Financial Institutions Supervisory Framework

AMF Solvency

2017

AUTORITÉ DES MARCHÉS FINANCIERS

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INTRODUCTION

The *Autorité des marchés financiers* (the "AMF" or the "Authority") is the body mandated by the Québec government to regulate Québec's financial sector and assist consumers of financial products and services, in particular in the areas of insurance, securities, derivatives, deposit institutions – other than banks – and the distribution of financial products and services.

As provided for under its constituting Act,[1] part of the AMF's mission is to:

> *"ensure that the financial institutions and other regulated entities of the financial sector comply with the solvency standards applicable to them as well as with the obligations imposed on them by law with a view to protecting the interests of consumers of financial products and services, and take any measure provided by law for those purposes."*

The mandate of the *Surintendance de l'encadrement de la solvabilité* ("AMF Solvency") is to:

- ensure that financial institutions hold all the necessary authorizations to operate in Québec;
- develop normative tools, such as guidelines or standards, which set out the AMF's expectations regarding sound and prudent management practices as well as sound commercial practices. These expectations guide financial institutions in the performance of their activities;
- oversee financial institutions to ensure that they meet the various legal, regulatory and normative requirements, including with respect to solvency, sound and prudent management practices and sound commercial practices.

The supervisory framework ("Framework") sets out the approach taken by AMF Solvency to adequately fulfill its mandate to supervise financial institutions. It is also aligned with the 2017-2020 Strategic Plan:

1 *Act respecting the Autorité des marchés financiers,* CQLR, c. A-33.2

"With the financial sector changing more and more quickly, the AMF has chosen to step up its proactive shift, which, in and of itself, is a challenge for any regulator. By proactively approaching its mission to regulate the financial sector, it seeks to ensure that its actions will contribute to the public's confidence in the markets and institutions and thereby foster a dynamic financial sector in Québec."

The supervisory approach presented in the Framework is shaped by the core principles and guidance published by the Basel Committee on Banking Supervision[2], the International Association of Insurance Supervisors[3] and other international bodies[4] that are recommended to regulatory authorities. In this regard, AMF Solvency also plays an active role in the key regulatory forums with respect to supervisory best practices, at both the national and international levels, enabling it to keep its supervisory approach current.

In the context of its supervisory activities, AMF Solvency co-operates, as needed, with other regulatory authorities and organizations set up to protect insureds and depositors, in particular with respect to an institution's condition and best supervisory practices. These exchanges remain confidential.

SCOPE

The Framework is applicable to institutions governed by the following statutes:

- *Deposit Insurance Act, CQLR,* c. A-26
- *Act respecting insurance, CQLR,* c. A-32
- *Act respecting financial services cooperatives, CQLR,* c. C-67.3
- *Act respecting trust companies and savings companies, CQLR,* c. S-29.01

The Framework is applied to financial institutions that operate independently as well as institutions that are part of a financial group.[5]

For financial institutions which carry on business in Québec but which are constituted under a law of another legislative authority, the AMF may, for the purpose of applying this Framework, consider the supervisory functions performed by the regulator in the home jurisdiction if deemed advisable.

The generic terms "financial institution" and "institution" are used to refer to all entities covered by the scope of the Framework.

The term "systemically important financial institution" is used to define an institution on the basis of its size, complexity, interconnectedness and substitutability in the financial system which, in case of financial difficulties or insolvency, could have a major impact on the financial system and local economy.

COMING INTO EFFECT AND UPDATING

The Framework is updated every three years or as needed based on developments in the financial sector, benchmarks for supervisory practices, regulation as well as new risks, emerging trends and the risks identified in the course of supervisory work.

Initially published in March 2009, revised in 2011 and 2014, the 2017 Framework comes into effect upon its publication.

2 Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision*, September 2012.

3 International Association of Insurance Supervisors (IAIS), *Insurance Core Principles, Standards, Guidance and Assessment Methodology*, October 2011, amended November 2015.

4 These bodies include the Bank for International Settlements (BIS), the Financial Stability Forum, the International Association of Deposit Insurers (IADI), the Organisation for Economic Co-operation and Development (OECD) and the International Financial Consumer Protection Organisation (FinCoNet).

5 For purposes of this document, the term "financial group" is considered to be any group of legal persons composed of a parent company (financial institution or holding company) and legal persons affiliated therewith.

