

Supervisory Framework

JUNE 2012



Financial Institutions
Commission

The Financial Institutions Commission of British Columbia (FICOM) is a regulatory agency of the Ministry of Finance, established in 1989 to contribute to the safety and stability of the British Columbia financial sector.

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Supervisory Framework

The Financial Institutions Commission of British Columbia

Structure

The Financial Institutions Commission of British Columbia (FICOM) is a regulatory agency of the Ministry of Finance, established in 1989 to contribute to the safety and stability of the British Columbia financial sector.

Day-to-day regulatory and operational decisions are administered by the Superintendent and CEO. Under the *Financial Institutions Act (FIA)*, certain regulatory decisions must be made by the Commission. The Commission has up to eleven members appointed by the Lieutenant Governor in Council on the recommendation of the Minister of Finance.

The Commission has two key roles:

- Making major regulatory decisions related to incorporations, business authorizations, amalgamations, liquidations and windups of financial institutions; and
- Making decisions on financial institution stabilization, supervision and deposit insurance. Stabilization and supervision are regulatory powers used to assist financial institutions that are experiencing financial or other difficulties.

Mandate

A properly functioning, efficient financial services sector in which British Columbians can place their trust and confidence is essential to the province's economy. To achieve this objective, FICOM must safeguard the interests of depositors, policyholders, beneficiaries, and pension plan members while at the same time allowing the financial sector to take reasonable risks and compete effectively. FICOM's goal is to balance competitiveness with financial stability and federal and international standards with local market realities.

FICOM supervises and regulates financial institutions—credit unions, insurers and trust companies—to determine whether they are in sound financial condition and are complying with their governing laws and supervisory standards. FICOM uses a risk-based supervisory framework to identify imprudent or unsafe business practices at financial institutions and intervenes on a timely basis, as required. This document describes the principles, concepts and core process used in this supervisory framework.

FICOM must safeguard the interests of depositors, policyholders, beneficiaries and pension plan members.

Introduction

The primary focus of FICOM's supervisory work is to determine the impact of current and potential future events, in both the internal and external environment, on the risk profile of the PRFI.

The Supervisory Framework

The supervisory framework sets out the principles, concepts, and core processes that FICOM uses to guide its supervision of Provincially Regulated Financial Institutions (PRFIs)¹. These principles, concepts, and core processes apply to all PRFIs in British Columbia, irrespective of their size, and accommodate the unique aspects of all industry sectors (i.e. credit union, trust company, life insurance, and property and casualty insurance). The primary focus of FICOM's supervisory work is to determine the impact of current and potential future events, in both the internal and external environment, on the risk profile of the PRFI.

Since FICOM's supervisory framework was first introduced in 2003, significant developments in the financial services industry have changed the nature of the risks and risk management of financial institutions. For example, product sophistication has increased, globalization has caused risks to become more systemic, and financial institutions have experienced multiple and severe stresses to their solvency and liquidity. Meanwhile, national and international standards and requirements for supervising financial institutions have also been strengthened.

The updated supervisory framework described in this document reflects the enhancements FICOM has made to address these changes, and the experience gained, from applying the 2003 framework over the past nine years.

In summary, these enhancements continue to make FICOM's risk-based supervision as dynamic and forward-looking as possible, and help ensure that FICOM can respond effectively to changes in the British Columbian and Canadian financial sectors, now and in the future.

Statutory Obligations

The supervisory framework is designed to assist FICOM in meeting its statutory obligations set out in the FIA and other governing legislation regarding the supervision of PRFIs. These obligations are broad and overarching, and to meet them in practice requires detailed and consistent standards and criteria for supervising PRFIs.

National and International Expectations

FICOM reviews and considers the application of guidance set by the federal Office of the Superintendent of Financial Institutions (OSFI), other provincial regulators and deposit insurers. FICOM also considers international standards set by the Basel Committee on Banking Supervision and International Association of Insurance Supervisors for guidance in setting supervisory standards and criteria.

1. PRFIs (or Provincially Regulated Financial Institutions) refers to British Columbia authorized credit unions, trust companies, property and casualty (P&C) insurance companies and life insurance companies.



General Approach

Consolidated Supervision

The supervision of a PRFI is conducted on a consolidated basis which involves an assessment of all material entities (including holding companies, all subsidiaries and joint ventures). FICOM uses information available from other regulators, as appropriate.

Relationship Manager

FICOM designates a relationship manager (RM) for each PRFI. The RM is responsible for maintaining an up-to-date risk assessment of the PRFI. Specialists and other staff within FICOM help support this work. The RM is the main point of contact for the PRFI.

Principles-Based Supervision

The supervision of PRFIs is principles-based. It requires the application of sound judgment in identifying and assessing risks, and determining, from a wide variety of supervisory and regulatory options available, the most appropriate method to ensure that the risks that a PRFI faces are adequately managed.

Supervisory Intensity and Intervention

The intensity of supervision will depend on the nature, size, complexity and risk profile of a PRFI, and the potential consequences of the PRFI's failure. Where there are identified risks or areas of concern, the degree of intervention will be commensurate with the risk assessment, and in accordance with powers provided by provincial legislation (e.g., FIA) and criteria set out in FICOM's Guide to Intervention for PRFIs.

Board and Senior Management Accountability

A PRFI's board of directors and senior management are responsible for the management of the PRFI and ultimately accountable for its safety and soundness and compliance with governing legislation. FICOM's supervisory mandate includes apprising PRFIs of situations having material risk and recommending or requiring corrective actions to be taken. FICOM also looks to the board and senior management to be proactive in providing FICOM with timely notification of important issues affecting the PRFI.

