



Office of the Superintendent of  
Financial Institutions Canada

Bureau du surintendant des  
institutions financières Canada

# **Office of the Superintendent of Financial Institutions**

## **Internal Audit Report on Supervision Sector - Property and Casualty Insurance Group (PCG)**

**June 2013**



OSFI  
BSIF

Canada 

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## 1. Background

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### Introduction

Internal Audit (*IA*) conducts assurance work to determine whether the Office of the Superintendent of Financial Institutions Canada's (*OSFI's*) risk management, control, and governance processes, as designed and represented by management, are adequate and functioning in a manner to ensure risks are appropriately identified and managed, and to ensure compliance with such requirements as policies, plans, procedures and applicable laws and regulations.

The audit of the Supervision Sector - Property and Casualty Insurance Group (*PCG*) was approved by the OSFI Audit Committee and the Superintendent for inclusion in the OSFI 2012 to 2013 Internal Audit Plan.

This report presents the results of that audit based on audit work completed at the end of April 2013. The audit recommendations will support PCG to continuously improve their control framework for assessing the risk profiles of the federally regulated Property and Casualty (*P&C*) Insurance companies.

This report was presented to the OSFI Audit Committee on June 20, 2013 and approved by the Superintendent on June 24, 2013. The Assistant Superintendent, Supervision Sector, and the Property and Casualty Insurance Group's Senior Director, who have provided their management comments within this report, have also reviewed it.

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### Context

The Property and Casualty Insurance Group (*PCG*) is part of OSFI's Supervision Sector and is the division that has responsibility for the supervision of the Property and Casualty (*P&C*) insurance companies. The PCG's mandate and activities include:

- supervise Federally Regulated Financial Institutions (*FRFIs*), specifically in the P&C Insurance industry, to determine if they are in sound financial condition and are complying with their governing law and supervisory requirements;
  - promptly advise those FRFIs in the event there are material deficiencies and take, or require management and boards to take, corrective action;
  - promote adoption by those FRFIs of policies and procedures designed to control and manage risk;
  - administer, through the Securities Administration Unit (*SAU*), the vested asset/ standard deposit accounts (for the deposit-taking branches and both Life and P&C insurance FRFIs) and reinsurance collateral framework.
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## 1. Background, Continued

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**Context**  
(continued)

The objective of OSFI's supervisory process is to assess the safety and soundness of FRFIs on a legal entity and consolidated basis and to provide early warnings of issues, so as to allow OSFI to intervene in a timely and effective manner where OSFI considers the FRFI's practices to be, or likely to become, imprudent or unsafe.

OSFI's supervisory process includes identifying material risks; assessing the sensitivities of the FRFI's activities to external factors; understanding how effectively the FRFI is managing its risks; and making recommendations to strengthen management and governance, where required. The supervisory process (which is described at a high level in the *Supervisory Framework 2010*), culminates in OSFI's assessment of the FRFI's risk profile, i.e. the Composite Risk Rating (*CRR*).

PCG is one of the three main supervisory groups within the Supervision Sector that applies the supervisory process to support OSFI's mandate in protecting depositors and policyholders from undue loss, by carrying out regular risk assessments, monitoring, on-site reviews, and early intervention activities at the FRFIs. OSFI's mandate seeks to provide equal protection to all depositors, policyholders and pension plan members through effective supervision.

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## 2. Audit Objective, Scope and Approach

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**Audit Objective** The objective of the audit was to provide reasonable assurance that the Property and Casualty Insurance Group (*PCG*) is effectively using and integrating the results of the stress testing from the federally regulated Property & Casualty Insurance (*P&C*) financial institutions into *PCG*'s risk assessments of those institutions. Specifically, the audit assessed whether:

1. The logical flow of the supervisors' analyses and assessments on the results of the FRFIs' stress tests flowing through the Risk Assessment Documents (*RADs*) and/ or the section notes support the rationale for the supervisors' risk assessments.
  2. Quality Control (*QC*) reviews are effective at detecting work quality issues and ensuring that OSFI's supervisory processes are applied as intended.
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**Audit Scope** *PCG*'s Relationship Management (*RM*) teams summarize the analyses and assessments of their respective institution's risk profile in the *RAD* and on the Risk Matrix. The audit focused on the supervisors' analyses and assessments on the results of the FRFI's stress testing that they documented on the *RADs* and risk matrices for a sample of *P&C* FRFIs from the Toronto and Vancouver offices.

