2%	61.7%	54.8%	83.7%	68.3%	89.5%	76.8%
2015	17.6%	24.9%	61.2%	55.1%	85.3%	68.1%	89.9%	76.5%

In 2015, the market share of the largest insurer or insurer group was 17.6% for insurance of persons and 24.9% for damage insurance. However, the reverse applies to the market share of the following nine insurers or insurer groups, which account for 72.3% of the insurance of persons market as opposed to 51.6% for damage insurance.

Table 3

HHI[13] for insurance of persons and damage insurance classes

	HHI	
Year	Insurance of persons	Damage insurance
2013	1,148	1,062
2014	1,163	1,030
2015	1,181	1,058

For 2015, the HHI is less than 1,500, the benchmark concentration index, which means that these markets are not considered concentrated.

More in-depth market concentration analyses are also presented in the sections of the report dealing specifically with insurance of persons, damage insurance and automobile insurance rates. These analyses show in particular that with respect to insurance of persons, the group insurance segment is more concentrated than individual insurance. They also show that with respect to automobile insurance, the market involving insurers carrying on business through a brokerage network is more concentrated than that involving direct insurers

The AMF is closely monitoring changes in market concentration to ensure that healthy competition continues in these sectors, for the benefit of consumers. These analyses will also help the AMF assess the impact that mergers and acquisitions may have on market concentration.

12 Market share is expressed as a percentage of total direct written premiums.

13 The HHI [Herfindahl-Hirschman Index] is a measure of the size of firms in relation to the industry and an indicator of the amount of competition among them. It is calculated by squaring the market share of each firm competing in a given market and adding the resulting numbers. A market in which the HHI is less than 1,500 is generally not considered to be concentrated. Markets in which the HHI is between 1,500 and 2,500 points is considered to be moderately concentrated and markets in which the HHI is in excess of 2,500 points is considered highly concentrated. Transactions that increase the HHI by more than 250 points in moderately concentrated markets are presumed likely to enhance market power whereas that threshold is 150 points or more in highly concentrated markets.

ENVIRONMENTAL ISSUES

Natural catastrophes

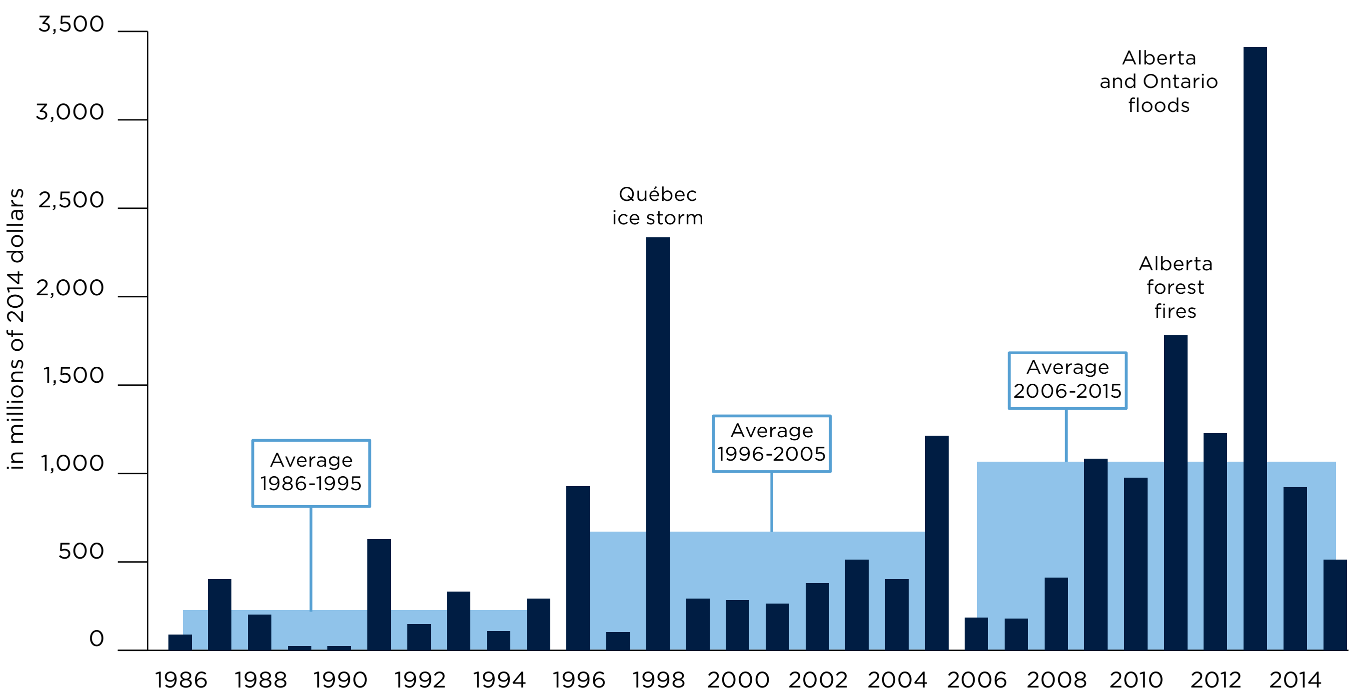
Natural catastrophes remain a significant concern for damage insurers. In the past, despite the constant increase in economic costs and the changing and unforeseeable nature of such events, insurers developed products to meet consumer needs.