Risk Tolerance

The objective of FICOM's supervision is to reduce the likelihood that a PRFI will fail. FICOM also recognizes that some degree of risk tolerance will be necessary, which may require PRFI's to take reasonable risks while operating in a competitive environment. As such, PRFIs can experience financial difficulties that could lead to their failure.

Reliance on External Auditors and Appointed Actuary

FICOM relies upon the PRFI's external auditor for the fairness of the financial statements and the appointed actuary's opinion for the adequacy of actuarial and other policy liabilities. FICOM's assessment of a PRFI's overall financial performance depends on the PRFI's audited financial statements and actuarial reports.

Use of the Work of Others

FICOM uses, where appropriate, the work of others to reduce the scope of its supervisory work and to minimize duplication of effort. This enhances FICOM's efficiency and its effectiveness. For example, supervisors may use the testing performed by a PRFI's external auditor and internal audit function to help them assess the effectiveness of controls. Similarly, they may use the detailed analysis performed by the PRFI's risk management function to help assess the effectiveness of the PRFI's models.

External sources of work that may be used by FICOM include, but are not limited to, the PRFI's external auditor and appointed actuary, as well as the PRFI's oversight functions such as financial, compliance, actuarial, risk management, internal audit, senior management and board functions. Other useful external sources include rating agencies, industry groups, other regulators, consultants, and organizations.

Key Principles

Principle #1

Focus on Material Risk

The risk assessment FICOM performs in its supervisory work is focused on identifying material risk to a PRFI, such that there is the potential for loss to depositors, policy-holders, or beneficiaries.

Principle #2

Forward-Looking, Early Intervention

Risk assessment is forward-looking. This view facilitates the early identification of issues or problems, and timely intervention where corrective actions need to be taken, so that there is a greater likelihood of a satisfactory resolution of issues.

Principle #3

Sound Predictive Judgment

Risk assessment relies upon sound, predictive judgment. To ensure adequate quality, FICOM management requires that these judgments have a clear, supported rationale.

Principle #4

Understanding the Drivers of Risk

Risk assessment requires understanding the drivers of material risk to a PRFI. This is facilitated by sufficient knowledge of the PRFI's business model (i.e., products and their design, activities, strategies and risk appetite), as well as the PRFI's external environment. The understanding of how risks may develop and how severe they may become is important to the early identification of issues at a PRFI.

Principle #5

Differentiate the Inherent Risks and Risk Management

Risk assessment requires differentiation between the risks inherent to the activities undertaken by the PRFI, and the PRFI's management of those risks—at both the operational and oversight levels. This differentiation is crucial to establishing expectations for the management of the risks and to determining appropriate corrective action, when needed.

Principle #6

Dynamic Adjustment

Risk assessment is continuous and dynamic to ensure that changes in risk, arising from both the PRFI and its external environment, are identified early. FICOM's core supervisory process is flexible, whereby identified changes in risk result in updated priorities for supervisory work.

Principle #7

Assessment of the Whole Institution

The application of the supervisory framework culminates in a consolidated assessment of risk to a PRFI. This holistic assessment combines an assessment of earnings and capital in relation to the overall net risk from the PRFI's significant activities, as well as an assessment of the PRFI's liquidity, to arrive at this composite view.

Risk assessment—the fundamental objective of supervision—is undertaken by following seven key principles.





Primary Risk Assessment Concepts

The supervisory framework uses many concepts to enable a common approach to risk assessment across PRFIs and over time. The primary concepts are described below.

1. Significant Activities

The fundamental risk assessment concept within the supervisory framework is that of a significant activity. A significant activity is a line of business, unit or process that is fundamental to the PRFI's business model and its ability to meet its overall business objectives (i.e., if the activity is not well managed, there is a significant risk to the organization as a whole in terms of meeting its goals).

FICOM identifies significant activities using various sources including the PRFI's organization charts, strategic business plan, capital allocations, and internal and external reporting. This facilitates a close alignment between FICOM's assessment of the PRFI and the PRFI's own organization and management of its risks, and enables FICOM to make use of the PRFI's information and analysis in its risk assessment.

Sound judgment is used in selecting significant activities, which may be chosen for quantitative reasons (such as the activity's percentage of total PRFI assets, revenue, premiums written, net income, allocated capital, or its potential for material losses), and/or qualitative reasons (such as its strategic importance, planned growth, risk, effect on brand value or reputation, or the criticality of an enterprise-wide process).

2. Inherent Risk

In the supervisory framework, the key inherent risks are assessed for each significant activity of a PRFI. Inherent risk is the probability of a material loss due to exposure to, and uncertainty arising from, current and potential future events. A material loss is a loss or combination of losses that could impair the adequacy of the capital of a PRFI such that there is the potential for loss to depositors, policyholders, or beneficiaries.

Inherent risk is intrinsic to a significant activity and is assessed without regard to the size of the activity relative to the size of the PRFI, and before considering the quality of the PRFI's risk management. A thorough understanding of both the nature of the PRFI's activities and the environment in which these activities operate is essential to identify and assess inherent risk.

FICOM uses the following six categories to assess inherent risk: **credit risk; market risk; insurance risk; operational risk; regulatory compliance risk; and strategic risk**. For each significant activity, the key inherent risks are identified and their levels are assessed as **low, moderate, above average, or high**. The categories and levels of inherent risk are described in more detail in *Appendix A*.

FICOM does not view reputational risk as a separate category of inherent risk. It is a consequence of each of the six inherent risk categories. Accordingly, it is an important consideration in the assessment of each inherent risk category.

Based on the key inherent risks identified for a significant activity and their levels, supervisors develop expectations for the quality of risk management. The higher the level of inherent risk, the more rigorous the day-to-day controls and oversight expected. Sound controls are expected where appropriate.