SUPERVISORY PRINCIPLES

The following six principles are at the core of AMF Solvency's supervisory approach.

INTEGRATION

AMF Solvency, in co-operation with other oversight bodies as needed, ensures integrated supervision of financial groups. The supervision comprises an evaluation of all significant entities, such as subsidiaries, branches and joint ventures, located in Québec, elsewhere in Canada and around the world.

PREVENTION

AMF Solvency places emphasis on early identification and management of risks so as to identify problems more quickly and be able to take timely action vis-à-vis financial institutions.

SCALABILITY

AMF Solvency's supervision will be graduated depending on the nature, scope and frequency of the supervisory activities, as well as the resources to be allocated to them, based on its evaluation of the institution's Risk Profile and its systemic importance, where applicable.

In the case of systemically important financial institutions, supervision of their activities, capital requirements and resolution procedures in the event of failure is increased as regards frequency and thoroughness.

ACCOUNTABILITY

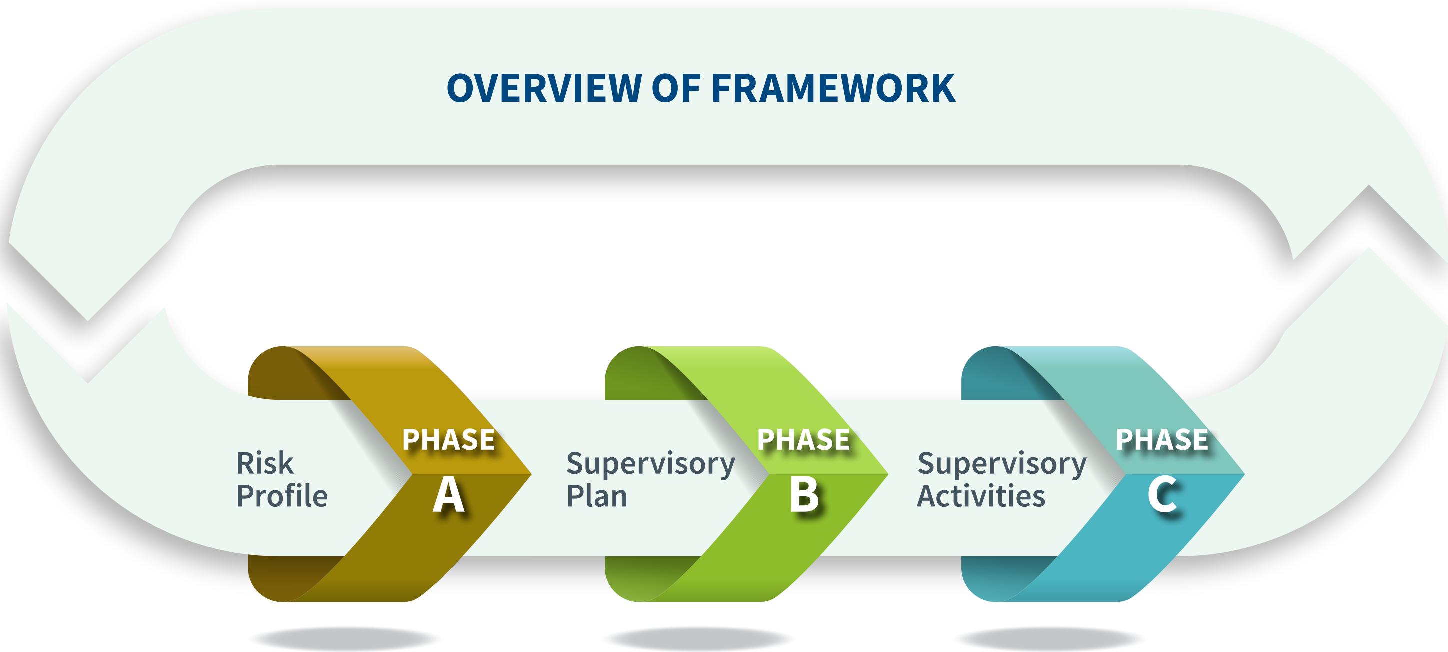
AMF Solvency assesses the quality and robustness of the lines of defense and the governance bodies set up by the institution. This assessment is performed for the second line of defense (generally consisting of risk management, compliance, finance and actuarial functions), the third line of defense (internal audit function) as well as the governance bodies (senior management and the board of directors). These functions are assessed in light of the expectations set out in the guidelines issued by the AMF.