However, the situation has changed over the past 30 years, due in particular to the rise of severe weather events as shown in Graph 8.[14]

In Canada, losses attributable to severe weather over the past ten years averaged $1.07B per year, an increase of just over 50% of the average loss for 1996 to 2005 ($673M), which in turn was three times greater than the average for the previous decade ($224M).[15]

Graph 8

Evolution of catastrophic losses in Canada over the past 30 years (millions of 2014 dollars)



In 2013, Canada experienced its worst year for insured property losses attributable to natural catastrophes, which reached over $3.2B. As a result, the Canadian Council of Insurance Regulators (CCIR) set up a working group to determine the ramifications of catastrophic events on the insurance available to consumers.

As an active member of the CCIR, the AMF participates in the working group, whose main findings will be presented to the industry and other stakeholders for consultation during the second half of 2016.

14 According to information available when this report was prepared, the wildfire in Fort McMurray, Alberta will be the most costly natural catastrophe in the history of Canada.

15 Data source: Insurance Bureau of Canada (IBC), *Facts of the Property and Casualty Insurance Industry in Canada 2015*; Property Claim Services Canada, February 2016.

Climate change

The notable increase in catastrophic events mentioned above is corroborated worldwide by the observations of the Intergovernmental Panel on Climate Change,[16] which confirms the relationship between climate change, extreme meteorological events and drought.

The damage insurance sector as a whole is affected by climate change. Other than home insurance, automobile insurance is also seeing an increase in the number of claims attributable to climate change. The observed changes result in the emergence of new trends in causes of losses, contributing to higher potential costs related to these business lines.

Climate change also represents a risk for financial markets and the return on investment in several asset classes related to the use of fossil fuels and their impacts on greenhouse gas. In response to a request by the G20 to determine how the financial sector should take account of climate change issues, on December 4, 2015 the Financial Stability Board (FSB) announced the setting up of the Task Force on Climate-related Financial Disclosures aimed at assessing, standardizing and reporting such information to investors. Regulators could eventually develop a standard for the reporting of climate-related risks.[17]

The AMF is closely following the developments which could result from the FSB's work on the quantification and disclosure to investors of the impact of climate change on the return of certain asset classes.

Water damage and flooding

In Québec, an increasing number of claims involving water damage have multiple causes such as wind, extreme tides, heavy precipitation, torrential rain and ice. The flooding which frequently ensues causes damage which is not generally covered by home insurance. Although water damage can have more than one cause, the interpretation and application of insurance clauses can be difficult and inconsistent when flooding is involved, both for the insurer and the consumer.

Given the trend in claims and the tightening of insurance conditions relating to water damage, some consumers could find themselves with inadequate coverage in the event of a loss.

The AMF is concerned about these developments and is pursuing discussions with IBC on enhancing insurers' awareness of growing uncertainty among consumers about insurance conditions and available coverage

In this context, insurers, individually or through IBC, have launched various initiatives to improve the situation in the medium and long term, including by encouraging policyholders to take preventive action. In collaboration with certain municipalities, IBC has developed tools to help municipalities determine and manage the risks associated with deficient infrastructures involving water management and recovery in order to limit sewer backups and basement floods.

Earthquake

In addition to catastrophic weather events, there is a real and significant risk of a high-magnitude earthquake occurring in the Québec City-Montréal-Ottawa corridor. According to the most recent scientific study[18] providing data on the issue, the probability of such an earthquake occurring over the next 50 years is between 5% and 15%.

