SUBMISSION

ON THE

REVIEW OF THE FEDERAL FINANCIAL SECTOR FRAMEWORK

TO THE

DEPARTMENT OF FINANCE CANADA

BY THE

CANADIAN LIFE AND HEALTH INSURANCE ASSOCIATION

Canadian Life and Health Insurance Association
79 Wellington St. West, Suite 2300
P.O. Box 99, TD South Tower
Toronto, Ontario M5K 1G8
416-777-2221 www.clhia.ca

Association canadienne des compagnies d'assurances de personnes
79, rue Wellington Ouest, bureau 2300
CP 99, TD South Tower
Toronto (Ontario) M5K 1G8
416-777-2221 www.accap.ca

Table of Contents

REVIEW OF THE FEDERAL FINANCIAL SECTOR FRAMEWORK

About CLHIA

The Canadian Life and Health Insurance Association (CLHIA) is a voluntary association with member companies which account for 99 per cent of Canada's life and health insurance business. The life and health insurance industry is a significant economic and social contributor in Canada. It protects over 28 million Canadians and makes more than $84 billion a year in benefit payments to residents in Canada (of which 90 per cent goes to living policyholders as annuity, disability, supplementary health or other benefits and the remaining 10 per cent goes to beneficiaries as death claims). In addition, the industry has $760 billion invested in Canada's economy. In total, 104 life and health insurance providers are licensed to operate in Canada. Canadian life insurers operate in more than 20 countries with invested assets of over $800 billion supporting their foreign operations. Three Canadian life companies rank among the 15 largest life insurers in the world.

General Comments

The industry views the periodic review of the financial sector legislative and regulatory framework as important to ensure the framework continues to support the financial sector, economy and Canadians over time. We are also pleased with the process set out in the Consultation Document for the 2019 review that will provide the opportunity to provide input and comments on multiple occasions as the Department considers the appropriate changes to the framework.

Overall, the industry believes the financial sector framework is generally working well. As such, many of our industry's proposed areas for consideration are largely technical in nature. These are outlined in some detail in the Annex.

There are, however, three areas that we believe deserve more substantive consideration. These are issues related to the private sector's involvement in infrastructure finance, issues related to fintech and cyber security. We elaborate on each below.

Areas of Substantive Reform

<u>Infrastructure</u>

Canada's life and health insurers are one of the largest institutional investors in longer-term assets in Canada. The industry has over $720 billion in assets in Canada about 90 per cent of which are held for the long-term. Our strong appetite for long-term assets is driven by the underlying nature of the life and health insurance business.

Canada's life and health insurers need long-term investments to match against long-term obligations to policyholders - many of which can extend for up to 50 years or more. In exchange for premiums, the industry promises to compensate policyholders through a range of products and pays benefits to policyholders. Insurers must invest the premiums they collect from policyholders to pay claims and benefits on their policies and to cover their operating and capital costs. An insurer's investment strategy is heavily influenced by the profile of its liabilities. As a result, the industry has a large demand for very long-term investments, such as infrastructure, and the industry has a strong appetite to do more in this area.

To this end, the industry has a keen interest in playing a strong role in assisting the government in meeting its infrastructure objectives to improve the long-term productivity of the economy and to improve the lives of Canadians. It is estimated that the Canadian infrastructure deficit is up to $400 billion. There is a clear role to play for private sector institutional investors, such as insurers, to support closing the gap.

Insurers have traditionally participated in infrastructure through public-private-partnership (P3) projects across Canada through debt financing, and will continue seeking opportunities to do so (including on federal projects). On the equity side, there are legislative and regulatory barriers in place, however, that limit the industry's ability to make equity investments in infrastructure that will hold us back. In particular, subsection 493(1) of the *Insurance Companies Act* precludes insurers from holding more than 25% total equity in a corporation or limited partnership. As well, under that subsection, insurers cannot own more than 10% voting interest in a corporation. Similar or analogous provisions apply in other parts of the *Insurance Companies Act*. The industry is supportive of the general goal of separating the financial and "real' economies through this provision. However, we feel there is a strong public policy rationale for providing relief from these provisions for carefully pre-qualified investments such as infrastructure that help support a broader public policy goal.

When investors take equity positions in a corporation, they generally want to have a degree of control over the management of the firm in order to have prudent oversight and risk management over their investments. This is generally seen as a best practice for equity investments in private companies. These two restrictions effectively preclude this, and therefore limit the industry's ability to pursue an equity investment strategy. In order to provide some additional flexibility to insurers in support of the government's broad agenda and our own asset-liability matching needs, we recommend that consideration be given to providing relief from these restrictions for carefully prescribed infrastructure investments. This would allow for the important broader restrictions on commercial ownership to remain in place while allowing a carve-out where it is appropriate and prudent to do so. We would note that such flexibility has been provided to life insurers in Europe and so a model for how this could be done is available for study.

