Supervisory Framework

For Provincially Regulated Financial Institutions

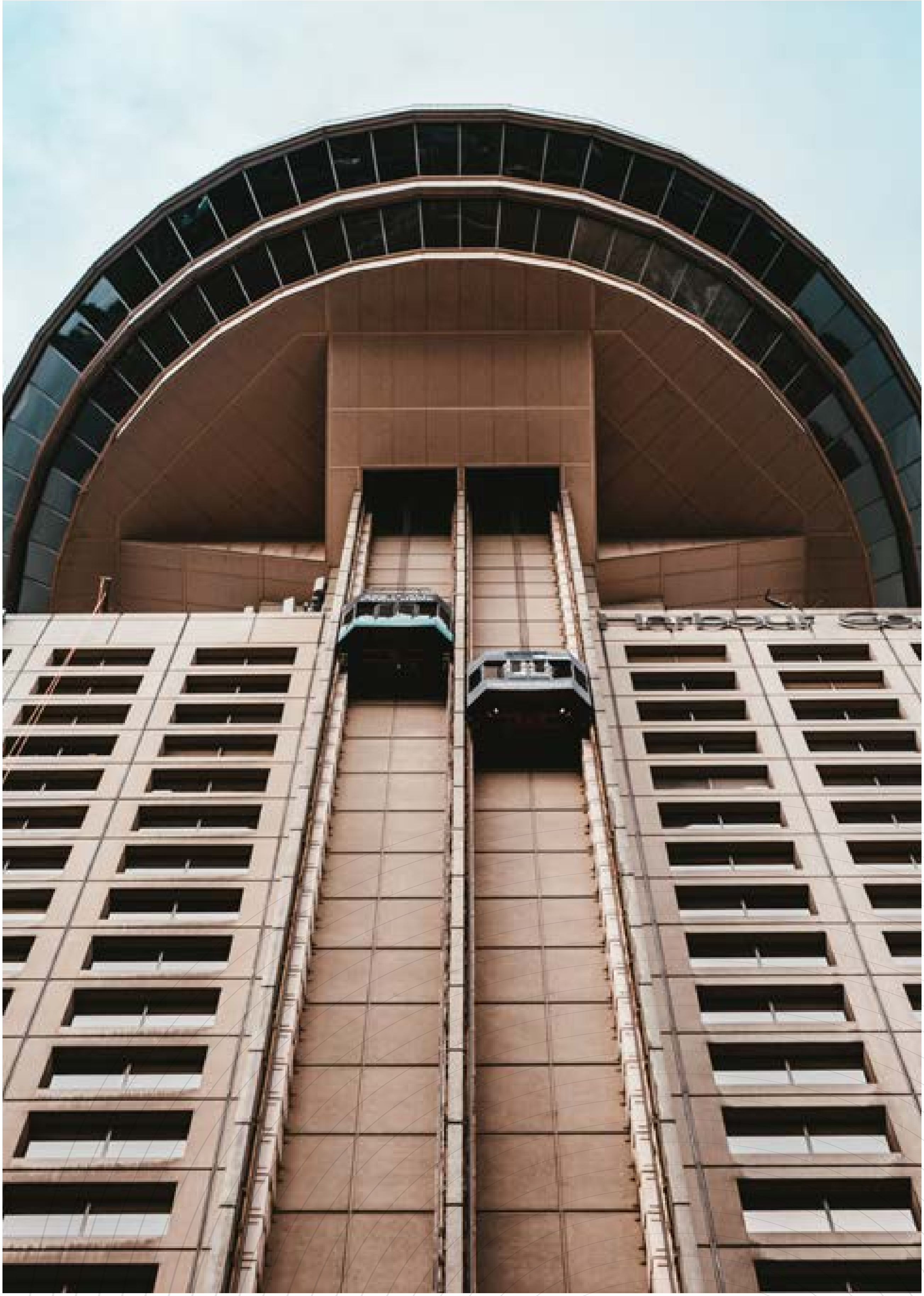
SEPTEMBER 2021

BCFSA

CLASSIFIED: PUBLIC

BC Financial Services Authority ("BCFSA") is a Crown regulatory agency of the British Columbia Government that oversees British Columbia's financial services sector.