Despite this probability, and as noted in the 2014 Annual Report on Financial Institutions, 22% of policyholders think they have earthquake insurance whereas in fact only 4% do.[19]

The AMF is concerned about consumers' misunderstanding of earthquake risk, the low rate of insurance coverage taken by consumers and the adequacy of the products offered. As a result, in addition to strictly monitoring industry initiatives to better manage this risk, the AMF participates in various forums on the subject and has entered into discussions with certain stakeholders such as IBC and the Property and Casualty Insurance Compensation Corporation (PACICC).

16 Intergovernmental Panel on Climate Change, *Synthesis Report*, 2014.

17 With the support of the United Nations Environment Program, the Montreal Carbon Pledge launched in 2014 led to the commitment of over 100 organizations around the world, including one Canadian insurer, to publicly disclose the carbon footprint of their investment portfolios.

18 Air Worldwide, *Study of Impact and the Insurance and Economic Cost of a Major Earthquake in British Columbia and Ontario/Québec*, July 2013.

19 Insurance Bureau of Canada, National Earthquakes Symposium Report, February 2015.

For damage insurers carrying on business in Québec, the AMF's expectations regarding the management of this risk are set out in the Sound Management and Measurement of Earthquake Exposure Guideline. The 2013 revision of this guideline introduced a new formula for determining the minimum capital to be maintained for this risk under the Capital Adequacy Guideline which took effect on January 1, 2015.

According to the Air Worldwide study cited above, a magnitude 7.1 earthquake with an epicentre 100 km north-east of Québec City could cause public and private losses of around $49B as well as $11B in indirect economic losses. Given the nature and significance of the estimated losses, the impact could also spread to other types of financial institutions, including deposit institutions and those with significant operations in residential hypothecary (mortgage) loans. Where applicable, the bankruptcy of many uninsured households could represent a significant credit risk and even a risk of default for deposit institutions.

TECHNOLOGICAL ISSUES

Digital technology has transformed business models in several areas of the economy, including finance and insurance. The many new applications and initiatives are radically changing established practices. The sharing economy is one example of the consequences of this transformation. By simplifying or reducing the usual sphere of intermediaries, all or part of this economy slips under the radar, avoiding traditional rules and eluding oversight bodies.

The AMF is concerned about these changes and is facing major challenges in its attempt to protect consumers of financial products and services. Other than fine-tuning the rules governing shadow banking and shadow insurance, it must closely monitor technological change and the risks associated with fintech.

Fintech and the sharing economy

The term "fintech," which refers to the integration of technology and finance, will be used to refer to all businesses operating in the financial sector, and deposit institutions and insurers in particular.

The financial services developed by fintech, which mainly target retail consumers, are up-ending traditional structures. Consumers, who are increasingly willing to embrace new technology, readily accept alternative solutions that facilitate access to financial services and increase their availability and speed, often at a lower cost. The arrival of fintech start-ups is likely to sharpen market competitiveness. While helping to modernize the industry, these new technologies could amplify or change the risks inherent in the financial services offered.

> *In response to institutions seeking to use or transpose business models as they relate to fintech, the AMF could put forward a framework based on sound and prudent management practices and sound commercial practices while being careful not to interfere with financial innovation or encourage any excesses which could result.*

As part of its oversight work, the AMF ensures that financial institutions set up an adequate system which allows them to determine, measure and control the risks associated with the use of technology in offering financial products and services. In this regard, the Integrated Risk Management Guideline sets out the AMF's expectations to help prevent and lessen the ripple effect of multi-hazard risks.

Moreover, in an effort to protect consumers of financial products and services from fintech-related risks, the AMF has issued warnings, particularly about the risks associated with the use of bitcoins. These warnings are not intended to stifle innovation, but to make consumers more aware of the potential risks associated with the use of virtual currencies.

Information technology is especially difficult to regulate because it has no borders. The AMF's participation in various national and international forums gives it an opportunity to discuss issues and to work with its counterparts on appropriate regulatory approaches.

Services which may rightly or wrongly be associated with the sharing economy are gaining in popularity around the world. According to the most recent edition of *Baromètre de la consommation*,[20] 9.4% of Quebeckers said that they had used Airbnb and Uber during the past twelve months. The sharing economy is gradually influencing the traditional economy, prompting businesses to innovate by offering products and services that meet consumers' new demands.