COMPLEMENTARITY

AMF Solvency may rely on the work conducted by third parties, such as the independent auditor and other supervisory bodies, if it deems the independence, scope and quality of their work to be adequate.

INTERACTIVITY

Open, bilateral communication takes place between the institutions and AMF Solvency, which informs institutions in due time of regulatory and supervisory developments, while institutions report, in a timely manner, all new initiatives or developments that could have an impact on their Risk Profile. For systemically important financial institutions, there is enhanced communication between the AMF, senior management and the board of directors.



AMF guidelines are based on principles rather than rules. They provide an indication of the AMF's expectations in regard to financial institutions' legal obligation to follow sound and prudent management practices and sound commercial practices. They deal with the interpretation, execution and application of this obligation imposed on financial institutions. Accordingly, AMF Solvency carries out risk-based prudential supervision according to a framework built on the three phases illustrated in the chart above.

RISK-BASED FRAMEWORK PHASES

This section describes the methodology supporting the risk-based supervisory approach. This methodology, which is tailored to the nature, size and complexity of an institution's activities, is applied on an ongoing basis to determine and document a financial institution's Risk Profile.

PHASE A
FINANCIAL INSTITUTION'S RISK PROFILE

The Risk Profile is an assessment of a financial institution's overall level of risk exposure. It is based on an evaluation of the risks inherent in the financial institution's Significant Activities, its ability to manage risks, its financial condition and its commercial practices.

The Risk Profile is dynamic, since it will be updated as warranted by changes in an institution's exposure to risks and by the results of the supervisory activities. It is used for AMF Solvency's internal purposes only and is not disclosed. The Risk Profile and its supporting documentation fall under the purview of the AMF's information security policy.

Step 1 – Identify Significant Activities

The first step of the methodology consists in identifying the Significant Activities of the institution.

A Significant Activity is generally defined as a line of business or key business process; a business unit can also be included. Significant Activities are identified through multiple sources of information, including the institution's financial reports, strategic plans, organization charts, and other internal and external information.

The criteria used to determine whether an activity is significant may include:

- assets generated by the activity in relation to total assets;
- revenue derived from the activity in relation to total revenue;
- net income before tax generated by the activity in relation to total net income before tax;
- capital allocated to the activity in relation to total capital;
- reserves held as a percentage of total reserves, if applicable;
- potential impact of the activity on the institution's reputation or its importance for achieving the institution's strategies and its objectives;
- repercussion of disruption of the activity on the institution's business continuity.

Step 2 – Identify and Assess Inherent Risks of Each Significant Activity

The second step consists in identifying and assessing the Inherent Risks of each Significant Activity. Inherent Risk is the probability and severity of potential loss intrinsic to a business activity, without considering control mechanisms.

The following Inherent Risks are typically assessed:

- credit risk;
- market risk;
- liquidity risk;
- insurance risk;
- operational risk;
- information and communication technologies risk;
- compliance risk;
- strategic risk;
- reputational risk.

These risk categories are described in Appendix 1.

Inherent Risk Assessment

An institution's degree of exposure to Inherent Risk as regards its Significant Activities is determined based on a number of qualitative and quantitative factors specific to each risk. Economic context, systemic importance, market concentration, the nature and complexity of product offerings, and entry in new markets are considered. This assessment requires a thorough knowledge of the financial institution's activities and its financial group, where applicable.

