AUTORITÉ DES MARCHÉS FINANCIERS

CAPITAL MANAGEMENT GUIDELINE

May 2015

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Introduction

The ability of financial institutions to fulfill their obligations toward their clients is a fundamental component of sound and prudent management practices. A financial institution's capital[1] plays an essential role in this regard since one of the institution's main functions is to ensure that commitments to insureds and depositors are met.

With this in mind, the AMF issues expectations regarding capital adequacy. These expectations are specifically described in guidelines[2] setting out regulatory capital levels based on the sector concerned and the risks assumed by financial institutions. These guidelines essentially form the basis of sound and prudent capital management by establishing and comparing institutions' capital needs and available capital to ensure they comply with the prescribed requirements.

The purpose of this guideline is to articulate the principles which should guide and oversee financial institutions' management of capital at a more global level, before determination of the regulatory minimum capital.

Capital management is a broad process which covers not only capital adequacy but also all the strategies, policies and procedures used by an institution to determine and plan its capital. Regulatory requirements, its environment, risk profile and risk appetite, strategic planning and economic imperatives must all form part of this process.

This guideline addresses the core elements of capital management, including governance and reporting practices related to capital management, the establishment of an internal capital target consistent with the institution's risk profile, the choice of capital raising strategies, and aspects relating to the quality and composition of capital.

International standards pertaining to sound and prudent risk management set out by bodies such as the Basel Committee on Banking Supervision[3] and the International Association of Insurance.[4] Supervisors encourage regulators to provide a framework which requires institutions to adopt a forward-looking approach, particularly with respect to capital management.

The AMF adheres to these principles and believes that the quality of a financial institution's capital management is essential to its longevity. Accordingly, the expectations in this guideline draw heavily on the fundamental principles set out by these bodies.

1. Capital management

> The AMF expects capital management to be integrated into all of a financial institution's strategic planning and risk management activities, including its stress-testing program, risk appetite statement and the establishment of its risk tolerance levels.

[1] In French, for the purpose of this guideline, the terms « capital » and « fonds propres » are considered to be equivalent.

[2] Capital Adequacy Requirements Guideline (CAR) – Life and health insurance; Capital Adequacy Requirements Guideline (MCT) – Property and casualty insurance; Adequacy of Capital Base – Financial services cooperatives; Capital Adequacy Guideline – Credit unions not members of a federation, trust companies and savings companies.

[3] Bank for International Settlements. Basel Committee on Banking Supervision. *Core Principles for Effective Banking Supervision*, September 2012. Bank for International Settlements. Basel Committee on Banking Supervision, *A Sound Capital Planning Process: Fundamental Elements*, January 2014.

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

Capital is a crucial component of a financial institution's solvency and its management is intrinsically related to its risk-taking.

The AMF therefore expects each financial institution to set up a process for assessing its own risk and solvency that allows it to identify the relationships between its activities, thereby facilitating decision-making based on its capital level, risk appetite and business strategies.

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

The institution should also have a broad vision and take account of elements such as procyclicality, economic imperatives, investor perception, regulatory organizations' expectations and, for financial groups, possible internal capital transfers. One of the financial institution's main objectives should be to achieve its 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.

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

- At the financial group level, capital management should take into account intra-group cash flow, capital fungibility between entities, contagion risk, possible double-gearing of funds and constraints and limitations on foreign-sourced capital;
- At the entity level, capital management should allow the establishment of internal capital targets based on each entity's nature, size, environment and regulatory requirements.

Regardless of whether capital is managed at the group or entity level, the objective of the planning process must be to develop an approach to current and future capital needs that is coherent and consistent.

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

2. Capital management governance

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

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

Senior management must develop the financial institution's organizational structure, strategies, plans, operational objectives and control measures. It must also demonstrate to the board of directors that established strategies, policies and procedures are adequate.