Some of these innovations have direct or indirect repercussions on the financial sector.

In December 2014 and February 2015 the AMF published warnings to remind consumers that the Québec automobile insurance policy form (Q.P.F.) No. 1 – Owners' Form, contains prohibitions and exclusions which could apply if a vehicle is used for ride-sharing services such as UberX. Other than the issue of the legality of such a service, Uber drivers could therefore be denied automobile insurance coverage.

Other peer-to-peer risk sharing platforms have gradually appeared in Québec. These platforms generally allow the pooling of participants' risks without going through an insurer. They offer to share certain risks related for example to health, travel, automobiles and job loss. The AMF has issued a warning to make consumers more aware of the risks such platforms represent since there is no insurance to cover the risk.

> *The AMF is aware that Québec's regulatory and prudential framework must take changing business models and their rapid growth into account. It will ensure that this framework is one which will adapt to market realities for financial products and services while maintaining adequate consumer protection.*

Self-driving vehicles

New technology has encouraged the development of self-driving and assisted-driving vehicles. Beyond the issue of the social acceptance of such vehicles, legal liability in the case of an accident, regulations governing the use of such vehicles and hacking are just a few of the challenges they introduce.

According to the insurers consulted,[21] the potential impact of the presence of self-driving vehicles will be a significant reduction in claim frequency along with a drop in demand for personal-lines automobile insurance and an increase in demand for commercial-lines insurance. The relative volume of personal-lines automobile insurance could thus significantly decrease for insurers in this market.

Among other things, self-driving vehicles could lead to the transfer of liability from the owner of the vehicle to a third party such as the automobile manufacturer. This transfer of risk could challenge the notion of liability for an accident and the manner in which claims are currently processed. Québec's automobile insurance system, based in particular on no-fault liability for bodily injury resulting from an automobile accident, would be affected.

Lastly, since self-driving vehicles essentially depend on smart devices, their exposure to hacking and cyberattacks constitutes a significant risk factor to which insurers will have to adapt.

Cyber-risk

Cyber-risk can take various forms but the greatest concern for all market players, including the AMF, is the protection and confidentiality of consumers' personal information. Due to the nature of their activities, financial institutions receive, transmit, process and store a great deal of third party data. The major challenge consists of protecting such information against the persistent threats that could impact its availability, integrity and confidentiality.

20 *Baromètre de la consommation responsable*, Édition Québec 2015, *Observatoire de la consommation responsable*, ESG UQAM.

21 This information was obtained following the AMF's request for additional information from all automobile insurers operating in Québec.

Cyberattacks can stem from a variety of sources such as internal malice, hacking, espionage, identity theft and data theft. There are multiple consequences to such actions: business interruption, data loss, direct monetary losses and customer loss, to name a few. Since the soundness of financial institutions depends on consumers' trust, any damage to their reputation could have devastating consequences.

> *Given the growing importance of cyber-risk and the related consequences, the AMF has paid particular attention to cyber-risk as part of its oversight activities over the past few years. Its observations led to a self-assessment survey regarding cybersecurity during 2015.*

Using a self-assessment questionnaire made up of 78 questions sent to some 80 financial institutions representing all industry sectors carrying on business in Québec, the AMF was able to carry out an assessment of cyber-risk, including the real and anticipated impact of cyber incidents, and risk management practices.

The responses provided by financial institutions show that cyber-risk and cybersecurity are a major concern for them. In all areas of the financial sector, organizations say they are aware of the threats they face and that they have taken steps to improve their practices and level of preparedness.

> *The findings of this self-assessment support an intensification of the AMF's oversight efforts and a clarification of its expectations regarding the management of cybersecurity risks.*

Furthermore, extensive media coverage of major cyber incidents, such as theft of the personal data of customers of large businesses in all areas of the economy, is spurring demand for cyber insurance. Cyber-risk has become a major concern and, in some cases, a strategic priority for business owners, corporate boards and governments.

The risks related to digital technologies therefore constitute not only a threat, but also a growth opportunity for damage insurers to broaden their range of cyber-insurance products.

> *As part of its oversight activities, the AMF closely follows the development of new products, and cyber-insurance is one of them.*

REGULATORY ENVIRONMENT AND OVERSIGHT

This section presents the AMF's oversight activities in respect of financial institutions as well as its contribution to the work of national and international organizations.