Inherent risk is the probability of a material loss due to exposure to, and uncertainty arising from, current and future events.

3. Quality of Risk Management

FICOM assesses the quality of risk management (QRM) at two levels of control—operational management and oversight functions.

Operational Management

Operational management for a given significant activity is primarily responsible for the controls used to manage all of the activity's inherent risks on a day-to-day basis. Operational management ensures that there is a clear understanding by PRFI line staff of the risks that the activity faces and must manage, and that policies, processes, and staff are sufficient and effective in managing these risks. When assessing operational management, FICOM's primary concern is whether operational management is capable of identifying the potential for material loss that the activity may face, and has in place adequate controls.

In general, the extent to which FICOM needs to review the effectiveness of operational management of a significant activity depends on the effectiveness of the PRFI's oversight functions (see *Appendix B*). In a PRFI with sufficient and effective oversight functions, it may often be possible for FICOM to assess the effectiveness of operational management for a given activity using the work of the oversight functions. However, this approach does not preclude the need for FICOM to validate periodically that key day-to-day controls are effective.

Oversight Functions

Oversight functions are responsible for providing independent, enterprise-wide oversight of operational management. There are seven oversight functions that may exist in a PRFI: **financial; compliance; actuarial; risk management; internal audit; senior management; and the board** (see *Appendix B*).

The presence and nature of these functions are expected to vary based on the nature, size and complexity of a PRFI and its inherent risks. Where a PRFI lacks some of the oversight functions, they are not sufficiently independent, or they do not have enterprise-wide responsibility, FICOM expects other functions, within or external to the PRFI, to provide the independent oversight needed.

For each significant activity, FICOM assesses operational management and each of the relevant oversight functions as **strong, acceptable, needs improvement, or weak**.

The appropriate rating is determined by comparing the nature and levels of the PRFI's controls or oversight to FICOM's expectations developed when assessing the levels of the key inherent risks.

For each relevant oversight function present in a PRFI, FICOM also determines an overall rating (**strong, acceptable, needs improvement, or weak**) that reflects the quality of the function's oversight across the entire PRFI (see *Appendix B*). FICOM has assessment criteria that guide the determination of the overall rating for each oversight function. The assessment includes a determination of the direction of the quality of oversight (improving, stable, or deteriorating).

4. Net Risk

For each significant activity, the level of net risk is determined based on judgment that considers all of the key inherent risk ratings and relevant QRM ratings for the activity. Net risk is rated **low, moderate, above average, or high**. *Appendix C* shows typical net risk ratings for combinations of inherent risk and QRM ratings. The net risk assessment includes a determination of the direction of net risk (decreasing, stable, or increasing).

Net risk is inherent risk(s) after mitigation by QRM.

FICOM expects a PRFI to maintain controls and oversight that are commensurate with the key inherent risks, so that levels of net risk are considered prudent by FICOM. Where levels of net risk are considered imprudent, a PRFI is expected to address the situation by either improving QRM or reducing inherent risk.

5. Importance and Overall Net Risk

The importance of the net risk of the significant activity is a judgment of its contribution to the overall risk profile of the PRFI. Importance is rated as **low, medium, or high**. The significant activities assigned higher importance ratings are the key drivers of the overall risk profile.

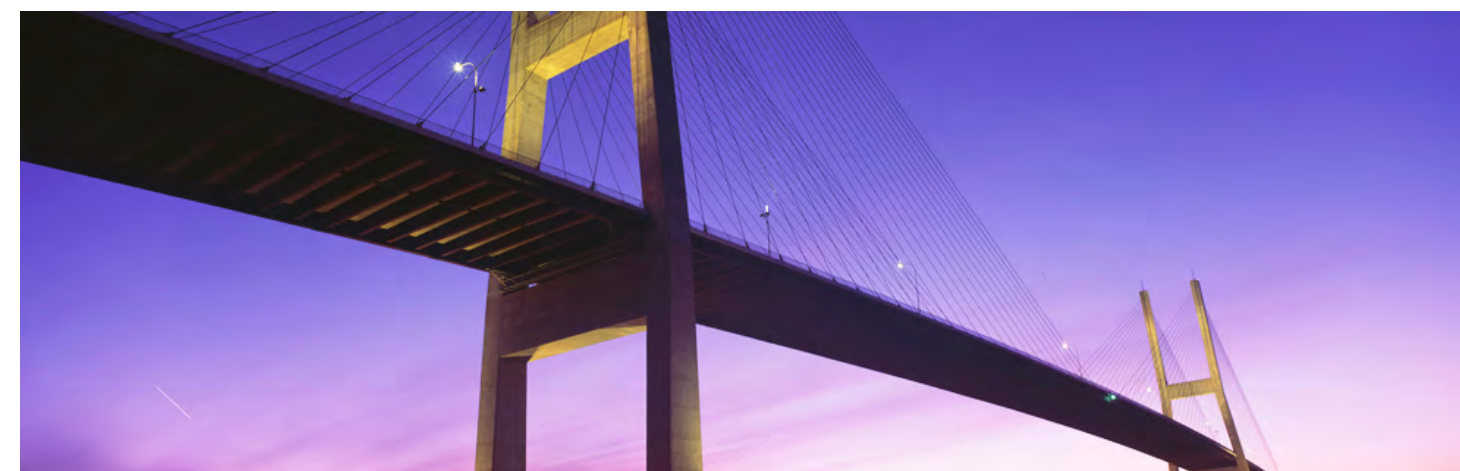
The net risks of the significant activities are combined, by considering their relative importance, to arrive at the overall net risk of the PRFI. The overall net risk is an assessment of the potential adverse impact that the significant activities

of the PRFI collectively could have on the earnings performance and adequacy of the capital of the PRFI, and hence on the depositors or policyholders. Overall net risk is rated as **low, moderate, above average, or high**, and the direction is assessed as **decreasing, stable, or increasing**.