Contents



1. Supervisory Framework

BC FINANCIAL SERVICES AUTHORITY

Structure

BC Financial Services Authority ("BCFSA") is a Crown regulatory agency of the British Columbia Government that oversees British Columbia's financial services sector.

BCFSA is governed by a Board of Directors of up to 11 members who are appointed by the Lieutenant Governor in Council.

Day-to-day regulatory and operational decisions are administered by one individual who acts both as lead regulator for the sector and BCFSA's Chief Executive Officer. Under the *Financial Institutions Act* ("FIA"), certain regulatory decisions must be made by BCFSA's Board.

Mandate

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

BCFSA supervises and regulates provincially regulated financial institutions ("PRFI")—credit unions, pension plans, insurers, and trust companies—to determine whether they are in sound financial condition and are complying with their governing laws and supervisory standards. BCFSA uses a risk-based supervisory framework (the "Supervisory Framework") to identify imprudent or unsafe business practices at PRFIs and intervenes on a timely basis, as required. This document sets out BCFSA's Supervisory Framework: its principles, concepts and core processes.

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

2. Introduction

THE SUPERVISORY FRAMEWORK

Statutory Obligations

The Supervisory Framework is designed to assist BCFSA 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. To meet them in practice requires detailed, consistent standards and criteria for supervising PRFIs.

BCFSA was established by the Financial Services Authority Act, 2019.

It administers the following six provincial statutes:

- ***Credit Union Incorporation Act:*** provides a corporate governance framework for credit unions consistent with their co-operative characteristics.
- ***Financial Institutions Act:*** provides a regulatory framework to govern all provincially regulated financial institutions including trust companies, insurance companies and credit unions. It also provides the licensing and regulatory framework for insurance agents, salespersons and adjusters under the supervision of the Insurance Council of British Columbia. The statute further provides for a credit union deposit insurance fund.
- ***Insurance Act:*** provides certain statutory requirements for contracts of insurance.
- ***Insurance (Captive Company) Act:*** establishes British Columbia as a domicile for captive insurance companies and provides a registration and regulatory framework for captive insurance companies.
- ***Mortgage Brokers Act:*** provides a registration and regulatory framework for mortgage brokers who deal with the public.
- ***Pension Benefits Standards Act:*** is designed to protect the interests of British Columbia's pension plan members by setting minimum standards for B.C. pension plans. It is also designed to protect the financial health of pension plans through establishing rules for investing a plan's assets as well as through setting funding and solvency standards.

National and International Expectations

BCFSA 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. BCFSA also considers international standards set by the Basel Committee on Banking Supervision and International Association of Insurance Supervisors for guidance on setting supervisory standards and criteria.

3. 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 material subsidiaries, and joint ventures). BCFSA uses information available from other regulators, as appropriate.

Relationship Manager

BCFSA 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 Team Members within BCFSA help support this work. The RM is the main point of contact for the PRFI.

Risk-Based Supervision ("RBS")

The supervision of PRFIs is principles-based.

Focus in RBS is on the most important risks. If they were to arise, those risks would have the greatest detrimental impact on BCFSA's mandate. RBS assesses the impact of the risks and the likelihood of their occurrence. Highest impact firms and activities are those considered to be a potential source of systemic risk in that failure would result in extensive losses to consumers, the broader B.C. economy, and members or policyholders.

RBS requires sound judgment in identifying and assessing risks as well as determining, from a wide variety of supervisory and regulatory options available, the most appropriate method to ensure that the risks 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 as well as the potential consequences of the PRFI's failure. Application of the Supervisory Framework, in particular RBS, revolves around the concepts of forward-looking risk assessments and proportionality.

Proportionality is a "tailored" approach to supervision that seeks to reflect how the PRFI responds to their business model, systemic importance, complexity, size, and scope of activities as well as the risks to which they are exposed. The aim of proportionality is therefore not to reduce effective governance and risk management but rather to reflect the relative differences between PRFIs in how they identify, measure, monitor, and mitigate risk. Proportionality impacts BCFSA's regulatory expectations (reporting and filing requirements).

Where there are identified risks or areas of concern, BCFSA will strive to ensure that the degree of intervention will be commensurate with the risk assessment, while taking into account and in accordance with the powers provided by provincial legislation (e.g., FIA) and criteria set out in BCFSA's Guide to Intervention for PRFIs.