COMMERCIAL PRACTICES

In 2014, the AMF sent a self-assessment questionnaire to financial institutions doing business in Québec to obtain a global view of their progress regarding the expectations set forth in the Sound Commercial Practices Guideline. Key points were subsequently identified as requiring monitoring due primarily to the lack of formal procedures and control measures, particularly with respect to incentives management, product design and marketing, governance and corporate culture.

> *In this context, in 2015 the AMF set up a working group on incentives management. Where the AMF considers it advisable to set out its expectations regarding the management of incentives, it will ensure that it acts in complete transparency by consulting financial institutions given the importance it places on the fair treatment of consumers and the negative ramifications of poor practices.*

LAPSE RATES OF LIFE INSURANCE POLICIES

Some life insurance products are sensitive to lapse risk.[22] Products based on lapse times generate gains for insurers when holders abandon their policy. Such gains were initially reflected in pricing and contributed to lower insurance premiums. Lower lapse rates than expected for such products therefore generate losses for insurers.

22 Lapse risk for insurers corresponds to the change in value of policies when the lapse rate differs from the expected rate.

In September 2015, the Research Committee of the Canadian Institute of Actuaries (CIA) published two studies[23] on the lapse experience for two types of products: term-to-100 insurance policies and universal life level cost of insurance policies. The findings show much lower lapse rates than many insurers had expected. The updating of the lapse rate assumption in calculating policy liabilities based on the study's findings therefore negatively affected several insurers in 2015.

Significant data are beginning to emerge regarding renewable temporary life insurance products with a 10-year term,[24] as these products were the subject of a recent study by the CIA. There is a strong correlation between premium increases after each 10-year term and lapse rates. The higher the premium upon renewal compared with the previous year, the greater the renewal lapse rate. Also, the mortality rate of policyholders who keep their insurance increases since policyholders in good health who still want insurance would rather take out a new policy than pay the higher renewal premium. The noteworthy jump in premiums is explained in particular by the strong competition among insurers for the first 10-year term.

The experience with lapse rates is only now coming to light for insurers since some types of products have only been issued for a few years.

> *Since past results show that reality can be very different from forecasts, the AMF considers lapse rates a risk factor that should be considered by each insurer in its internal assessment of its risks and solvency. For its part, the AMF will continue to monitor this risk.*

ACCOUNTING STANDARDS REVIEW

In 2015, the International Accounting Standards Board (IASB) continued its work on IFRS 4 - *Insurance Contracts* (IFRS 4).[25] The final standard is not expected to be published before the third quarter of 2016, coming into effect on January 1, 2020 at the earliest.

In July 2014, the IASB published the integral version of IFRS 9 *Financial Instruments* (IFRS 9), which sets out terms relating to the accounting and measurement of financial instruments. It will take effect on January 1, 2018. Since IFRS 4 and IFRS 9 could involve significant changes to results and the presentation of financial statements, financial institutions have expressed concerns about the different effective dates for two major accounting changes.

In December 2015, the IASB published ED/2015/11 *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts (Proposed amendments to IFRS 4)*. The proposed amendments would postpone the effective date of IFRS 9 to align with the effective date of the new IFRS 4. They also provide for amendments to IFRS 4 to deal with the problem of accounting mismatches and volatility.

> *The AMF is actively monitoring work by the IASB, the International Actuarial Association (IAA) and the International Association of Insurance Supervisors (IAIS) while pursuing its own work with the Office of the Superintendent of Financial Institutions (OSFI) and the industry. As soon as the new IFRS 4 is published, empirical work will be carried out in conjunction with industry members in Québec and the rest of Canada to identify and quantify its impacts, particularly as regards capital adequacy.*

23 Lapse Experience under Universal Life Level Cost of Insurance Policies and Lapse Experience under Term-to-100 Insurance Policies, September 2015.

24 These are products whose premiums are the same for each 10-year period but increase from one period to the next.

25 International Financial Reporting Standards.

MODERNIZATION OF CAPITAL ADEQUACY REQUIREMENTS FOR INSURERS OF PERSONS

The AMF has been working for close to ten years with the OSFI and Assuris on modernizing the capital adequacy requirements for life insurers. This has been the subject of ongoing consultations with the parties involved, particularly Québec's insurance of persons sector. In 2015, the latest impact study was conducted with insurers carrying on business in Canada. An analysis of the results of that study and comments provided by the various stakeholders led to a draft guideline on the new capital adequacy requirements. The final version will be published during the second half of 2016. The target effective date for the new guideline is still 2018 to allow insurers to complete the implementation of the more complex aspects.