6. Earnings

Earnings are an important contributor to a PRFI's long-term viability. Earnings are assessed based on their quality, quantity and consistency as a source of internally-generated capital. The assessment takes into consideration both historical trends and the future outlook, under both normal and stressed conditions. Earnings are assessed in relation to the PRFI's Overall Net Risk.

Earnings are rated as **strong, acceptable, needs improvement, or weak**, and their direction is assessed as **improving, stable, or deteriorating**.



The importance of the net risk of the significant activity is a judgment of its contribution to the overall risk profile of the PRFI.

7. Capital

Adequate capital is critical for the overall safety and soundness of PRFIs. Capital is assessed based on the appropriateness of its level and quality, both at present and prospectively, and under both normal and stressed conditions, given the PRFI's overall net risk. The effectiveness of the PRFI's capital management processes for maintaining adequate capital relative to the risks across all of its significant activities is also considered in the assessment. PRFIs with higher overall net risk are expected to maintain a higher level and quality of capital and stronger capital management processes.

Capital is rated as **strong, acceptable, needs improvement, or weak**, and its direction is assessed as **improving, stable, or deteriorating**.

8. Liquidity

Adequate balance sheet liquidity is critical for the overall safety and soundness of PRFIs. FICOM assesses liquidity at a PRFI by considering the level of its liquidity risk and the quality of its liquidity management. Liquidity risk arises from a PRFI's potential inability to purchase or otherwise obtain the necessary funds to meet its on- and off-balance sheet obligations as they come due. The level of liquidity risk depends on the PRFI's balance sheet composition, its funding sources, its liquidity strategy, and market conditions and events. PRFIs are required to maintain, both at present and prospectively, a level of liquidity risk and liquidity management processes that are prudent, under both normal and stressed conditions.

Liquidity is rated as **strong, acceptable, needs improvement, or weak**, and the direction is assessed as **improving, stable, or deteriorating**.

9. The Risk Matrix and Composite Risk Rating

A risk matrix (see *Appendix E*) is used to record all of the assessments described above. The purpose of the risk matrix is to facilitate a holistic risk assessment of a PRFI. This assessment culminates in a composite risk rating (CRR).

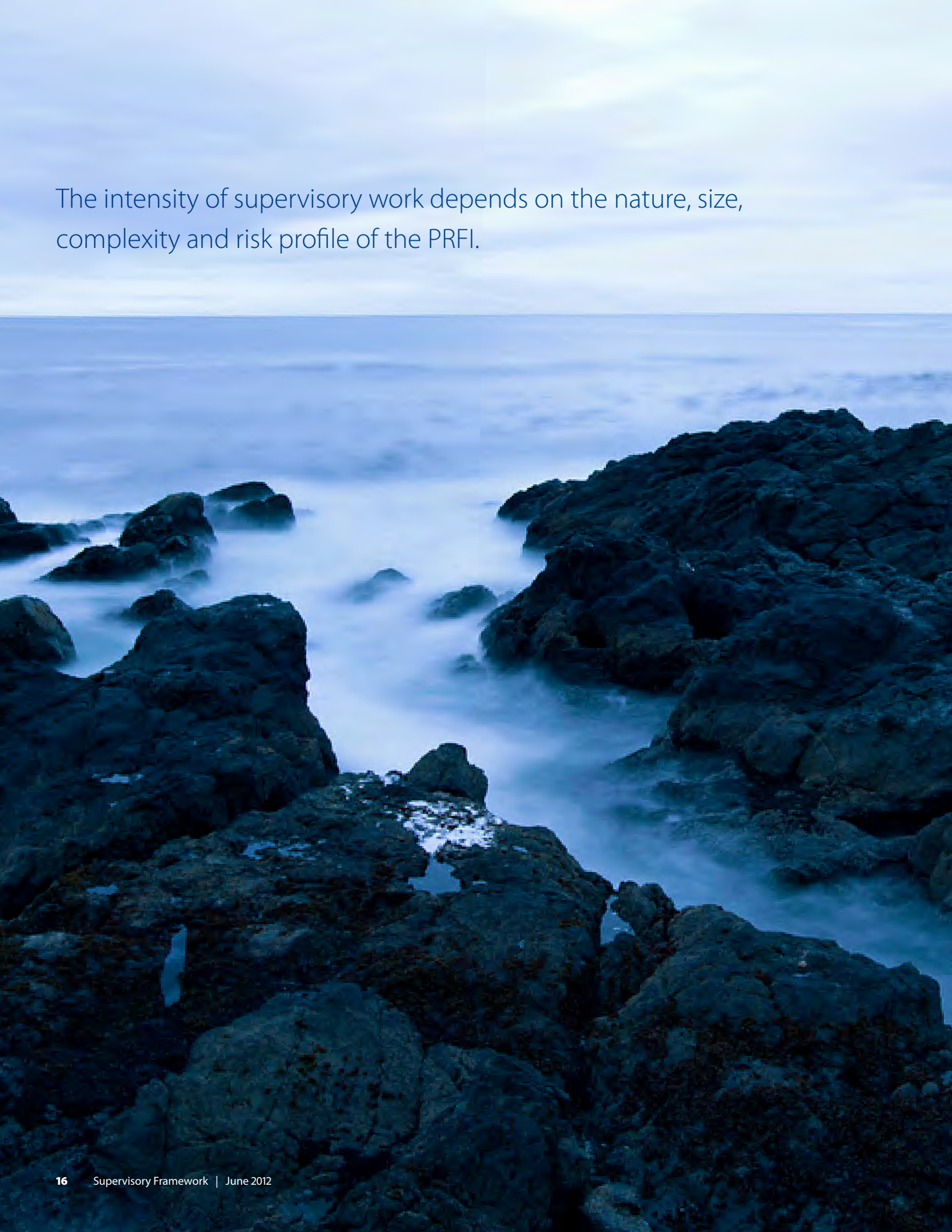
The CRR is an assessment of the PRFI's risk profile, after considering the assessments of its earnings and capital in relation to the overall net risk from its significant activities, and the assessment of its liquidity. The CRR is FICOM's assessment of the safety and soundness of the PRFI with respect to its depositors, policyholders or beneficiaries. The assessment is over a time horizon that is appropriate for the PRFI, given changes occurring internally and in its external environment.