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

2.1 Roles and responsibilities of the board of directors

With regard to the expectations outlined by the AMF in the *Governance Guideline*,[5] the board of directors has ultimate responsibility for sound and prudent capital management. In particular, it should:

- Ensure that the institution establishes and maintains an appropriate level of capital in line with regulatory requirements, its environment, strategic plan and risk profile and economic imperatives.
- Approve capital management strategies and policies and examine the underlying procedures, which should address, among other things, the internal capital target and the capital the institution needs to carry on current and planned activities as well as the strategies for recovering capital in a crisis or in the case of an unexpected shock which could require additional capital. They should also be reviewed periodically.
- Oversee the implementation of an own risk and solvency assessment mechanism[6] and ensure that the related strategies, policies and procedures are aligned with the institution's activities.
- Remain up-to-date with the results of the stress[7] testing program and, more specifically, validate the proposed strategies and corrective measures in situations where capital falls below the internal target.

2.2 Roles and responsibilities of senior management

For capital management, the roles and responsibilities of senior management and, as applicable, the chief risk officer,[8] are primarily to:

- Develop a capital management framework adapted to the institution's risk profile and strategic plan.
- Implement, manage and ensure the monitoring of the capital management framework.
- Ensure the design and implementation of a process for own risk and solvency assessment so as to strengthen the institution's overall integrated risk management framework.
- Establish terms of communication with and escalation to higher levels in the organization in response to major changes in the institution's environment, risk profile or any other element which could affect the level, quality or composition of its capital.

3. Capital management framework

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

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

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

5 Autorité des marchés financiers. *Governance Guideline*.
6 This process is often called ORSA (Own Risk and Solvency Assessment) for insurers and ICAAP (Internal Capital Adequacy Assessment Process) for deposit institutions. The AMF's expectations with respect to ORSA are outlined in section 5.
7 Autorité des marchés financiers. *Stress Testing Guideline*.
8 Autorité des marchés financiers. *Integrated Risk Management Guideline*.

Depending on the nature, size, complexity, and risk profile of each financial institution, the capital management framework should include the following in particular:

- Description of the roles and responsibilities relating to the implementation of capital requirement strategies and policies;
- Policies setting capital targets and capital adequacy objectives based on:
  - Risk appetite and risk tolerance levels;
  - Risk profile;
  - Economic imperatives;
  - Strategic plan.
- Measures for identifying and including material risks which could require capital;
- Procedures for the assessment of overall capital adequacy based on risk and the strategic plan;
- Internal control, review and validation mechanisms to ensure adequacy of capital taking into account regulatory requirements and the financial institution's needs;
- Limits and restrictions regarding the quality and composition of capital;
- Capital raising strategies according to circumstances;
- Possible corrective measures by senior management in a crisis or following a major shock;
- Frequency of approval processes and review of decisions regarding all components of the capital management framework.

4. Regulatory capital, internal capital target and excess capital

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

Under the laws the AMF administers, financial institutions are required to maintain adequate capital to ensure sound and prudent management.[9]

The minimum regulatory capital requirements corresponding to this obligation are established by the different capital guidelines issued by the AMF.[10] Since those requirements are based on standardized assumptions applicable to the entire industry, they cannot accurately reflect the specific risk profile of each institution.

Therefore, in addition to regulatory capital requirements, a financial institution should also maintain additional capital levels to reflect its specific risk profile and have a margin to cover its other needs. There are several incremental levels of capital:

Regulatory capital:

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

9 *Insurers Act*, CQLR, c. A-32.1, sections 74; *Deposit institution and deposit protection act*, CQLR, c. I-13.2.2, section 28.21 and following; *Act respecting financial services cooperatives*, CQLR, c. C-67.3, section 440.1 and following, and 450 and following; *Trust companies and savings companies Act*, CQLR, c. S-29.02, section 46.

10 See Footnote 3.

Internal capital target[11]

This refers to the required amount of capital determined by the institution in connection with its activities, considering specifically its risk appetite and stress testing. It takes into account risk related to the implementation of the institution's strategic plan as well as all the risks the institution could be exposed to in connection with its current and planned activities, such as reputation risk, strategic risk and risk related to access to market capital.