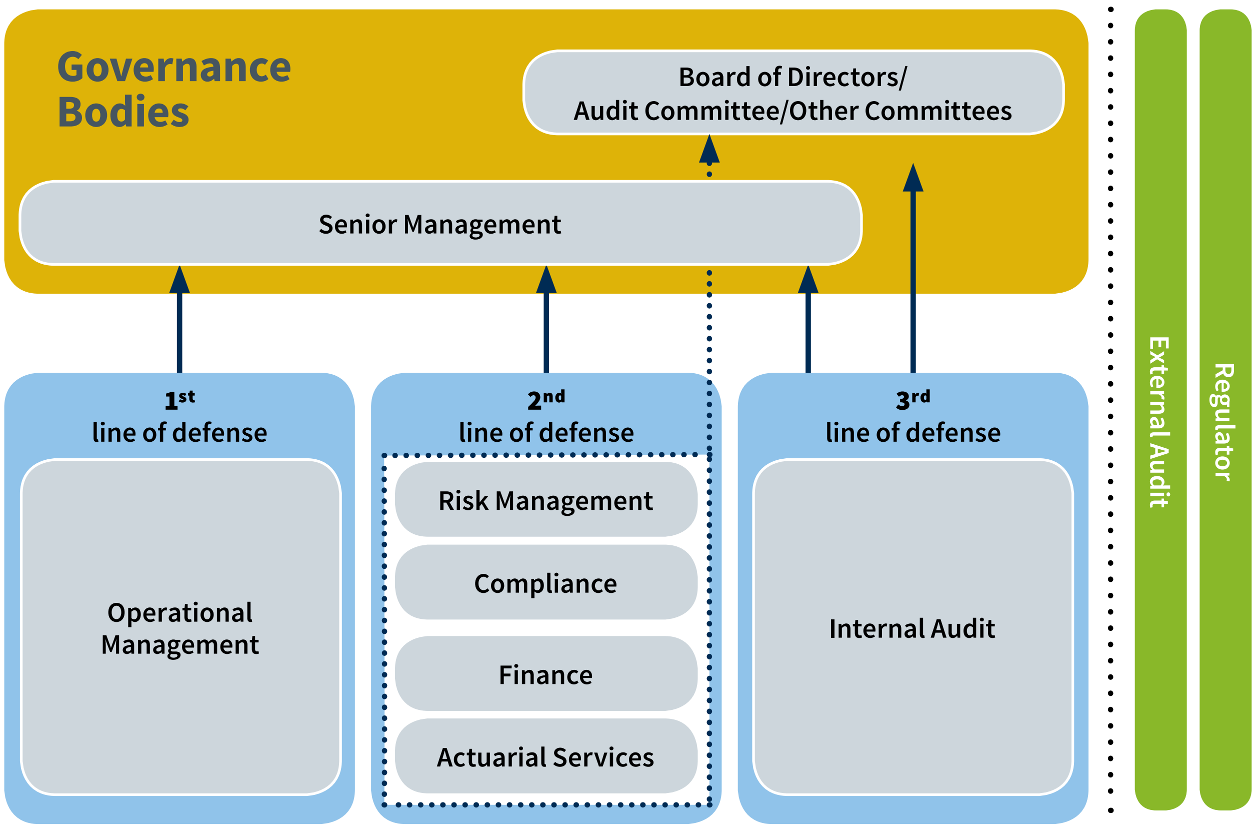
The level of Inherent Risk for each Significant Activity is assessed as "Very High," "High," "Moderate," or "Low":

- Very High Inherent Risk – Very high probability of a material adverse impact on an institution's capital, earnings and even business continuity due to exposure to and uncertainty from potential future events;
- High Inherent Risk – High probability of a material adverse impact on an institution's capital, earnings and even business continuity due to exposure to and uncertainty from potential future events;
- Moderate Inherent Risk – Moderate probability of a material adverse impact on an institution's capital, earnings and even business continuity due to exposure to and uncertainty from potential future events;
- Low Inherent Risk – Low probability of a material adverse impact on an institution's capital, earnings and even business continuity due to exposure to and uncertainty from potential future events.

Step 3 – Evaluate Quality of Risk Management

Evaluating the quality of risk management helps measure the extent to which Inherent Risks are mitigated. An institution's quality of risk management is evaluated through the effectiveness of the lines of defense and governance bodies.[6]

GOVERNANCE BASED ON THREE LINES OF DEFENSE MODEL*



* Adapted from Federation of European Risk Management Associations (FERMA) / European Confederation of Institutes of Internal Auditing (ECIIA), Guidance on the 8th EU Company Law Directive, article 41

The scope of supervisory activities involving operational management in respect of a Significant Activity may be adjusted based on the effectiveness of the functions represented by the second and third lines of defense and the governance bodies. An assessment of the quality and effectiveness of these functions is based in particular on compliance with the legal, regulatory and normative provisions, the results of previous supervisory activities and any third-party work.