Composite risk is rated **low, moderate, above average or high**. The assessment is supplemented by the direction of composite risk, which is FICOM's assessment of the most likely direction in which the CRR may move. The direction of composite risk is rated as **decreasing, stable, or increasing**.

The CRR of a PRFI is used in determining its stage of intervention, which is described in FICOM's intervention process for credit unions, trust companies and insurance companies. *Appendix D* shows the combinations of composite risk ratings and intervention ratings usually assigned.

While the risk matrix is a convenient way to summarize FICOM's conclusions of risk assessment, it is supported by detailed documentation of the analysis and rationale for the conclusions.





The intensity of supervisory work depends on the nature, size, complexity and risk profile of the PRFI.

The Core Supervisory Process

Performing supervisory work in this fashion helps keep FICOM's risk assessments current and future oriented, which is vital to its ongoing effectiveness.

1. Planning Supervisory Work

A supervisory strategy for each PRFI is prepared annually. The supervisory strategy identifies the supervisory work necessary to keep the PRFI's risk profile current. The intensity of supervisory work depends on the nature, size, complexity and risk profile of the PRFI.

The supervisory strategy outlines the supervisory work planned for the next three years, with a more defined description of work for the upcoming year. The supervisory strategy is the basis for a more detailed annual plan, which indicates the expected work and resource allocations for the upcoming year.

Supervisory work for each significant activity is planned and prioritized after considering the net risk assessment of the activity (including the types and levels of inherent risk, the quality of risk management, and any potential significant changes), the need to update FICOM's information on the activity (due to information decay), and the importance of the activity. Similarly, supervisory work for each relevant oversight function is planned and prioritized after considering the assessment of the quality of its oversight, and the need to update FICOM's information on the function.

In addition to PRFI-specific planning, FICOM's planning also includes a process to compare the work effort across PRFIs. This is done to ensure that assessments of risk for individual PRFIs are subject to a broader standard, and that supervisory resources are allocated effectively to higher-risk PRFIs and significant activities.

2. Executing Supervisory Work and Updating the Risk Profile

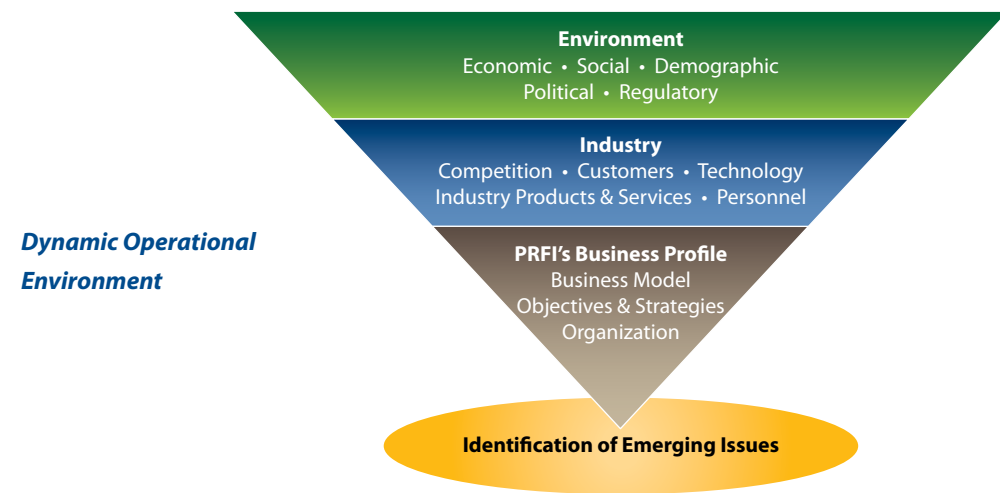
There is a continuum of supervisory work that ranges from monitoring (PRFI-specific and external), to limited off-site reviews, to extensive on-site reviews, including testing or sampling where necessary.

Monitoring refers to the regular review of information on the PRFI and its industry and environment, to keep abreast of changes that are occurring or planned in the PRFI and externally, and to identify emerging issues.

PRFI-specific monitoring includes the analysis of the PRFI's financial results, typically considering its performance by business line and vis-à-vis its peers, and any significant internal developments. It may also extend to gathering information on non-regulated entities which have a significant influence on the PRFI. PRFI-specific monitoring generally also includes discussions with the PRFI's management, including oversight functions.

Continuous Supervisory Process





Given the dynamic environment in which PRFIs operate, FICOM also continuously scans the external environment and industry, gathering information as broadly as possible, to identify emerging issues. Issues include both PRFI-specific and system-wide concerns. FICOM may periodically require PRFIs to perform specific stress tests which FICOM uses to assess the potential impact of changes in the operating environment on individual PRFIs, industries and sectors. Environmental scanning and stress testing have increased in importance since the supervisory framework was first introduced in 2003; changes in the external environment are a main driver of rapid changes in PRFI risk profiles.