Board and Senior Management Accountability

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

BCFSA's Risk Tolerance

The objective of BCFSA's supervision is to reduce the likelihood that a PRFI will fail. BCFSA also recognizes that some degree of risk tolerance will be necessary, which may require PRFIs 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

BCFSA relies on the PRFIs' external auditor for the fairness of the financial statements and on the appointed actuary's opinion for the adequacy of actuarial and other policy liabilities. BCFSA'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

BCFSA uses, where appropriate, the work of others to reduce the scope of its supervisory work and to minimize duplication of effort. This enhances BCFSA's efficiency and its effectiveness. For example, supervisors may use the testing performed by a PRFI's external and internal auditors 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 BCFSA include, but are not limited to, the PRFI's external auditor and appointed actuary as well as the PRFI's oversight functions such as compliance, risk management, internal audit, senior management, and board functions. Other useful external sources include rating agencies, industry groups, other regulators, consultants, and organizations.

4. Key Principles

Principle #1

Focus on Material Risk

BCFSA's risk assessment approach focuses on identifying material risk to a PRFI, including the potential for loss to depositors, policyholders, or beneficiaries.

Principle #2

Forward-Looking, Early Intervention

Risk assessment is forward-looking. This perspective facilitates the early identification of issues or problems and timely intervention where corrective actions need to be taken. This results in a greater likelihood of a satisfactory resolution of issues.

Principle #3

Proportionality

Risk assessment will consider size, scale, complexity, and nature of the PRFI's risk profile when applying the assessment criteria for rating the quality of risk management. This approach recognizes the uniqueness of each institution as well as differences in risk across institutions. Proportionality means emphasizing various components of the assessment criteria and adapting them to the specifics of the institution: its risk profile, its business model, and its size.

Principle #4

Sound Predictive Judgment

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

Principle #5

Understanding the Drivers of Risk

Risk assessment requires an understanding of 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. Use of quantitative analytics informs BCFSA questions of the PFRI by considering external and internal risk drivers and how these may expose vulnerabilities in the PRFI's risk management and mitigation. 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 #6

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 risks and to determining appropriate corrective action when needed. This differentiation is also linked to the concept of proportionality.

Principle #7

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. BCFSA's core supervisory process is flexible whereby identified changes in risk result in updated priorities for supervisory work.

Principle #8

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.

5. Primary Risk Assessment Concepts

1. SIGNIFICANT ACTIVITIES

The fundamental risk assessment concept within the Supervisory Framework focuses on significant activities. 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).

BCFSA 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 BCFSA's assessment of the PRFI and the PRFI's own organization and management. This enables BCFSA 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 and/or qualitative reasons. Quantitative reasons can include the activity's percentage of total PRFI assets, revenue, premiums written, net income, allocated capital, or its potential for material losses. Qualitative reasons can include the activity's strategic importance, planned growth, risk, effect on brand value or reputation, or the criticality of an enterprise- wide process.

Lines of Business Activities

A line of business is a revenue-generating activity through which an institution executes its strategy.

For example, an insurance company's lines of business may include automobile insurance or homeowners' insurance. For a credit union, they can include retail and/or commercial lending.

A line of business may be further segmented if it is organized by subsidiaries, geographical regions, product, and market segment.

For example, an insurance company may organize its insurance lines by region such as Western Region or Eastern Region. A credit union may organize its operations along product, service, or market segment, such as wealth management or insurance services through a subsidiary.

Centralized Activities

A centralized or enterprise-wide process refers to activities that are not a line of business, business unit or risk management control function as defined in the Supervisory Framework. These processes are related to the IT platform, banking book, or investments management whose activities encompass the aggregate positions or support across the whole organization. A process is considered centralized or enterprise-wide when it operates across several significant activities, lines of business, and/or business units.

Examples of centralized processes are treasury, asset and liability management, investment management and anti-money laundering. Processes such as information technology and business continuity may also be considered enterprise-wide if they are managed centrally across several significant activities, lines of business, and/or business units.

Generally, centralized activities are defined as discrete centralized activities that operate and are managed independently from the business activities they support. As discrete activities, they have their own unique inherent risks and controls.

Each PRFIs may have the following centralized/enterprise-wide activities:

- Information technology and business continuity;
- Treasury or investment management; and
- Anti-money laundering (only for credit unions, trust and life insurance companies).