6 Governance Guideline, September 2016

For each Significant Activity, the quality of risk management is assessed as or deemed to be either "Strong," "Acceptable," "Needs Improvement" or "Unsatisfactory." The following factors in particular will be considered in making the assessment:

- implementation of a strong risk management culture which includes clear communication of expectations by senior management and the Board of Directors as well as the identification of duties for employees;
- whether senior management has identified, assessed, quantified, controlled, mitigated and ensured the monitoring of its Inherent Risks, based on the systemic importance of the institution, where applicable;
- the ability of senior management to identify and control new risks as they arise in a changing environment, taking into account the institution's strategic plan;
- the implementation of appropriate policies, procedures and limits;
- whether management information systems and other forms of communication are consistent with the level of business activity and complexity of products.

Step 4 – Evaluate the Net Risk of a Significant Activity and the Aggregate Net Risk

Net Risk of a Significant Activity

The Net Risk of a Significant Activity is a function of its Inherent Risk (Step 2), mitigated by its Quality of Risk Management (Step 3).

Aggregate Net Risk

A financial institution's Aggregate Net Risk is the weighted Net Risk of its Significant Activities, based on their relative significance.

Step 5 – Analyze the Institution's Financial Condition

The analysis of an institution's financial condition, which focuses in particular on an assessment of its capital, liquidity and earnings, is a critical component of the supervisory approach. It includes the adequacy of the institution's capital, liquidity and earnings to sustain current and future operations and contribute to their long-term viability.

The evaluation of an institution's current and projected capital adequacy and its liquidity includes a review of the quality, quantity and availability of capital and liquidity, as well as their compliance with laws, regulations and guidelines.

The evaluation of earnings is used to determine their contribution to internal cash flow generation. It is performed by analyzing the level and historical record of earnings using different indicators and performance measurements. An analysis of earnings sources, financial forecasts and peer benchmarking further supports the earnings evaluation.

Step 6 – Assess Commercial Practices

The last step is to determine if the institution meets the AMF's expectations with respect to the fair treatment of consumers, taking into account the level of risk to which the institution is exposed and that it represents for consumers, other market participants and Québec's financial system. This step assesses the conduct of an institution toward its clients, at each stage of a product's life cycle, whether or not the network offer is independent of the institution. This assessment is conducted for both the institution as a whole and each of its Significant Activities and includes the following:

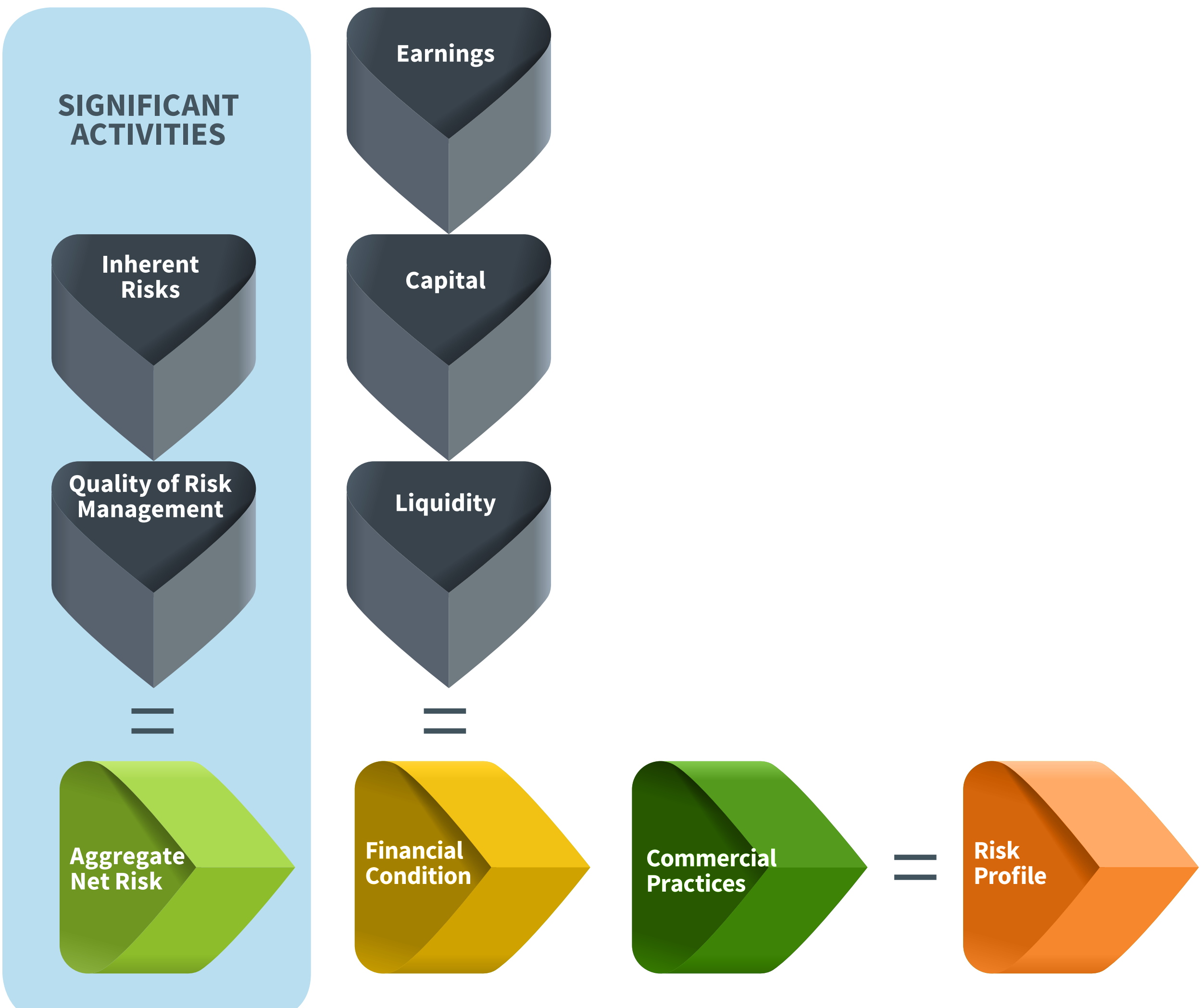
- evaluation of the governance and corporate culture regarding the fair treatment of consumers;
- analysis of the strategies, policies, procedures and control mechanisms set up in relation to the fair treatment of consumers in order to:
  - supply products that meet consumers' needs;
  - use distribution methods adapted to the products;
  - ensure compliance process control for the supply of products and services;
  - promote incentives based on the fair treatment of consumers;
  - provide adequate information to consumers;
  - protect the personal information of consumers;
  - examine and settle claims diligently and fairly;
  - manage complaints diligently and fairly.
- examination of complaints and reports.