Reviews refer to more extensive supervisory work than monitoring. The nature and scope of information reviewed, and the location of the review (“off-site” at FICOM premises when the scope of the review is limited or “on-site” at the PRFI’s premises when the scope is more extensive), are based on the specific requirements identified in the planning process. When an on-site review is conducted, FICOM may request information from the PRFI in advance. Reviews include discussions with the PRFI’s board of directors and oversight functions.

In addition to the core supervisory work of monitoring and reviews, FICOM frequently undertakes comparative or benchmarking reviews to identify standard and best industry practices.

As supervisory work is conducted, the RM updates the overall risk profile of the PRFI. The risk matrix and supporting documentation detail FICOM’s formal assessment of the PRFI’s business model and associated safety and soundness, both current and prospective. Key documents are subject to sign-off protocols within FICOM.

When there are shifts in the risk assessment of the PRFI, FICOM responds by adjusting work priorities set out in the supervisory strategy and annual plan, as necessary, to ensure that important matters emerging take precedence over items of lesser risk. Such flexibility is vital to FICOM’s ability to meet its legislated mandate.

3. Reporting and Intervention to PRFIs

In addition to ongoing discussions with the PRFI’s management and/or board, FICOM communicates to PRFIs through various formal, written reports.

Annually, or as appropriate, FICOM prepares a supervisory letter to the PRFI. The supervisory letter is the primary written communication to the PRFI. It summarizes FICOM’s key findings and recommendations (and requirements, as necessary) based on the supervisory work that was conducted since the last supervisory letter was issued, and discloses or affirms the PRFI’s composite risk rating.

Supervisory letters are addressed to the board of directors and to senior management. In all cases, FICOM requests that a copy of the supervisory letter be provided to the external auditor and to the appointed actuary where applicable.

Given the dynamic environment in which PRFIs operate, FICOM also continuously scans the external environment and industry, gathering information as broadly as possible, to identify emerging issues.

Before issuance of the supervisory letter, findings and recommendations are discussed with the PRFI. A letter is generally issued within 45 calendar days of the completion of a review. The PRFI is typically asked to provide a response within 60 calendar days of the date the letter is issued. FICOM analyzes the PRFI’s response for appropriateness, and follows up on the PRFI’s actions on a timely basis.

In the letter, PRFIs are reminded that supervisory information is confidential. FICOM requests PRFI not disclose, directly or indirectly, prescribed supervisory information (including Supervisory Letters) to anyone other than directors, officers, actuaries, employees, auditors, securities underwriters or legal advisors, or those of its affiliates, and ensure that the information remains confidential.

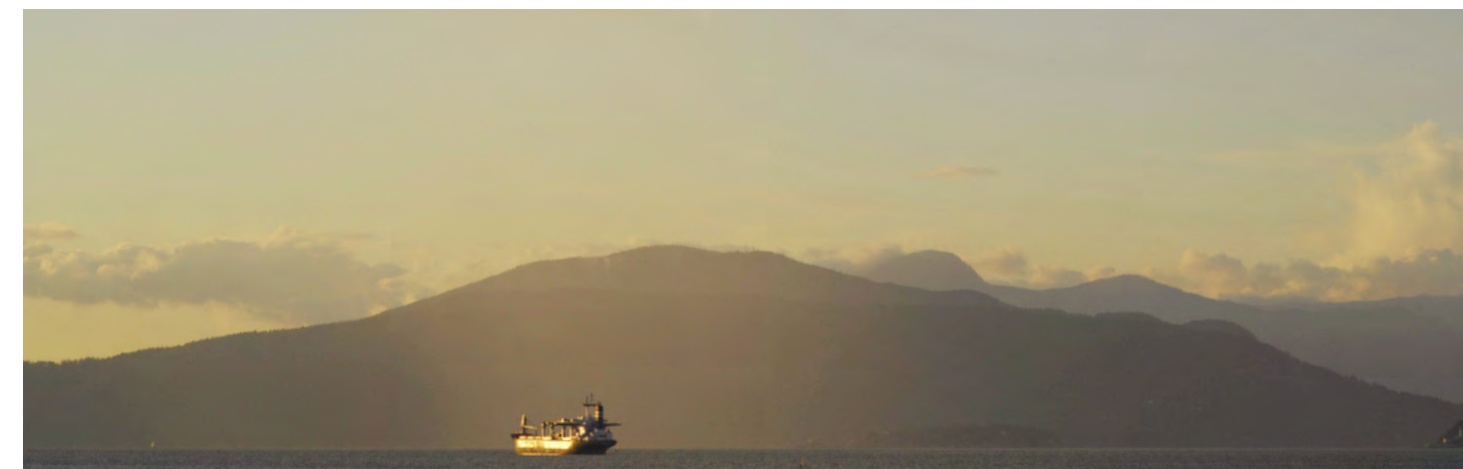
Other Canadian Regulators

FICOM shares its supervisory letters with the Credit Union Deposit Insurance Corporation (CUDIC) and, where necessary, other provincial and federal regulators. Reporting to these parties is in accordance with respective information sharing agreements.

In accordance with the FIA, FICOM is also permitted to share information pertaining to compliance with the Proceeds of Crime (Money Laundering) and Terrorist Financing Act with the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC).

The Financial Institutions Commission

FICOM staff regularly reports to the Commission on the safety and soundness of PRFIs and their compliance with the governing legislation.