2. INHERENT RISK

In the Supervisory Framework, key inherent risks are assessed for each significant activity of a PRFI. Inherent risk is the probability of an adverse impact on the significant activity due to exposure to and uncertainty arising from potential future events.

Inherent risk is intrinsic to a significant activity. It 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 identifying and assessing inherent risk.

Inherent Risk is exposure to loss from possible future events, or changes in business or economic conditions. It is evaluated by making well-considered assumptions about the probability of such events or changes in conditions happening and an estimate of the potential severity of their effect on an institution's earnings, capital, and liquidity. Because of the difficulty of achieving any degree of exactness in assessing probability and effect, the assessment of Inherent Risk is primarily qualitative.

BCFSA assesses inherent risk across the following six risk categories: **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 either low, moderate, above average, or high. The categories and levels of inherent risk are described in more detail in *Appendix A*.

BCFSA 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 is, the more rigorous the day-to-day controls and oversight should be. Sound controls are expected where appropriate.

Inherent risk is the probability of an adverse impact on the significant activity due to exposure to and uncertainty arising from potential future events.

3. QUALITY OF RISK MANAGEMENT

BCFSA 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 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 that they must manage. It also ensures that policies, processes, and staff are sufficient and effective in managing these risks. When assessing operational management, BCFSA's primary concern is whether operational management can detect the potential for adverse impacts the activity may face and has adequate controls in place.

In general, the extent to which BCFSA 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*). If a PRFI has sufficient and effective oversight functions, it may be possible for BCFSA 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 BCFSA 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 five oversight functions that may exist in a PRFI: **compliance, risk management, internal audit, senior management,** and **the board** (see *Appendix B*).

The presence and design of oversight functions are expected to vary based on the PRFI's nature, size, and complexity as well as its inherent risks. Where a PRFI lacks some of the oversight functions or if these functions are not sufficiently independent or lack enterprise-wide responsibility, BCFSA expects other functions, internal or external to the PRFI, to provide the independent oversight needed.

For each significant activity, BCFSA assesses operational management and each of the relevant oversight functions as either **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 BCFSA's expectations developed when assessing the levels of the key inherent risks.

For each relevant oversight function present in a PRFI, BCFSA 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*). BCFSA has assessment criteria that guide the determination of the overall rating for each oversight function.

4. NET RISK

For each significant activity, the level of net risk is determined based on judgment that considers all 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. BCFSA has assessment criteria that guide the determination of the net risk rating for each significant activity.

BCFSA expects a PRFI to maintain controls and oversight that are commensurate with their key inherent risks so that levels of net risk are considered to be prudent and consistent with widely acknowledged risk management and governance best practices. 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 either **low, medium,** or **high**. 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 the significant activities of the PRFI could collectively have on the earnings performance and adequacy of the capital of an institution. This would in turn affect the PRFI's safety and soundness, impacting depositors or policyholders. Overall net risk is rated as either **low, moderate, above average,** or **high**, and the direction is assessed as either **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 outlook, under normal and stressed conditions. Earnings are assessed in relation to the PRFI's overall net risk.

Earnings are rated as either **strong, acceptable, needs improvement,** or **weak**.

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, as it represents the PRFIs' capacity to absorb losses. Capital is assessed based on the appropriateness of its level (quantity) and quality, at present and prospectively, as well as under normal and stressed conditions given the PRFI's overall net risk. Accessibility to capital is also considered in BCFSA's assessment. The effectiveness of the PRFI's capital management processes for maintaining adequate capital relative to the risks across all 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 either **strong, acceptable, needs improvement,** or **weak**.

8. LIQUIDITY

Adequate balance sheet liquidity is critical for the overall safety and soundness of PRFIs. BCFSA 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, funding sources, and liquidity strategy as well as 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 normal and stressed conditions.

Liquidity is rated as either **strong, acceptable, needs improvement,** or **weak**.

9. THE RISK MATRIX AND COMPOSITE RISK RATING

A risk matrix (see *Appendix D*) is used to record all 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 BCFSA's assessment of the PRFI's safety and soundness with respect to its depositors, policyholders, or beneficiaries. The assessment is over a time horizon that is appropriate for the PRFI, taking into consideration changes that occur internally and in the external environment.