Recognizing that the supervisory process is a cumulative knowledge process and is continuously evolving, IA examined the *RADs* and risk assessments for the period from January 2012 to March 2013.

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**Scope exclusions**

The scope of the audit work excluded the following:

- an assessment of the accuracy and completeness of the FRFIs' stress tests, including the assumptions used within the stress tests, which are leveraged by the *PCG* *RMs* into their risk assessments that they document on the *RADs* and risk matrices;
  - *PCG*'s supervision of mortgage insurance companies, as this is scheduled for a future audit.; and
  - the *P&C* insurance subsidiaries of the Deposit-Taking Institutions (*DTIs*) and the Life Insurance conglomerates, because the responsibility for supervising these subsidiaries is with other divisions.
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## 2. Audit Objective, Scope and Approach, Continued

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### **Audit Approach**

The audit was conducted in accordance with the Institute of Internal Auditors' International Standards for the Professional Practice of Internal Auditing, consistent with the Treasury Board Policy on Internal Audit.

The audit of the Property and Casualty Insurance Group was predominantly conducted by leveraging the internationally recognized Enterprise Risk Management – Integrated Framework recommended by the Committee of Sponsoring Organizations of the Treadway Commission (*COSO*).

The approach to conducting the audit included:

- A review of OSFI's supervisory framework and related guides to update our understanding of the requirements.
  - A review of the applicable OSFI Guidelines to update our understanding of the FRFI's responsibilities for stress testing.
  - A walkthrough of the process to review, assess and incorporate the FRFI's stress test results into the supervisory team's updates of the section notes, RAD and risk matrix.
  - Sample testing of the supervisory documentation for the logical flow of the RMs' assessments on the results of FRFI's stress tests.
  - Assessing the effectiveness of the Managers' Quality Control reviews of the supervisors' work.
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### 3. Conclusion

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**Conclusion**

Overall, IA is reasonably assured that the Property and Casualty Insurance Group (PCG) is using and integrating the results of the federally regulated Property & Casualty Insurance (P&C) financial institutions' stress testing into PCG's risk assessments of those institutions. Specifically, we found that:

- The logical flow of the supervisors' analyses and assessments on the results of the FRFIs' stress tests flowing through the various supervisory documentation support the rationale for the supervisors' risk assessments.
- Quality Control (QC) reviews are adequate at detecting work quality issues and ensuring that OSFI's supervisory processes are applied as intended.

Internal Audit has identified two opportunities for improvement, where PCG can further strengthen its process and controls activities as follows:

1. Performs a more detailed review of its resourcing model during its annual and ongoing resource planning and allocation.
2. Ensures that the supervisory staff who were not available for the previously scheduled Supervisory Framework training are given the appropriate training, by coordinating with the Practices Division and the Learning & Development group.

In my professional judgment as Chief Audit Executive, sufficient and appropriate audit procedures have been conducted and evidence gathered to support the accuracy of the opinion provided and contained in this report. The opinion is based on a comparison of the conditions, as they existed at the time, against pre-established audit criteria that were agreed on with management. The opinion is applicable only to the entity examined. The audit was conducted in conformance with the internal audit standards of the Government of Canada, as supported by the results of the Quality Assurance and Improvement Program.

We wish to recognize the excellent rapport and exchange of views with all involved in the audit. The depth of the review and focusing on what matters would not have been possible without the support received throughout the audit.

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Chief Audit Executive, IA

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Date

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## 4. Management Response

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### Overview

This report has been reviewed by the Senior Director, Property and Casualty Insurance Group (PCG) and the Assistant Superintendent, Supervision Sector who acknowledge its observations and recommendations.

The recommendations will support PCG in their continuing efforts to enhance and improve the training of its staff and continue to improve its documentation processes.

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### Responses / Comments

PCG wishes to express thanks to the audit team for the professional, clear and transparent way in which they conducted their audit. We are in agreement with the general themes as outlined in the audit report.

We are pleased to note the positive comments in response to our integration of the results of insurer stress tests into PCG's risk assessments of property and casualty insurance companies. PCG is committed to addressing the areas outlined in the audit report.