Step 7 – Risk Profile

Further to the identification of Significant Activities (Step 1), their Inherent Risks and their management (Steps 2 and 3), the Net Risk of each activity and the institution's Aggregate Net Risk (Step 4), Steps 5 and 6 adjust the Aggregate Net Risk to determine the institution's Risk Profile.

The Risk Profile corresponds to the combination of ratings given to the institution's Aggregate Net Risk, its financial condition and its commercial practices. It may also be updated following an analysis of the financial condition of the group, where applicable, of which the institution is a part.

The evaluation of an institution's Risk Profile is illustrated by the following diagram:



PHASE B
SUPERVISORY PLAN

A three-year Supervisory Plan is developed based on the institution's Risk Profile, taking into account its systemic importance, where applicable. The plan is prepared on the basis of the orientations and priorities set by AMF Solvency and available resources. It is updated annually or more frequently, as needed.

For each institution, the nature, scope and frequency of the supervisory activities as well as the resources allocated to them are determined using the above criteria as a guide.

The Supervisory Plan may be modified at any time when AMF Solvency becomes aware of an event that could have an impact on the institution's Risk Profile. For instance, a management practice or commercial practice which could have a material impact on consumers would cause the Risk Profile to be updated and appropriate supervisory work to be performed.

Moreover, the Supervisory Plan includes an analysis of the financial and non-financial information set forth in an institution's statutory disclosures sent to the AMF, regardless of its Risk Profile.

Relationships with Financial Institutions

A Relationship Manager ("RM") is appointed from within AMF Solvency for each institution to oversee supervisory activities. Other members of the supervisory team contribute to the activities by providing expertise in various fields.

The RM is responsible for co-ordinating communications with the institution and its financial group, where applicable. In this capacity, the RM establishes and maintains relationships with senior management as well as with the institution's key internal and external experts.

The RM generally participates in meetings between the institution's officers and directors and AMF Solvency.

PHASE C
SUPERVISORY ACTIVITIES

Phase C results from the activities necessary to identify the institution's Risk Profile (Phase A) and development of the Supervisory Plan (Phase B).