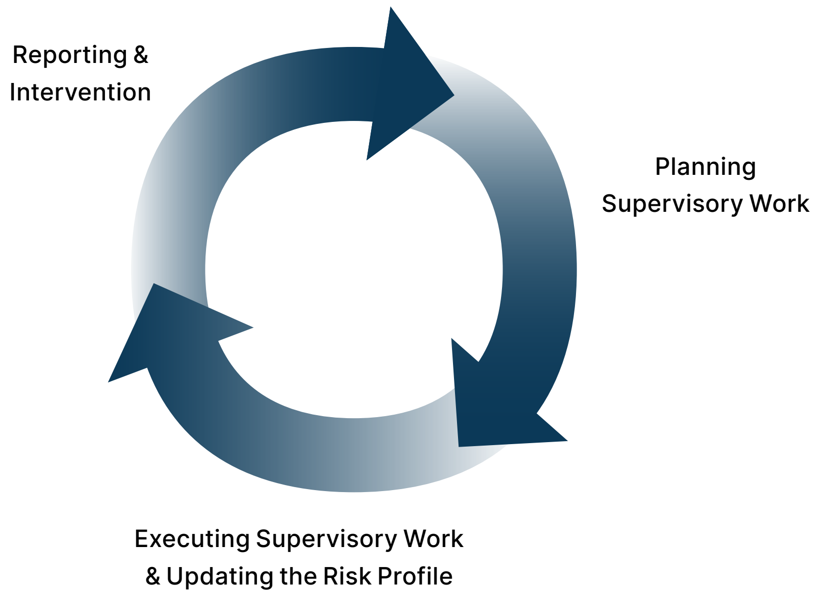
Composite risk is rated either **low, moderate, above average,** or **high**. The assessment is supplemented by the direction of composite risk. This is BCFSA's assessment of the most likely direction in which the CRR may move. The direction of composite risk is rated as either **decreasing, stable,**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

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

While the risk matrix is a convenient way to summarize BCFSA'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.

6. The Core Supervisory Process



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 PRFI's nature, size, complexity, and risk profile. The supervisory strategy informs the depth and focus of the continuous monitoring activities.

Monitoring may identify specific areas which require additional supervisory work to understand and/or assess changes in the institution's operations, risk management, or governance. While other inquiries are simply to update BCFSA's information on the activity (due to information decay).

Some inquiries may involve off-site and/or on-site supervisory work. Where such an inquiry involves additional supervisory work, BCFSA will consider the timing of the work to minimize the disruption or burden on the institution.

In addition to PRFI-specific monitoring activities, BCFSA'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

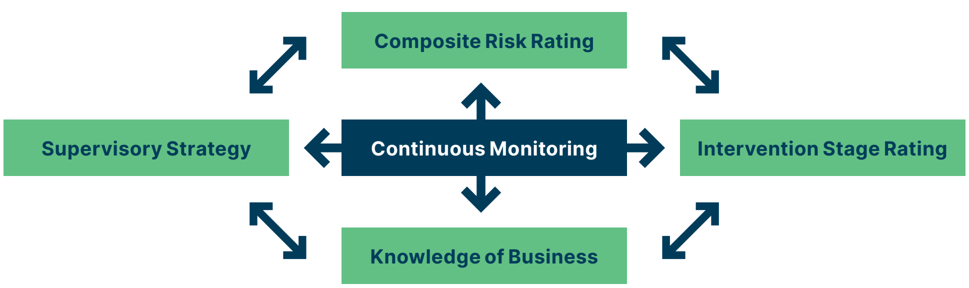
There is a continuum of supervisory work that ranges from continuous monitoring (PRFI-specific and external), to off-site and on-site reviews, including testing or sampling where necessary.

Monitoring refers to the continuous review of information on the PRFI, its industry, and environment. It aims to keep abreast of changes that are occurring or planned at the PRFI and to identify emerging issues. Monitoring focuses on these changes and formulates updates to BCFSA's forward-looking view of the institution's risk profile.

Monitoring enables proactive identification of systemic trends and/or emerging issues in the industry. It identifies needs for horizontal reviews (cross-sector, benchmarking) or new guidance materials. It also enables changes in the allocation of supervisory resources in support of BCFSA's risk-based approach (i.e., resources assigned to high-risk activities and/or riskier institutions).