Since the internal capital target should capture a broader range of risks, it should exceed regulatory capital.

11 The term "economic capital" is more commonly used for deposit institutions.

Excess capital

This refers to the available capital exceeding the internal capital target as established by the institution. It is normally maintained for strategic purposes. For example, additional capital could be maintained to carry out acquisitions and projects, achieve or maintain a credit rating or simply absorb annual variations in financial results in order to ensure that available capital does not fall below the internal capital target.

5. Own risk and solvency assessment

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

It is up to each financial institution to set up a mechanism allowing it to identify all material risks, regardless of whether they are readily quantifiable or not, and assess them based on its capital. The mechanism should also enable the financial institution 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, a financial institution's material risks and the capital required to support them. This tailored alignment of risks with capital is key and an indispensable part of a financial institution's integrated risk management.

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

In addition to the close relationship of this mechanism with the Integrated Risk Management Guideline[12], some of the AMF's expectations set forth in the governance,[13] stress testing[14] and capital adequacy[15] guidelines, as well as actuarial standards of practice with respect to Dynamic Capital Adequacy Testing (DCAT), are also closely associated with it.

The added value of this mechanism therefore lies in formally and continually taking into account existing relationships between the institution's solvency, risk profile and strategic goals as well as the impacts they may have on each other. Given that it is forward-looking, this mechanism should be consistent with the institution's strategic and business planning and should contemplate the potential adverse capital impacts over the institution's planning horizon.

The AMF expects the application of own risk and solvency assessment mechanism to be the subject of an official report to the board of directors at least once a year, or more often if the financial institution's risk profile changes significantly.

The report should reflect the institution's consolidated activities and contain enough information to allow

[12] Autorité des marchés financiers. *Integrated Risk Management Guideline*.
[13] Autorité des marchés financiers. *Governance Guideline*.
[14] Autorité des marchés financiers. *Stress Testing Guideline*.
[15] See Footnote 2.

the board to assess the results based on the institution's risk profile and possible threats to its capital and solvency. In particular, the board should ensure that the results meet the limits it has set for the institution according to its risk appetite and tolerance. It should allow to assess the accuracy of the capital in relation to the quality and composition of capital and confirm the internal target of it.

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

6. Additional capital raising

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

Based on different crisis scenarios, the institution should be able to anticipate and set up a capital-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 institutions should not assume that capital will be easily accessible when they need it, but should consider instead the fact that in certain circumstances, access to market capital could become more difficult. As a result, an institution should act prospectively and raise additional capital in anticipation of such adverse circumstances.

The financial institution should also analyze the different characteristics of its assets and liabilities and their potential impact on its solvency taking into account the volatility of, and potential changes in, its assets and liabilities, among other things. When it reduces its risks or obligations through intragroup transactions, reinsurance or securitization, the institution should ensure that it captures all risks related to such transactions. Where appropriate, the financial institution should also ensure that it meets the expectations set out in the *Reinsurance Risk Management Guideline*[16] and the *Securitization Risk Management Guideline*ˆ [Autorité des marchés financiers. *Securitization Risk Management Guideline*.]. The *Liquidity Risk Management Guideline*[17] also sets out the AMF's expectations in connection with financing and capitalization to facilitate the institution's access to capital so that it is able to meet its obligations as they become due.

More generally, the institution should:

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

[16] Autorité des marchés financiers. *Reinsurance Risk Management Guideline*.
[17] Autorité des marchés financiers. *Liquidity Risk Management Guideline*.

7. Quality and composition of capital

The AMF expects a financial institution to be particularly mindful of the quality and composition of its capital. The institution should take into consideration the specific characteristics of its capitalization instruments and the risks inherent in their use while ensuring that it complies with capitalization criteria and limits set out in guidelines applicable under different sector-based laws.

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

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

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

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

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