There is currently some regulatory flexibility provided to insurers to hold infrastructure assets. However, we do not feel it adequately addresses our concerns. The Specialized Financing (Life Companies) Regulations limit the length of time an insurer can hold certain assets to 13 years.

As noted above, in order to provide flexibility to allow insurers to fully support the government's infrastructure priority, through debt as well as through equity financing, we believe the best approach would be to provide a carve-out to the restrictions on substantial investment for pre-qualified infrastructure investments as we have recommended. If that is not possible, we would recommend changes to the 13-year restriction, which limits the ability of insurers to make equity investments in infrastructure. We do not believe there is a strong public policy rationale for requiring insurers to sell high quality infrastructure assets after 13 years. Therefore, we would recommend that insurers be permitted to hold pre-qualified infrastructure assets held in Specialized Financial Entities for their full natural life.

Fintech

Fintech has been driving innovative change across the economy. The industry believes that collaboration in the area of fintech is of mutual benefit to both traditional market participants and new fintech companies. Established players offer new entrants a strong understanding of the consumer, the market, and how to deliver products in accordance with regulatory objectives. Fintech companies bring new perspectives to the table and the ability to apply technologies, processes and concepts that can enhance current services and create new market opportunities. It is for these reasons that there are a number of financial institutions that are interested in partnering with fintech companies to explore opportunities.

However, we note that compliance with Canada's legislative and regulatory framework for financial institutions can constitute a hurdle for smaller, emerging companies, as the process can be confusing, expensive and time consuming. In our view, a properly structured framework for fintech will facilitate innovation, while also achieving consumer protection and a level playing field between incumbents and new entrants.

Globally, all jurisdictions are struggling with achieving this balance. There are some international jurisdictions that may provide some interesting approaches for consideration. For example, jurisdictions such as Singapore, the U.K. and Australia have adopted a "regulatory sandbox" framework whereby qualified fintech startups are allowed to test their products and services with a limited number of users without having to comply with existing rules for a restricted period of time. Following this testing period, the fintech startups exit the regulatory sandbox and must start complying with existing regulations in the interest of consumer protection and so as to avoid the potential for regulatory arbitrage.

Another approach to compliance is to create fintech hubs where active members of the fintech ecosystem, such as financial institutions and venture capitalists, dedicate resources to supporting fintech companies as they navigate the compliance process. These new approaches could serve as best practices for stakeholders in the Canadian financial services industry and we would encourage the government to consider how such approaches could be adopted in Canada and what the implications would be.

As noted above, financial institutions are seeking to collaborate or partner with fintech companies to innovate and bring benefits to consumers. There are, however, legislative barriers that stand in the way of such partnerships. Notably, as referenced in the infrastructure section above, insurers cannot hold more than 25% total equity in a corporation or limited partnership, nor can insurers own more than 10% voting interest in a corporation. Consistent with the views we expressed in the section on infrastructure, we would recommend that flexibility be provided for prescribed investments in fintech, while allowing the commercial links restrictions to remain in place more generally. Addressing these barriers would allow the industry to make greater investments in fintech thereby helping to drive benefits to consumers in Canada.

Cyber Security

Cyber security has become a priority for governments and businesses regardless of what industry they are in. Ultimately, the prevention and management of cyber incidents is a shared responsibility among the government, private sector, and individuals.

The Government of Canada, through Public Safety, recently conducted a consultation on cyber security that will help determine how cyber security could be approached to best position the country in this area. As the government furthers its work on cyber security, we believe the Government of Canada has an important leadership and coordination role across the public and private sectors, as well as internationally.

The G7 recently issued guidelines for protecting the global financial sector from cyber-attacks, which we believe is a positive sign of international collaboration on this issue. On October 14, 2016, the Minister of Finance endorsed the G7 Fundamental Elements of Cyber Security in the Financial Sector. In the news release that accompanied this endorsement it was noted that officials from the Department of Finance, the Office of the Superintendent of Financial Institutions (OSFI) and the Bank of Canada have been working with their G7 counterparts since last year on identifying measures to defend against cyber threats to the financial sector and best practices that could be applied across the G7. The industry commends the government for its collaboration in this area.

The private sector also has an important role to play in putting in place practices and procedures to ensure it protects the information it holds, both from a corporate and consumer perspective. Cyber security is a priority for the Canadian life and health insurance industry and it is well regulated in this area through private sector privacy legislation and through the emphasis that OSFI has placed on this issue for a number of years. In the industry's view, this has been an appropriate and positive approach to regulation that helps ensure that insurers are acting prudently to protect the information and data they hold.

We understand that there may be consideration of developing legislation for identified industries that provide critical infrastructure to Canada with respect to cyber security. We would recommend that such legislation be narrowly targeted to industries that can clearly be shown to provide such critical infrastructure rather than having it apply broadly to all sectors of the economy.