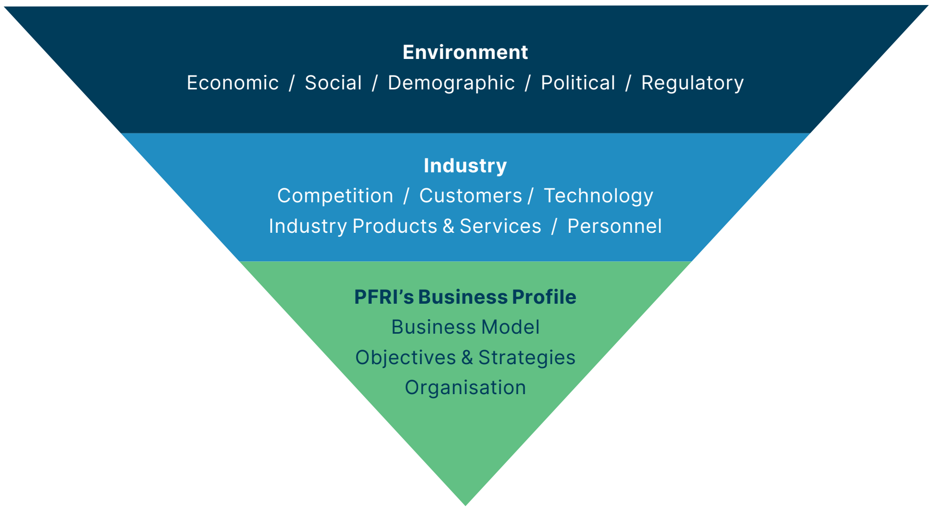
Monitoring involves a high-level analysis of statistics and forecasts, key financial indicators for each institution relative to its industry and peer group as well as information on macro-economic and industry conditions and trends. It also allows for the identification and analysis of other information that is critical to an institution's circumstances, as identified in the knowledge of business analysis.

The effectiveness of identifying critical information and changes that may impact an institution as well as interpreting the impact of such changes on the institution is highly dependent on a sound understanding of the institution, its risk drivers, and vulnerabilities.



Monitoring may result in changes in risk ratings, which may lead to staging or de-staging of an institution. Also, monitoring may result in changes to the Knowledge of Business and Identification of Significant Activities analysis, or the Supervisory Strategy originally set out for an institution.

Dynamic Operational Environment



Identification of Emerging Issues

BCFSA may periodically require PRFIs to provide defined data submissions, and/or perform specific stress tests which BCFSA 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 updated in 2012. 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 as well as the location of the review ("off-site" at BCFSA premises or "on-site" at the PRFI's premises) are based on specific requirements identified in the planning process or the result of information obtained through continuous monitoring. When a review is conducted, BCFSA may request information from the PRFI in advance. Reviews include discussions with the PRFI's board of directors, senior management, and oversight functions.

In addition to the core supervisory work of monitoring and reviews, BCFSA 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 BCFSA'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 BCFSA.

When there are shifts in the risk assessment of the PRFI, BCFSA responds by adjusting work priorities set out in the supervisory strategy and annual plan, as necessary, to ensure that important and emerging matters take precedence over items of lesser risk in support of the framework's proportionality principle. Such flexibility is vital to BCFSA'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, BCFSA communicates to PRFIs through various formal, written reports. This communication usually takes the form of a "supervisory letter".

Supervisory letters are addressed to the board of directors and to senior management. It summarizes BCFSA's key findings and recommendations based on supervisory work performed. In all cases, BCFSA requests that a copy of the supervisory letter be provided to the external auditor and to the appointed actuary where applicable.

Before issuance of the supervisory letter, findings and recommendations are discussed with the PRFI. A letter is generally issued within 45 days of the completion of a review. The PRFI is typically asked to provide a response within a predetermined period after receipt of BCFSA's supervisory letter. BCFSA 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. BCFSA requests PRFIs 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. BCFSA also requests that PRFIs ensure that the information remains confidential.

Other Canadian Regulators

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

In accordance with the FIA, BCFSA 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").

