"Structure, Principles and Effectiveness of Insurance Regulation in the 21st Century: Insights from Canada"

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The Geneva Papers, 2012, Vol. 37, 155-174

Synopsis by William Reimer

The 2008 financial crisis resulted in the failure of many large financial institutions that had previously been thought to be "too large to fail." Among the countries that were classified as G8 countries, Canada was the only nation that did not have to provide financial support to distressed financial institutions. Kelly, Kleffner, and Leadbetter analyze the Canadian insurance regulatory structure to see what insight could be gleaned in today's increasingly internationalized business structure. To explore their thesis the authors impose a "public interest theory" framework in this research.

According to the authors:

> *The public interest theory of regulation provides a rationale for regulation; it exist to serve the public interest and therefore governments regulate industries to improve or protect public safety, to increase social welfare, and to prevent market failure.*[1]

The authors argue that government intervention in insurance markets is both beneficial and necessary to the economy and the insurers that operate in its midst. The researchers theorized that one of the most important aspects of Canadian regulatory oversight was the "holistic" approach that Canadian entities were steered towards.[2] In taking a broad approach to risk, Canadian companies were regulated in a much more comprehensive and effective manner than insurers operating in other countries.

Canadian Regulation

The effectiveness of Canadian insurance regulation relies on *ex ante* and *ex post* regulation. The Canadian regulatory agencies have set in place policies that act as preventative measures as well as laws that are meant to deal with the possibility of infractions or the failure of a company. In Canada, *ex ante* regulations emphasize prudent investment strategies in order to prevent the failure of insurance companies and ensure that minimum capital requirements adequate minimum reserves are kept in place. *Ex ante* regulation acts as a preventative measure to keep insurance companies from entering into positions in which they could become insolvent. In Canada, insurers can choose to be regulated on either the federal level or the provincial level. Within Canada it is required for insurance companies to undergo a government run test such as the Minimum Capital Test (MCT) and the Branch Adequacy of Assets Test (BAAT) to operate within the country. According to the authors, the MCT/BAAT promotes a prudent investment strategy and to show the risk from both assets and liabilities of an insurer. By contrast, in the U.S., statutory accounting principles are applied where GAAP accounting

[1] Page 156
[2] Page 155

is used to measure risks. The Canadian government also requires that every insurer must have reserves valued by an appointed actuary who reports in writing to the CEO and CFO. The Office of the Superintendent of Financial Institutions (OSFI) is unique in that their function is to advise and regulate deposit-taking institutions in order to ensure that they are in sound financial condition and follow prudent risk taking strategy. The OSFI states that:

> *In Canada, we do not look at ratios; we try to analyze the risks facing the company and the quality of its risk management. Our approach is really based on understanding each company and the unique risks that the company faces.* (OSFI, 11 June 2009)[3]

The OSFI takes a very in-depth look at each company and the risks that they may have with the objective to ensure stable financial markets. If the OSFI sees a financial product as unreasonably risky they will place an outright ban on it such as they did in banning the underwriting of financial guarantee insurance.[4]

Canada places as much emphasis on *ex post* regulation as they do on *ex ante*, in order to take corrective actions and prevent the failure of insurers. The *ex post* regulations that have been put in place by Canadian regulatory agencies prescribe a set plan if a company becomes insolvent. The authors note that this strengthens *ex ante* regulation and creates a framework in the event of the worst outcome. As noted by Kelly et al this is something that many other countries have failed to do, and the issues are dealt with on a case by case basis. The value that Canada places on *ex post* regulation increases the amount of immediate corrective action that can be taken by regulatory agencies in Canada and acts to prevent future negative events.

The financial crisis in 2008 saw the failure of many large institutions worldwide. Between the years 2007-2009, national governments provided approximately CAD$1.6 trillion in support for failing institutions.[5] The authors conclude that among industrialized economies, Canada was the only country that did not provide financial support to distressed institutions due to the structural and regulatory factors that had been implemented years prior to the crisis.[6] During the crisis, all Canadian financial institutions remained solvent and needed no assistance from the government. Although Canadian companies remained solvent there were 26 subsidiaries of foreign companies that were considered at risk institutions. After the crisis, the OSFI expanded its oversight of foreign subsidiaries and financial institutions within the country.

Conclusion

The Canadian regulatory structure should be looked to by other countries as a guide to effectively regulate large entities in order to ensure that the risk of mass institutional failure I mitigated through such structure. Due to increased internationalization of the large financial institutions that operate in the global markets, the pressure for a global supervisory authority may be forthcoming. The authors believe that two criteria for global regulation are important. As they state,

> *Solvency supervisors should require all financial institutions to annually submit an organizational infrastructure map, identifying all legal entities, the location of critical information technology systems and the interconnections across affiliates with respect to instruments such as guarantees, contractual commitments or other significant intra-group transactions.*

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[3] Page 161
[4] Page 161
[5] Page 163
[6] Page 163

Supervisors should ensure that regulated financial institutions maintain legal connectivity with assets and information technology during intra-group transactions. [7]

The cost of implementing such regulations would be large and would be met with much resistance among institutions and governments. However, in the wake of the financial crisis the need for prevention of systemic failure cannot be ignored. The Canadian success story may highlight the importance of thorough risk management and oversight as well as a robust distress resolution framework to provide policyholders with confidence in the international system.[8] Although Canadian regulation is in and of itself a success story, the effectiveness of implementing stringent regulations in a larger and more complex economy could achieve less than effective results. And it is reasonable to expect that investors can achieve some level of diversification on their own. However, if another crisis happens it could open the door for the type of regulation the Kelly, Kleffner, and Leadbetter propose.

[7] Page 170
[8] Page 172