Step 1 – Collect and Analyze Data

Collection and analysis of data are an integral part of off- and on-site supervisory activities, and help maintain and enhance knowledge of an institution's activities and the sector in which it operates in order to update the Risk Profile.

In addition, under the methodology, the RM is required to assess the extent to which he or she can rely on the work of the independent auditor and the regulator in the home jurisdiction, where applicable. It is the responsibility of the institution to inform these bodies of the supervisory activities and the possibility of being contacted by the RM.

Off-Site Supervisory Activities

Off-site supervisory activities include qualitative and quantitative analyses of the data collected pursuant to laws, regulations and guidelines as well as regular communications with the institution's officers. Within the scope of its activities, AMF Solvency may also request additional information to enhance its supervisory activities with respect to the financial institution, including through correspondence, questionnaires and self-assessment forms.

On-Site Supervisory Activities

On-site activities are a critical part of the supervisory process. The scope of on-site activities depends on the Risk Profile of an institution, its systemic importance, where applicable, and the Supervisory Plan. These activities and interaction with persons who carry out the institution's lines of defense and governance body functions also help with further understanding the institution and serve as a basis for enhanced assessment of the Risk Profile.

The institution is normally notified by AMF Solvency in writing of the on-site supervisory activities at least four weeks in advance, with details given about the date of the intervention, its scope and the name of the RM. The institution is required to appoint a resource person to co-ordinate various tasks. It may be asked for additional information, as needed, to complete the review.

Step 2 – Reporting Results of Supervisory Activities

AMF Solvency may notify the institution of the results of off-site supervisory activities in the form it determines. The results of the on-site supervisory activities are presented in a Supervisory Report.

The on-site Supervisory Report generally includes:

- a summary of the Supervisory Activities that were carried out;
- an overall assessment;
- a discussion of the findings;
- a presentation of the associated recommendations.

It may also give details about the assessment of the effectiveness of any corrective actions previously taken by the institution. The report is sent to the chief executive officer, with a copy to the audit committee chair.

The findings and recommendations are discussed with the relevant principal managers of the institution before the report is released and the points discussed are considered in the final drafting of the report, particularly if they clarify the findings and recommendations that were presented.

AMF Solvency may, if it deems it necessary, meet with the institution's Board of Directors to present the report's contents and discuss other supervisory matters, including its assessment of the institution's financial condition.

Prioritization of Recommendations

The recommendations are prioritized from 1 through 4 based on the degree of urgency of the corrective measures expected to be taken with respect to:

- weaknesses noted with respect to the implementation and application of policies and procedures;
- repeated non-compliance with internal and external rules governing the financial institution;
- deficient internal controls;
- inappropriate management and commercial practices;
- weaknesses noted when assessing the supervisory functions represented by lines of defense and governance bodies;
- the institution's distressed financial condition.

The prioritization of the recommendations is defined below:

Priority	Description
1.	The recommendation involves one or more deficiencies which are not expected to have a material impact on the assessment of one or more components of the institution's Risk Profile but which require improvement. The AMF will require that corrective measures be applied according to a schedule determined by the institution.
2.	The recommendation involves one or more deficiencies which are not expected to have a material impact, in the short term, on the assessment of one or more components of the institution's Risk Profile. The AMF will require that corrective measures be applied according to a schedule determined by the institution.
3.	The recommendation involves one or more deficiencies which are repeated or which have a material impact, in the short term, and which, if not corrected, could change the assessment of one or more components of the institution's Risk Profile. The AMF Solvency will require that corrective measures by applied within the prescribed time period. If considered necessary, approval of an action plan by the Board of Directors or a Board committee will be required.
4.	The recommendation involves one or more deficiencies which have a material impact, in the short term, and which, if not immediately corrected, could change the assessment of one or more components of the institution's Risk Profile. An action plan will have to be carried out within the time period prescribed by the AMF, which will evaluate the action taken and may require that adjustments be made. Approval of the action plan by the Board of Directors or a Board committee will also be required.

Follow-up by Financial Institution on AMF Solvency Recommendations

Generally, within 30 days of receipt of the final report, the institution must respond to the recommendations with a corrective action plan, including a timetable and/or a description of actions already taken. The action plan must be drawn up by a representative of the institution's senior management and approved by the Board of Directors or a Board committee, when required by AMF Solvency. Depending on the significance of the recommendations and/or the response provided, either a shorter timetable or additional or alternative corrective actions to those presented in the action plan may be required.