With respect to Recommendation 1, PCG will conduct two processes to address the recommendation and related underlying observations.

- i. PCG will conduct a detailed resource analysis to support PCG's core supervisory efforts and processes. The presentation of the results of this review to the Assistant Superintendent Supervision, by December 2013, will provide confirmation that the Recommendation has been addressed.

Responsibility: Senior Director, PCG

- ii. In response to the related observations, PCG will enhance its quality assurance processes relating to documentation consistency. Targeted reviews will be conducted and corrective actions will be completed by June 2014 to provide confirmation that the observations relating to consistency have been addressed.

Responsibility: Managing Director, PCG

With respect to Recommendation 2, training sessions with the applicable staff to reinforce the application of the recent changes to the Supervisory Framework are being initiated together with Practices Division. The training will be conducted by December 2013. PCG will continue to conduct staff training sessions to maintain and update staff knowledge and skills and will implement a system for tracking registration with the Learning and Development (L&D) Division. Tracking staff registration to training events through the L&D Division will provide confirmation that the recommendation has been addressed in full.

Responsibility: Director (Operations), PCG

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## 5. Observations and Recommendations

**Audit Evaluation Criteria**

The audit criteria were derived from IA’s assessment of the key risks inherent to the Property and Casualty Insurance Group (PCG) and are based on the internationally recognized Enterprise Risk Management – Integrated Framework recommended by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Each observation below links directly to the audit criteria that were used to assess PCG.

**Process and Control Activities:**

- a. Supervisory documentation templates and related guidance to assist the supervisory teams in their responsibilities are accessible, formalized and communicated to the PCG Relationship Managers (RMs) and supervisors.
- b. The RM periodically and consistently updates the supervisory documents for significant events that may be identified from the FRFI’s stress tests.
- c. Prudential issues identified through the stress tests that could potentially affect the risk profile of the institution are assessed on a timely basis.
- d. The logical flow of the supervisors’ analyses and assessments on the results of the FRFI’s stress tests flowing through the supervisory documentation generally support the rationale for the supervisors’ risk assessments. Opportunities for improvement exists – please refer to Observation/ Recommendation #1 below.

*Application of OSFI’s Supervisory Framework and Guides*

**Governance:**

*Management Oversight*

- a. Quality Control (QC) reviews are conducted by the appropriate level of management and are effective at detecting work quality issues, while ensuring that OSFI’s supervisory processes are applied as intended.
- b. Management provides adequate oversight over the supervisory team’s risk assessments of the FRFIs.
- c. Training on the updated supervisory methodology and its application are generally rolled out to staff. Opportunities for improvement exist – please refer to Observation/ Recommendation #2 below.

**Observation #1:**

**Inconsistencies in the risk ratings across the supervisory documentation**

OSFI’s Supervisory Framework states: *“Supervision involves assessing the safety and soundness of Federally Regulated Financial Institutions (FRFIs), providing feedback as appropriate, and using powers for timely intervention where necessary. OSFI designates a relationship manager (RM) for each FRFI. The RM is responsible for maintaining an up-to-date risk assessment of the FRFI. Specialists and other staff within OSFI help support this work.”*

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## 5. Observations and Recommendations, Continued

**Observation #1**  
(Continued)**Inconsistencies in the risk ratings across the supervisory documentation**

*“A Risk Matrix is used to record all of the (RM’s) assessments. The purpose of the Risk Matrix is to facilitate a holistic risk assessment of a FRFI. While the Risk Matrix is a convenient way to summarize OSFI’s conclusions of risk assessment, it is supported by detailed documentation of the analysis and rationale for the conclusions.”*

The supervisory teams document their analyses and rationale for the risk ratings on the Risk Matrix within the Risk Assessment Document (RAD) and where applicable<sup>1</sup>, on the detailed Section Notes (SNs) underlying the RADs, using the related supervisory documentation templates and guidance on the application of the Supervisory Framework. The results of the FRFI’s stress tests are one of several components that the supervisors review, analyze and assess when determining the risk ratings for the inherent risks and “Quality of Risk Management” (QRM) functions for each of the FRFI’s business or significant activity.

Internal Audit (IA) noted documentary inconsistencies in the risk ratings across the supervisory documents.