7. Appendix A

INHERENT RISK CATEGORIES AND RATINGS

Inherent risk is a risk which cannot be segregated from the significant activity. It is intrinsic to an activity and arises from exposure to and uncertainty from potential future events. Macroeconomic and industry factors may increase or decrease the level of inherent risk in an activity.

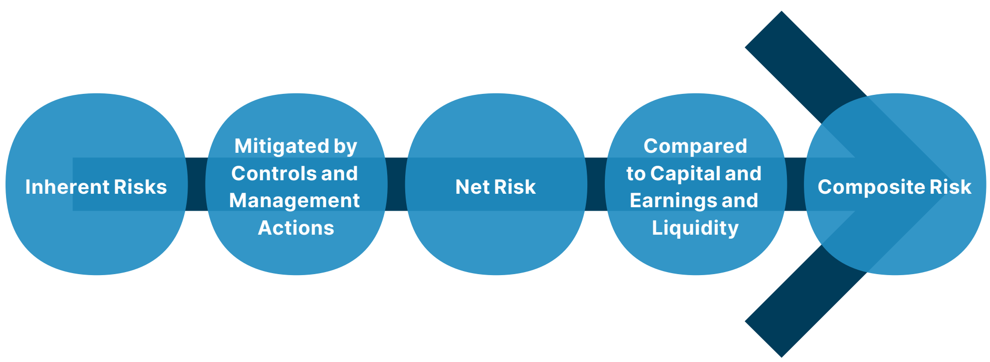
An inherent risk impact is evaluated **before consideration of the adequacy of controls and management actions as well as the availability or size of financial resources** (i.e., capital, earnings, and liquidity).

In assessing the probability of events happening or their potential impact, a thorough understanding of the significant activity and its operating environment is needed to inform BCFSA's judgement so that we can identify the factors that increase or decrease risk, such as:

- The nature of the products, customers, jurisdictions;
- The extent of concentrations, complexity; and
- The condition of the economic environment.

By comparing the similarities or differences in the nature of similar significant activities of different institutions, BCFSA is able to understand why assessments of key inherent risks may differ.

Example of the assessment pathway for a single significant activity institution



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 when 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, 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. They 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 cashflows from premiums, commissions, claims, payouts, and related settlement expenses;

b) the timing of the receipt and payment of these cashflows; and

c) policyholder behaviour (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 changes to business plans and strategies, introduce new products, enter new geographic territories, or adapt to changes in its business environment. Strategic risk considers emerging risks and the speed in which the business environment is changing.

Ratings

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

Low

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

Moderate

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

Above Average

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

High

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

8. Appendix B

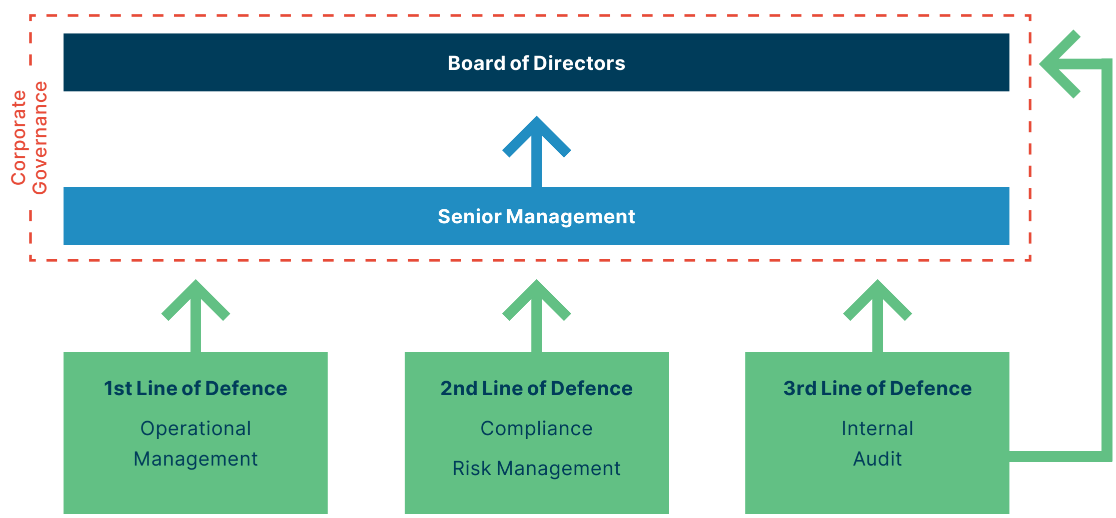
QUALITY OF RISK MANAGEMENT CATEGORIES AND OVERALL RATINGS

The Supervisory Framework characterizes the institution's risk management under a "Three Lines of Defence" model.