This work aims primarily to take account of changes to actuarial methods, notions of economic capital and financial theory. It also aims to produce a guideline on the new capital adequacy requirements which will include an effective assessment of solvency risk. The revised approach should lead to a better matching of risk measures and the economic reality life insurers are facing, the goal being to ensure that they can better manage risk and make more fully informed business decisions.

The work also aimed to take into consideration the changes under IFRS 4 since initially the effective date of the new guideline was to coincide with that of the new accounting standard. However, as mentioned, the effective date of this standard has been postponed to January 1, 2020 at the earliest. The guideline on the new capital adequacy requirements will take account of this later date and include appropriate adjustments.

When it takes effect in 2018, the new guideline is not expected to have a significant impact on the overall level of capitalization in the industry. This work should make it possible to better take account of risks and their diversification in determining the amount of capital each insurer will require in order to meet its commitments with a high level of confidence.

MODERNIZATION OF CAPITAL ADEQUACY REQUIREMENTS FOR DAMAGE INSURERS

The work of reforming the solvency framework applicable to damage insurers was begun in 2010 and completed in 2014, and the changes finally took effect on January 1, 2015. This work led to a significant revision of the Capital Adequacy Guideline. Despite a few differences, this standard remains broadly harmonized across Canada for all insurers licensed to sell damage insurance. The impact of this reform will be felt gradually over a three-year period.

The changes introduced in particular a revision of the definition of available capital, with the inclusion of various limits regarding the use of capital instrument categories, the updating of various requirements and the addition of new requirements for risks not covered or not taken into account explicitly, such as operational risk. The revised guideline also integrates capital requirements in connection with the exposure of damage insurers to earthquake risk and acknowledges, to a certain extent, that the risks are not perfectly correlated. This acknowledgment resulted in the introduction of a credit for diversification between insurance risk and asset risk, i.e. between the capital requirements for insurance risk and the sum of the capital requirements for credit and market risks.

UPDATING OF PRUDENTIAL FRAMEWORK

In addition to the capital adequacy requirements and in connection with the requirement that financial institutions properly manage their risks, in 2009 the AMF published the first version of its Integrated Risk Management Guideline. Since then, in the wake of the financial crisis, the international organizations and associations responsible for establishing principles for the supervision of financial institutions have introduced new expectations to ensure that financial institutions set up internal processes for assessing risks associated with their solvency. These processes are known as the ORSA (*Own Risk and Solvency Assessment*) for insurers and ICAAP (*Internal Capital Adequacy Assessment Process*) for deposit institutions.

Although most of its expectations in connection with these measures are covered by the AMF's existing framework, the updating of international principles[26] and the findings resulting from the AMF's oversight activities have led the AMF to review and update the expectations set out in the Integrated Risk Management Guideline and to create a new Capital Management Guideline. The changes, which took effect on May 1, 2015, clarified and updated the notions of risk appetite and the existing relationship between the risk management framework, the solvency position and strategic goals.

In order to take account of the evolution of the principles of sound and prudent management issued by international bodies involving governance,[27] in 2015 the AMF also began work which will led to a complete review of its Governance Guideline.[28]

CONTRIBUTION TO WORK BY NATIONAL AND INTERNATIONAL BODIES

Market interconnectedness and the similarity of issues call for close cooperation among regulators. This cooperation, which occurs primarily through the participation of regulators in the work of various national and international forums, provides for the coordinated development of legislation and regulatory frameworks broadly harmonized to ensure better market regulation and maintain global financial stability.

The AMF's participation in this work allows it to compare its practices and approaches with what is being done elsewhere, influence the development of international standards and ensure that the regulatory framework set up in Québec meets the highest standards. These networks represent a very important pool of knowledge that can enhance discussions on the various problems encountered by regulators.

Canadian Council of Insurance Regulators

In 2015, Canadian insurance regulators undertook to update their Memorandum of Understanding and Protocol on Cooperation and the Exchange of Information (MOU) to improve the coordinated supervision of regulated entities carrying on business in several provinces or territories. Although all regulators plan to sign the MOU, 10 of the 13 jurisdictions, including Québec, had signed it as of December 31, 2015.