Critical infrastructure refers to processes, systems, facilities, technologies, networks, assets and services essential to the health, safety, security or economic well-being of Canadians and the effective functioning of government (e.g., health, energy and utilities, telecommunications, finance/payments). Disruptions of critical infrastructure could result in catastrophic loss of life, adverse economic effects and significant harm to public confidence. While insurers play an important role in supporting Canadians and the economy, insurance payments are not on demand payments and are not generally time sensitive. A short-term disruption would not have significant adverse implications in the economy or on Canadians' immediate well-being. Therefore, insurance does not, generally, fall within the definition of critical infrastructure.

Conclusion

The industry appreciates the opportunity to provide input on the review of the financial sector framework and would be pleased to assist in any way we can, including providing further detail on our comments, if it would be helpful.

ANNEX: OTHER/TECHNICAL AMENDMENTS

<u>Subsidiaries in Annual Report – sections 331 and 334 of the ICA</u>

Subsections 331(3)(b) and 334(3) of the *Insurance Companies Act* ("ICA") provide that if an insurance company is found not to have included a list of its subsidiaries, "other than subsidiaries that are not required to be listed by the regulations …" in its annual report, then the company's annual meeting shall be adjourned until it is in compliance. For insurers that may deem some of their subsidiaries to be immaterial, these provisions do create some risk in that an argument could be made that the company is not in compliance.

We strongly recommend that the ICA be amended to remove the need to disclose immaterial subsidiaries in insurers' annual reports. Alternatively, we recommend that the regulation-making power set out in the Act be utilized to achieve the same objective. The use of a regulation could address this matter more quickly.

<u>Equal Treatment for Registered and Unregistered Shareholders – section 334 of the ICA</u>

Consistent with the provisions of business corporation statutes, such as the *Canada Business Corporations Act* (“CBCA”), section 334 of the ICA provides that the annual financial statements of an insurance company must be delivered to shareholders before the annual meeting. The requirement can be waived by the shareholders in writing.

The term "shareholder" in the context of the ICA means a registered shareholder. For most public companies, the number of registered shareholders is very small as The Canadian Depository for Securities ("CDS"), under the book entry system, is the registered shareholder. Most traded shares are beneficially owned by institutions or individuals in brokerage accounts with CDS as the registered shareholder. This means that a company would be entitled to treat CDS as the shareholder entitled to annual statements under section 334 (or its equivalent in the CBCA).

Under securities regulations, a public company must annually send a request card to its securities holders that the security holders can use to request a hard copy of annual and interim statements. The company is only required to send materials to requesting securityholders. This process applies to beneficial shareholders in addition to registered holders.

In effect, corporate law and the securities law creates different rights for shareholders depending on whether their holdings are registered or not. Under the ICA, registered holders must receive an annual mailing while beneficial holders must positively request materials in order to receive them. For most companies, the difference probably matters little, as the vast majority of shareholders are non-registered (through CDS). However, for the demutualized companies, the difference is material because hundreds of thousands of policyholders became registered shareholders on demutualization. While those companies are happy to send materials to shareholders who desire it, they are concerned that many of the packages to registered shareholders are thrown away unread.

There does not appear to be any policy rationale for treating the registered shareholders differently than beneficial shareholders. Consequently, we recommend that the ICA be amended to defer to the requirements of securities legislation in these matters for publicly traded insurers.

Providing Online Access to Materials - Part VI and other ICA sections

With a view to further modernizing communications between companies and their shareholders, we recommend that the ICA be amended to allow insurers to deliver proxy related material to shareholders and participating policyholders by posting the documents online, rather than having to send the material by mail. The proposed system is commonly referred to as the "notice and access" system, and the change would be consistent with Bill C-25, which proposes similar flexibility for companies incorporated under the CBCA.

Fraternal Benefit Societies – Part XII of the ICA

Part XII of the ICA, relating to fraternal benefit societies, is long overdue for modernization and update. Since this Part was put in place in 1992, there have been various adjustments to parallel changes made to other parts of the Act and to place greater responsibilities on societies. One of the results, for example, is that societies in Canada are subject to much the same regulatory and governance regimes as commercial insurers, yet their powers are significantly restricted to generally the "insuring of risk" (section 542). There should be more balance in this regard and we recommend an in-depth review of Part XII.

Two examples of specific areas that should be considered as part of that review are as follows:

- Section 542 should be revised and should incorporate the wording in subsections 440(1) and (2) of the ICA by adding the phrases 'business of providing financial services' and 'investment counselling and portfolio management services'. These changes should be accompanied by appropriate approval processes.