Appendix A:

Inherent Risk Categories and Ratings

Risk Categories

Credit Risk

Credit risk arises from a counterparty's potential inability or unwillingness to fully meet its on- and/or off-balance sheet contractual obligations. Exposure to this risk occurs any time funds are extended, committed, or invested through actual or implied contractual agreements.

Components of credit risk include: loan loss/principal risk, pre-settlement/replacement risk and settlement risk.

Counterparties include: issuers, debtors, borrowers, brokers, policyholders, reinsurers and guarantors.

Market Risk

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

Positions include: traded instruments, investments, net open (on- and off-) balance sheet positions, assets and liabilities, and can be either cash or derivative (linear or options-related).

Insurance Risk

Insurance risk arises from the potential for claims or payouts to be made to policyholders or beneficiaries. Exposure to this risk results from adverse events occurring under specified perils and conditions covered by the terms of an insurance policy. Typical insured perils include: accident, injury, liability, catastrophe, mortality, longevity, and morbidity.

Insurance risk includes uncertainties around:

- a) the ultimate amount of net cash flows from premiums, commissions, claims, payouts, and related settlement expenses;
- b) the timing of the receipt and payment of these cash flows; and
- c) policyholder behavior (e.g., lapses).

Although the business of insurance contributes to the investment portfolio of an insurer, actual or imputed investment returns are not elements of insurance risk.

Operational Risk

Operational risk arises from potential problems due to inadequate or failed internal processes, people and systems, or from external events. Operational risk includes legal risk (i.e., potential unfavourable legal proceedings). Exposure to operational risk results from either normal day-to-day operations (such as deficiencies or breakdowns in respect of transaction processing, fraud, physical security, money laundering and terrorist financing, data/information security, information technology systems, modeling, outsourcing, etc.) or a specific, unanticipated event (such as litigation, court interpretations of a contract liability, natural disasters, loss of a key person, etc.).

Regulatory Compliance Risk

Regulatory compliance risk arises from a PRFI's potential non-conformance with laws, rules, regulations, prescribed practices, or ethical standards in any jurisdiction in which it operates.

Strategic Risk

Strategic risk arises from a PRFI's potential inability to implement appropriate business plans and strategies, make decisions, allocate resources, or adapt to changes in its business environment.

Ratings

A material loss is a loss or combination of losses that could impair the adequacy of the capital of a PRFI such that there is the potential for loss to depositors, policyholders, or beneficiaries.

Low

Low inherent risk exists when there is a lower than average probability of a material loss due to exposure to, and uncertainty arising from, current and potential future events.

Moderate

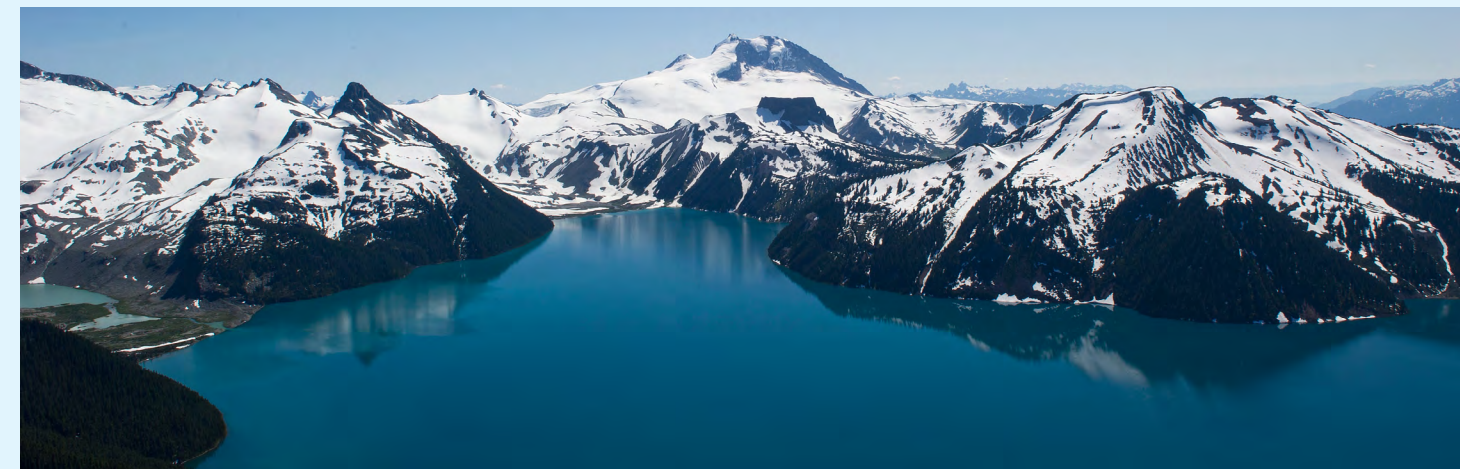
Moderate inherent risk exists when there is an average probability of a material loss due to exposure to, and uncertainty arising from, current and potential future events.

Above Average

Above average inherent risk exists when there is an above average probability of a material loss due to exposure to, and uncertainty arising from, current and potential future events.

High

High inherent risk exists when there is a higher than above average probability of a material loss due to exposure to, and uncertainty arising from, current and potential future events.



Appendix B:

Quality of Risk Management Categories and Overall Ratings

Categories

Operational Management

Operational management is responsible for planning, directing and controlling the day-to-day operations of a significant activity of a PRFI.

Oversight Functions

Financial

Financial is an independent function responsible for ensuring the timely and accurate reporting and in-depth analysis of the operational results of a PRFI in order to support decision-making by senior management and the board. Its responsibilities include:

- providing financial analysis of the PRFI's and business line/unit performance and the major business cases to senior management and the board, highlighting matters requiring their attention; and
- ensuring that principal risks are identified and appropriately managed.