Step 3 – Follow-up on Action Plans Resulting from Recommendations in the Supervisory Report

The RM follows up on the progress being made with the action plan drawn up by the institution in response to the recommendations in the Supervisory Report. This follow-up is part of an ongoing process and is done to ensure the consistency and adequacy of the measures adopted on the basis of the recommendations and their implementation according to the timetables set out in the institution's action plan. Any changes made by the institution that affect the corrective measures or the timetables must be communicated to AMF Solvency.

Additional Measures under Applicable Legislation

Where the corrective actions proposed or taken are considered inadequate, the institution continually fails to implement the required corrective actions or does not respect the timetables, AMF Solvency may take progressive actions as provided for in applicable legislation.

APPENDIX 1 – RISK CATEGORIES

The following definitions illustrate some of the most common concepts of risk for financial institutions. This is not an exhaustive list of the risks monitored by the AMF or the risks faced by institutions.

Credit Risk

Credit risk is the risk of loss if a borrower or counterparty does not meet its financial or contractual obligations to an institution. This risk arises from uncertainty about the counterparty's or client's capacity or willingness to meet its obligations. Counterparties include issuers, debtors, borrowers, brokers, underwriters, reinsurers, guarantors and the contracting parties for OTC derivatives.

Market Risk

Market risk is the risk of loss from fluctuations in market prices and rates, the correlation between them and the range of volatility. Exposure to this risk can result from market-making, dealing, and position-taking activities as well as foreign exchange. The related parameters can include interest and foreign exchange rates, and prices of securities, commodities and real estate.

a. Interest Rate Risk

Interest rate risk is the risk of loss from changes in interest rate levels, yield curve shapes, interest rate spreads and mortgage loan prepayments. It stems primarily from a balance sheet mismatch in rates and basis risk on off-balance-sheet products.

b. Foreign Exchange Risk

Foreign exchange risk is the risk of loss from fluctuations in spot and forward prices and the volatility of foreign exchange rates.

Liquidity Risk

Liquidity risk arises from an institution's inability to meet its financial obligations within the time prescribed and at a reasonable price. Financial obligations include:

- commitments to depositors and policyholders;
- payments due in relation to derivatives contracts;
- settlement of securities borrowing and securities redemption;
- lending and investment commitments;
- any other payment due.

Insurance Risk

a. Product Design and Pricing Risk

Product design and pricing risk arises from transacting insurance and/or annuity business where costs and liabilities assumed in respect of a product line exceed expectations in pricing.

b. Underwriting and Liability Risk

Underwriting and liability risk is the exposure to financial loss resulting from the selection and approval of risks to be insured, the reduction, retention and transfer of risk, the reserving and settlement of claims, and the management of contractual and non-contractual product options.

Operational Risk

Operational risk is defined as the risk of loss resulting from faults or inadequacies in processes, people, and systems or from external events, and it includes legal risks.

a. Legal Risk

Legal risk is the risk of harm to which a financial institution is exposed due to the application of a legal standard or the performance of a contractual commitment in combination with the occurrence of an event (internal/external) that could impact its civil, contractual or penal liability. Such harm could arise from the misinterpretation or misapplication of contractual provisions. Legal risk covers exposure to fines, penalties, damages and class actions.

Information and Communication Technologies Risk

Information and communication technologies (ICT) risk is the business risk associated with the use, ownership, operation and implementation of ICT within an institution. This risk covers the risks relating to availability and continuity, security (including cyber security), ICT system changes, data integrity and IT outsourcing.

Compliance Risk

Compliance risk means the risk of regulatory non-compliance with the laws, regulations and guidelines governing financial institutions. This risk does not however include risks related to ethics and professional conduct.

Strategic Risk

Strategic risk arises from an institution's inability to implement appropriate business plans, strategies, decision-making processes and resource allocation methods adapted to changes affecting the commercial context and to changes in its business environment.

Reputational Risk

Reputational risk means the risk faced by institutions with respect to their brand image. The risk factors stem primarily from their social and environmental practices, ethics and professional conduct, and integrity. Reputational risk is the current and future impact on the institution's business conduct arising from negative public opinion. Exposure to this risk may cause a significant decline in earnings and capital, and may ultimately undermine the institution's viability.