- Section 554, which deals with permitted investments, is unnecessarily convoluted and somewhat restrictive. With respect to addressing the investments provisions more generally (i.e., sections 550 to 570 of the ICA), consideration should be given to deleting these provisions and incorporating, by reference, the investment sections that apply to "companies" (i.e., sections 490 to 514 of the ICA) so that they apply to fraternal benefit societies as well. Again, these changes should be accompanied by appropriate approval processes.

In developing these proposals, we have specifically consulted with those CLHIA members that are societies as well as the American Fraternal Alliance, which represents fraternal benefit societies across North America.

Compliance Self-Evaluative Privilege - ICA

The life and health insurance industry recommends that a compliance self-evaluative privilege be enacted into law for effective risk management. Self-evaluative activities are an integral part of OSFI's supervisory framework. Such a privilege would cover documents that are requested by or filed with a regulator and self-evaluative activities related to an insurance company's risk management framework, as expected by its regulator.

Enactment of a compliance self-evaluative privilege would have many benefits:

- Consumers would benefit from greater scrutiny of company compliance with laws and regulations designed to protect consumers – at no additional taxpayer expense.
- Insurers would benefit from protection against unwarranted litigation.
- Regulators would benefit by being able to redirect resources currently consumed in examinations of compliant companies towards areas of greater need.

The industry endorses the Privilege Model set out by the Canadian Council of Insurance Regulators in its *"Final Report on Privilege Model and Whistle Blower Protection"* dated May 2008. The CCIR Model was developed by a working group of provincial, territorial and federal insurance regulators, including OSFI, that *"examined the role of privilege and whistle blower protection within the risk-based system of regulation and consulted at length with various stakeholder groups to best reflect the balance of views in presenting a privilege model."* To date, Alberta, Saskatchewan (to be proclaimed), and Manitoba have added a provision to their Insurance Act which addresses this important issue, based on the CCIR model.

It is important to note that the incorporation of a compliance self-evaluative privilege in the ICA would not inhibit the exercise of the regulatory and supervisory authority of OSFI in protecting insurance consumers. In fact, it would enhance such supervision by promoting full and frank disclosure between insurers and OSFI, make regulatory review more efficient and effective and, as noted above, allow OSFI to focus scarce resources where they are most required.

Solvent Resolution – ICA and WURA

Assuris, the not for profit organization that protects Canadian policyholders if their life insurance company should fail, has provided input to this consultation and recommends that the resolution system for life insurance companies in Canada should be strengthened by being made more efficient and more certain. With a view to minimizing disruption to the system and best serve the evolving needs and interests of consumers, and given the evolving complexity of life insurance companies and their resolution, Assuris proposes that various improvements be made in the context of resolvability.

Assuris recommends that Finance consider expanding the powers of OSFI in the context of resolution, to ensure the resolvability and to facilitate the solvent resolution of life insurance companies. Assuris also recommends that the resolution provisions of the *Winding-up and Restructuring Act* ("WURA") be clarified.

The CLHIA is in agreement with and supports the recommendations made by Assuris.

Set-off under WURA

Section 73(1) of WURA recognizes the right of set-off by a debtor "for the recovery of debts due or accruing due to a company **at the commencement of the winding up of the company** … as if the business of the company was not being wound up." By contrast, the *Bankruptcy and Insolvency Act* and the *Companies' Creditors Arrangement Act* both enshrine the right of set-off, but without the language denoted in bold, above.

In the 2008 case Canada (Attorney General) v. Reliance Insurance Co. ("Reliance"), the Superior Court interpreted the WURA language to mean that only those quantifiable amounts at the date of liquidation may be set off against one another.

Reinsurance treaties, which typically provide for set-off, reflect the expectation of the parties that set-off will be available in respect of all claims arising after the commencement of winding-up proceedings, whether liquidated or not. The Reliance decision requires a reinsurer to pay claims without set-off even if the ceding insurer has not paid all of its premiums under the treaty. The problem is particularly acute where the cedant retains the reinsurers' reserves backing the liabilities (a "funds withheld" transaction), on the understanding that these funds will be set-off against future claims to be paid by the reinsurer. The result of the Reliance decision is to create a windfall for the estate of the insolvent insurer and also to produce a chilling effect on the market for new funds withheld transactions.

Funds withheld transactions achieve important objectives -- allowing investment risk to remain with the party best able to manage it; controlling the counterparty credit risk assumed by a cedant; removing the need for the parties to sell assets to back liabilities, which can be problematic from a tax, liquidity timing, or capital perspective. Other arrangements are far less efficient in achieving these benefits, if they can be realized at all.

CLHIA supports amended WURA language which would mirror the other insolvency statutes, and which would preserve the benefits of funds withheld transactions and also remove the uncertainty around set off for regular reinsurance treaties. While we hope that this amendment can be made prior to 2019, we are including it here for completeness as to outstanding issues.