AUTORITÉ
DES MARCHÉS
FINANCIERS

2020

Financial Institutions Supervisory Framework

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INTRODUCTION

The Autorité des marchés financiers (the "AMF" or the "Authority") is the body mandated by the Québec government to regulate Québec's financial sector and assist consumers of financial products and services, particularly in the areas of insurance, securities, derivatives, deposit institutions – other than banks – the distribution of financial products and services and, since May 1, 2020, mortgage brokerage.

As provided for under its constituting Act,[1] part of the AMF's mission is to:

> *"ensure that the financial institutions and other regulated entities of the financial sector comply with the solvency standards applicable to them as well as with the obligations imposed on them by law with a view to protecting the interests of consumers of financial products and services, and take any measure provided by law for those purposes."*

The mandate of the Surintendance de l'encadrement de la solvabilité ("AMF Solvency") is to:

- ensure that financial institutions hold all the necessary authorizations to operate in Québec
- develop oversight tools, such as guidelines or regulations, which set out the AMF's expectations and requirements regarding sound and prudent management practices as well as sound commercial practices
- oversee financial institutions to ensure that they meet prudential expectations and legal and regulatory requirements, including with respect to solvency, sound and prudent management practices and sound commercial practices

1 *Act respecting the regulation of the financial sector*, CQLR, c. E-6.1

The supervisory framework (“Framework”) sets out the approach taken by the AMF to adequately fulfill its mandate to supervise financial institutions. It is important to note that financial institutions operate in a competitive environment requiring risk-taking in accordance with the risk appetite approved by the Board of Directors. The supervisory activities conducted by the AMF therefore reduce, but do not eliminate, the likelihood of institution bankruptcy.

The supervisory approach presented in the Framework is shaped by the core principles and guidance published by the Basel Committee on Banking Supervision,[2] the International Association of Insurance Supervisors[3] and other international bodies[4] that are recommended to regulatory authorities. The AMF also plays an active role in key domestic and international regulatory forums on best practices, which, among other things, enables it to keep its supervisory approach current.

In the context of its supervisory activities, the AMF co-operates, as needed, with other regulatory authorities and organizations set up to protect insureds and depositors, in particular with respect to an institution’s condition and best supervisory practices. These exchanges remain confidential.

Scope

The Framework is applicable to institutions governed by the following statutes:

- *Deposit Institutions and Deposit Protection Act,* CQLR, c. I-13.2.2
- *Insurers Act,* CQLR, c. A-32.1
- *Act respecting financial services cooperatives,* CQLR, c. C-67.3
- *Trust Companies and Savings Companies Act,* CQLR, c. S-29.02

The Framework is applied to financial institutions that operate independently as well as institutions that are part of a financial group.[5]

For financial institutions which carry on business in Québec but which are constituted under a law of another legislative authority, the AMF may, for the purpose of applying this Framework, consider the supervisory functions performed by the regulator in the home jurisdiction, if deemed advisable.

The generic terms “financial institution” and “institution” are used to refer to all entities covered by the scope of the Framework.

The term “systemically important financial institution” refers to an institution whose insolvency, because of its size, complexity, interconnectedness and substitutability in the financial system, could cause significant disruption to the financial system and the local economy.

Updates

The Framework is updated every three years or as needed based on developments in the financial sector, benchmarks for supervisory practices, regulation as well as new risks, emerging trends, and the risks identified in the course of supervisory work.

Initially published in March 2009, the Framework was revised in 2011, 2014, 2017, and 2020.

2 Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision*, September 2012.

3 International Association of Insurance Supervisors (IAIS), *Insurance Core Principles, Standards, Guidance and Assessment Methodology*, October 2011, as amended November 2015, 2017, 2018 and 2019.

4 These bodies include the Bank for International Settlements (BIS), the Financial Stability Forum, the International Association of Deposit Insurers (IADI), the Organisation for Economic Co-operation and Development (OECD), the International Organization of Securities Commissions (IOSCO) and the International Financial Consumer Protection Organisation (FinCoNet).