The first line is made up of the risk-takers who make the decision to take on the risks and manage the risks they generate. The second line is an independent staff within the institution that sets risk-taking limits and ensures that all risks are being appropriately managed. The third line audits and verifies the efforts of the other two to ensure that nothing falls through the cracks.

Overseeing these lines of defence is the responsibility of the Board of Directors and Senior Management

Three Lines of Defence Model



Arrows indicate the reporting relationships

CATEGORIES

Operational Management (First Line of Defence)

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

Oversight Functions (Second Line of Defence)

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 compliance matters to senior management and the board.

Risk Management

Risk management is an independent function responsible for the identification, measurement, 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 monitor and 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 assessments and monitoring to senior management and the board.

The presence and design of oversight functions are expected to vary based on the PRFI's nature, size, and complexity as well as its inherent risks.

Assurance Function (Third Line of Defence)

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 the results of its work on a regular basis to senior management and directly to the Audit Committee of the Board.

Corporate Governance

Board of Directors

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 policies related to the management of capital and liquidity;
- reviewing and approving codes of ethics and conduct;
- ensuring that emerging risks are identified and appropriately assessed and managed;
- ensuring that compensation for employees, senior management, and the board is aligned with the PRFI’s longer-term interests;
- reviewing and approving significant strategic initiatives (e.g., mergers and acquisitions);
- ensuring accountability and disclosure to shareholders/members; and
- providing an independent assessment of management controls.

Senior Management

Senior management is responsible for directing and overseeing the effective management of the PRFI’s general operations. 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 PRFI’s longer-term interests;
- 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.

Overall Ratings

Strong

The characteristics (e.g., mandate, organization structure, resources, methodologies, practices) of the function exceed what is considered necessary to effectively direct and control the institution, given its nature, scope, complexity, and risk profile. 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 to effectively direct and control the institution, given its nature, scope, complexity, and risk profile. 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 to effectively direct and control the institution, given its nature, scope, complexity, and risk profile, 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, considered necessary to effectively direct and control the institution, given its nature, scope, complexity, and risk profile. 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.

9. Appendix C

TYPICAL NET RISK RATING

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

Level of Inherent Risk for a Significant Activity				
Aggregate Quality of	Low	Moderate	Above Average	High
Risk Management for a Significant Activity	**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

10. Appendix D

RISK MATRIX

Significant Activities	Inherent Risks						Quality of Risk Management						Net Risk	Importance
							First Line of Defence	Second Line of Defence		Third Line of Defence	Corporate Governance			
	Credit	Market	Insurance	Operational	Regulatory Compliance	Strategic	Operational Management	Compliance	Risk Management	Internal Audit	Senior Management	Board of Directors		
Lines of Business														
Centralized Activities														
Overall Ratings														
											Overall Net Risk Rating			**Direction**

Support Factors	Ratings
Earnings	
Capital	
Liquidity	

	Rating	Direction	Timeframe
Composite Risk			
Intervention Stage Rating			

11. Appendix E

ALIGNMENT BETWEEN COMPOSITE RISK RATINGS AND INTERVENTION RATINGS

Composite Risk Rating	Intervention Stage Ratings for Credit Unions	Intervention Stage Ratings for Insurance Companies[1]
Low	0 Normal	0 Normal
Moderate	0 Normal 1 Elevated	0 Normal 1 Early Warning
Above Average	1 Elevated 2 Early Warning 3 Risk to Financial Viability or Solvency	1 Early Warning 2 Risk to Financial Viability or Solvency
High	3 Risk to Financial Viability or Solvency 4 Future Financial Viability in Serious Doubt 5 Non-viability/Insolvency Imminent	2 Risk to Financial Viability or Solvency 3 Future Financial Viability in Serious Doubt 4 Non-viability/Insolvency Imminent

1 Due to the harmonization of Intervention Stage Ratings for Insurance Companies with other Canadian regulators, these ratings remain the same as published in the 2012 Supervisory Framework.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