Since supervision of commercial practices in the insurance industry falls under the exclusive jurisdiction of the provinces and territories, in November 2015 the members of the CCIR also adopted a Framework for Cooperative Market Conduct Supervision in Canada, which is expected to better identify and proactively address market conduct issues. It ultimately aims to ensure that consumers are treated fairly and consistently across all provinces and territories.

> *The AMF worked closely on the development of the Memorandum of Understanding and Protocol on Cooperation and the Exchange of Information and the Framework for Cooperative Market Conduct Supervision. The implementation of the Framework, expected to take place in 2017, will facilitate the supervision of commercial practices by regulators.*

Segregated funds

While the industry has pointed out cross-sectoral issues concerning the framework applicable to segregated funds (insurance sector) and mutual funds (securities sector), in 2015 the AMF completed a comparative analysis of the framework applicable to these products and their distribution in Québec. The goal was to determine the main discrepancies and make recommendations in the event of regulatory arbitrage or if the reporting rules for investors were affected, in order to support informed decision-making and, more globally, ensure that investors' interests are protected.

> *The results of this work were shared with a CCIR working group. In 2016 the CCIR will consult the insurance industry, consumer associations and other interested parties to foster a harmonized framework across the country*

26 In particular, the principles relating to the ORSA as stated by the IAIS.

27 The governance principles of international associations of regulators of deposit institutions and insurers were reviewed in 2015: *Basel Committee on Banking Supervision, Bank for International Settlements, Corporate Governance Principles for Banks (Guidelines)*, July 2015 and IAIS, *Insurance Core Principles 8*, November 2015.

28 On May 3, 2016, the AMF published its main oversight initiatives for 2016-2017 in respect of the financial institutions it supervises.

With its active participation on various CCIR committees, the AMF is further able to contribute to the development of oversight practices. Its representatives on these committees share their expertise with their counterparts and obtain information which allows the AMF to maintain a framework adapted to the Québec market.

International Association of Insurance Supervisors

The IAIS represents insurance regulators and supervisors of more than 200 jurisdictions in nearly 140 countries. Its objectives are to promote effective and consistent supervision of the insurance industry around the world in order to develop and maintain fair, safe and stable insurance markets for the benefit and protection of policyholders, and to contribute to global financial stability.

Like 54 other insurance regulators, in March 2015 the AMF became a signatory to the IAIS Multilateral Memorandum of Understanding (MMoU).

The AMF actively participates in the work of various IAIS committees. As part of the Market Conduct Working Group, it helped draft orientation documents for commercial practices and will also work on the reform of core principles involving intermediaries and market conduct.

With respect to the Governance Working Group, the AMF also participated in the revision of the core principles involving governance and risk management.

Lastly, as part of the Financial Crime Task Force, the AMF contributed to a document on issues relating to cyber-risk as a member of the drafting group.

International Association of Deposit Insurers (IADI)

The AMF chairs the Subcommittee of Resolution Issues for Financial Cooperatives (SRIFC), whose work involves issues relating to the resolution of financial cooperatives and the adaptation of bank-oriented resolution tools to financial cooperatives.

This Subcommittee is attracting growing interest from the international financial community, including the World Bank and U.S. Treasury Department. In the past year, the SRIFC published its research plan, analyzed case studies from member jurisdictions and conducted a survey of 130 insurers-depositors or resolution authorities around the world.

The SRIFC contributes to a better understanding by international regulatory organizations of the particular issues associated with financial cooperatives.

The AMF also sits on two other committees – the Research and Guidance Committee and the Regional Committee of North America – and participates in the work of several other IADI committees.

The Research and Guidance Committee conducts research and develops and promotes the IADI's core principles with a view to improving the efficiency of deposit insurance regimes. The presence of multiple deposit insurers in the same country and deposit insurers evolving under the purview of an integrated regulator are examples of topics which will be discussed that are of special concern to the AMF.

During the IADI Executive Committee meeting, which was held in March 2016, the AMF was chosen to host the 16th annual general meeting of IADI members which will take place in Québec City in October 2017. This event will promote the work relating to the resolution of financial cooperatives and foster discussions among the AMF and various partners and stakeholders, particularly regarding financial cooperatives.