The inconsistencies were all noted in the supervisory documentation maintained by the Toronto RM teams; IA did not note any such instances of inconsistencies for the supervisory documentation maintained by the Vancouver RM teams.

The inconsistencies did not impact the overall assessment of the FRFI because they were isolated instances on the final risk matrix; however for sustainability and knowledge transfer purposes it is important to have consistent documentation.

Through discussions with PCG, IA noted that the following increases the risk of inconsistencies in supervisory documentation:

1. The resourcing model for PCG has remained unchanged even though the workload requirements for the RMs have increased as a result of:
  - a. OSFI’s Guideline B-3 (Sound Reinsurance Practices and Procedures) that was released in December 2010 has resulted in a higher volume of reinsurance related collateral reviews and approvals at year end. The RMs are required to validate these requests prior to these being approved by the Securities and Administration Unit.
  - b. The ongoing enhancements to the guidance on the application of the Supervisory Framework.

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<sup>1</sup> For the larger and more complex Property and Casualty (P&C) insurance entities, the RM teams use SNs to document the full rationale for their risk assessments of the FRFI’s significant activities.

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## 5. Observations and Recommendations, Continued

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**Observation #1**  
(Continued)

**Inconsistencies in the risk ratings across the supervisory documentation**

2. Some supervisors may not always be clear on how to rate the risks for some of the QRM functions for a business activity. This is due to the continuously evolving guidance on the application of the Supervisory Framework and the newness of some of the QRMs (e.g. Actuarial) and of some supervisors within the PCG RM teams. As examples:
  - a) OSFI's Supervisory Framework was updated in 2010 and guidance on the application of the Principles and Concepts outlined in the Supervisory Framework continues to evolve.
  - b) Further guidance on assessing (i) "Reinsurance Ceded" as a Significant Activity and (ii) certain QRM functions (e.g. Actuarial) were rolled out to the supervisory teams in 2011/ 2012. The supervisors' application of such guidance is yet to mature with the continuing support of the Practices Division, the Actuarial Department and the Supervision Support Groups.
3. The volume of FRFIs that a PCG RM in Toronto is typically responsible for appears to be higher than some other groups and the reasons for this are not clear.

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**Recommendation #1**

IA recognizes that PCG Senior Management reviews the adequacy and allocation of its resources as part of its annual budgeting and planning. While PCG adopts a risk-based approach to the planning and allocation of its resources for performing on-site reviews at the FRFIs, minimum supervisory documentation standards still need to be maintained for those FRFIs where no detailed on-site reviews were completed during the year.

IA recommends that PCG:

- a) performs a more detailed review of its resourcing model during its annual and ongoing resource planning and allocation; and
- b) continues reinforcing the need with staff for a well-supported risk matrix, through coaching and feedback in the quality control review process.

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## 5. Observations and Recommendations, Continued

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**Observation #2:** OSFI updated its Supervisory Framework in 2010. OSFI's Practices Division, in conjunction with the Learning & Development group are responsible for rolling out the training on the updated Supervisory Framework to all new and existing supervisory staff. This training was initially rolled out as three modules, with each module given within a limited period of time.

**Training on the updated Supervisory Framework**

As a result of reviewing the Learning & Development records for the PCG supervisory staff in the Toronto office and for all supervisory staff in the Vancouver and Montreal offices, IA noted that a substantial number of non-executive level staff (employed by OSFI prior to 2011) did not attend training in the final module of the updated Supervisory Framework as follows:

- 6 out of the 25 PCG supervisory staff in Toronto;
- 2 out of the 7 Vancouver supervisory staff; and
- 3 out of the 4 Montreal supervisory staff.

Note that supervisory staff in the regional offices (Vancouver and Montreal) are responsible for both P&C and Deposit-Taking FRFIs.

IA notes that this is somewhat mitigated since PCG Management regularly arranges for Subject Matter Experts (*SMEs*) from the Actuarial Department and the Practices Division to provide additional training or clarity on the supervisory methodology, as appropriate, during the PCG's monthly or other scheduled staff meetings.

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**Recommendation #2** IA recommends that PCG:

- a) continues to arrange regular industry and supervisory methodology training to its staff; and
  - b) coordinates with the Practices Division and the Learning & Development group to ensure that all PCG supervisory staff have the appropriate training for any outstanding modules of the updated Supervisory Framework.
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