Compliance

Compliance (including the Chief Anti-Money Laundering Officer) is an independent function with the following responsibilities:

- setting the policies and procedures for adherence to regulatory requirements in all jurisdictions where the PRFI operates;
- monitoring the PRFI's compliance with these policies and procedures; and
- reporting on compliance matters to senior management and the board.

Actuarial

Actuarial is an independent function, applicable only to PRFIs with insurance business, with responsibilities beyond the legal requirements of the appointed actuary that could include the following:

- evaluating the design, pricing and valuation of the insurance products offered by the PRFI;

- assessing the reasonableness of provisions set for policy liabilities, and the appropriateness of the process followed;
- reviewing models used to determine exposures, and the adequacy of reinsurance programs to mitigate these exposures;
- analyzing stress testing results, and the process used, to establish the adequacy of capital and capital planning for the PRFI under adverse conditions; and
- reporting on the results of its work to senior management and the board.

Risk Management

Risk management is an independent function responsible for the identification, assessment, monitoring, and reporting of risks arising from the PRFI's operations. Its responsibilities typically include:

- identifying enterprise-wide risks;
- developing systems or models for measuring risk;
- establishing policies and procedures to manage risks;
- developing risk metrics (e.g., stress tests) and associated tolerance limits;
- monitoring positions against approved risk tolerance limits and capital levels; and
- reporting results of risk monitoring to senior management and the board.

Internal Audit

Internal audit is an independent function with responsibilities that include:

- assessing adherence to, and the effectiveness of, operational controls and oversight, including corporate governance processes; and
- reporting on the results of its work on a regular basis to senior management and directly to the board or audit committee.

Senior Management

Senior management is responsible for directing and overseeing the effective management of the general operations of the PRFI. Its key responsibilities include:

- developing, for board approval, the business model and associated objectives, strategies, plans, organizational structure and controls, and policies;
- developing and promoting (in conjunction with the board) sound corporate governance practices, culture and ethics, which includes aligning employee compensation with the longer-term interests of the PRFI;
- executing and monitoring the achievement of board-approved business objectives, strategies, and plans and the effectiveness of organizational structure and controls; and
- ensuring that the board is kept well informed.

Board

The board is responsible for providing stewardship and oversight of management and operations of the entire PRFI. Its key responsibilities include:

- guiding, reviewing and approving the business model and associated objectives, strategies and plans;
- reviewing and approving corporate risk policy including overall risk appetite and tolerance;
- ensuring that senior management is qualified and competent;
- reviewing and approving organizational and procedural controls;
- ensuring that principal risks are identified and appropriately managed;
- ensuring that compensation for employees, senior management and the board is aligned with the longer term interests of the PRFI;
- reviewing and approving policies for major activities; and
- providing for an independent assessment of management controls.

Overall ratings

Strong

The characteristics (e.g., mandate, organization structure, resources, methodologies, practices) of the function exceed what is considered necessary, given the nature, scope, complexity, and risk profile of the PRFI. The function has consistently demonstrated highly effective performance. The function's characteristics and performance are superior to sound industry practices.

Acceptable

The characteristics (e.g., mandate, organization structure, resources, methodologies, practices) of the function meet what is considered necessary, given the nature, scope, complexity, and risk profile of the PRFI. The function's performance has been effective. The function's characteristics and performance meet sound industry practices.

Needs Improvement

The characteristics (e.g., mandate, organization structure, resources, methodologies, practices) of the function generally meet what is considered necessary, given the nature, scope, complexity, and risk profile of the PRFI, but there are some significant areas that require improvement. The function's performance has generally been effective, but there are some significant areas where effectiveness needs to be improved. The areas needing improvement are not serious enough to cause prudential concerns if addressed in a timely manner. The function's characteristics and/or performance do not consistently meet sound industry practices.

Weak

The characteristics (e.g., mandate, organization structure, resources, methodologies, practices) of the function are not, in a material way, what is considered necessary, given the nature, scope, complexity, and risk profile of the PRFI. The function's performance has demonstrated serious instances where effectiveness needs to be improved through immediate action. The function's characteristics and/or performance often do not meet sound industry practices.

Appendix C: Typical Net Risk Ratings

The chart below shows typical net risk ratings for combinations of inherent risk and QRM ratings.

Aggregate Quality of Risk Management for a Significant Activity	Level of Inherent Risk for a Significant Activity			
	Low	Moderate	Above Average	High
Net Risk Assessment				
Strong	Low	Low	Moderate	Above Average
Acceptable	Low	Moderate	Above Average	High
Needs Improvement	Moderate	Above Average	High	High
Weak	Above Average	High	High	High

Appendix D: Alignment Between Composite Risk Ratings and Intervention Ratings

Composite Risk Rating	Intervention Rating
Low	0 Normal
Moderate	0 Normal
	1 Early Warning
Above Average	1 Early Warning
	2 Risk to financial viability or solvency
High	2 Risk to financial viability or solvency
	3 Future financial viability in serious doubt
	4 Non-viability/insolvency imminent

Appendix E: Risk Matrix

Significant Activities	Inherent Risks						Quality of Risk Management						Net Risk	Direction of Risk	Importance	
	Credit	Market	Insurance	Operational	Regulatory Compliance	Strategic	Operational Management	Financial	Compliance	Actuarial	Risk Management	Internal Audit				Senior Management
Activity 1																
Activity 2																
Activity 3																
Etc.																
Overall Rating																

	Rating	Direction	Time Frame
Earnings			
Capital			
Liquidity			
Composite Risk			

Intervention Stage	
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