5 For purposes of this document, “financial group” means any group of legal persons composed of a parent company (financial institution or holding company) and legal persons that are affiliated with it.

SUPERVISORY PRINCIPLES

The following six principles are at the core of the AMF's supervisory approach.

Integration

The AMF, in cooperation, when necessary, with other supervisory bodies, applies an integrated approach to the supervision of financial groups. This approach involves an evaluation of all significant entities (subsidiaries, branches, joint ventures, etc.) inside and outside Québec and elsewhere in the world.

Prevention

The AMF is placing greater emphasis on early risk identification and management with a view to detecting issues and intervening with financial institution in a timely manner.

Scalability

The AMF scales its supervisory activities to the nature, scope and frequency of the work involved and to the resources to be allocated based on its assessment of the institution's Risk Profile and systemic importance (if applicable).

The activities and capital requirements of systemically important financial institutions, as well as their resolution procedures in the event of failure, are subject to more frequent and intense supervision.

Accountability

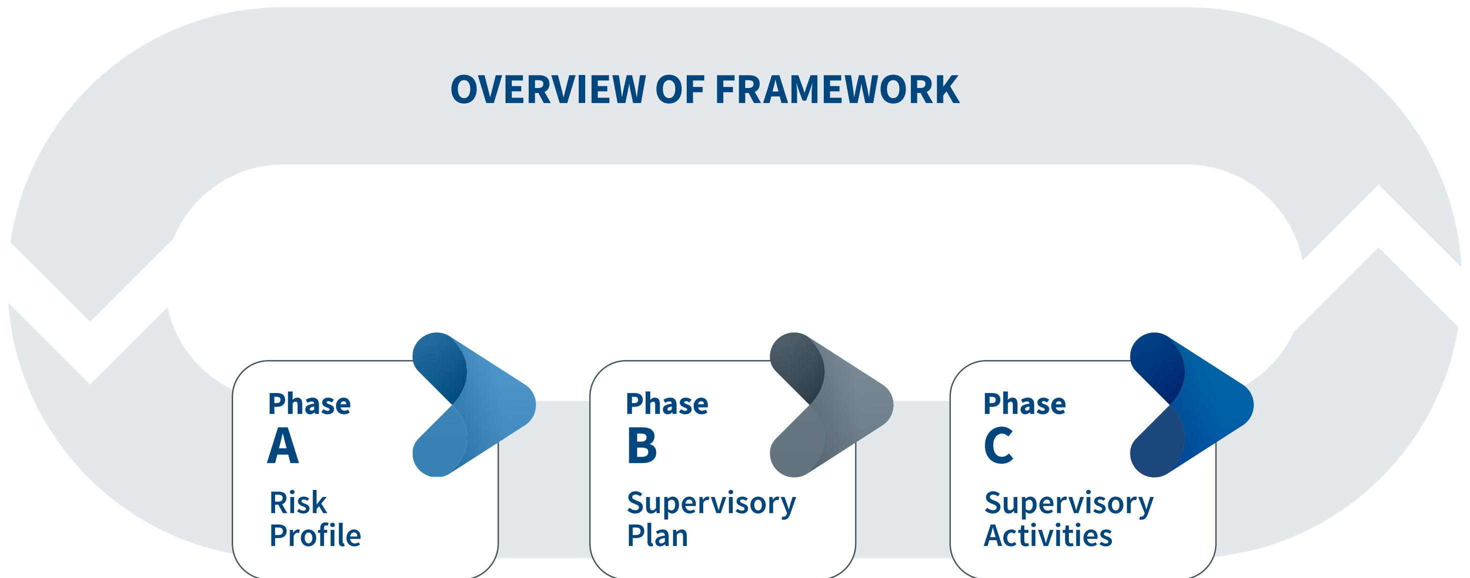
The AMF assesses the quality and robustness of the lines of defence, senior management and the governance bodies established by the institution. These functions are assessed according to the expectations set out the AMF's guidelines.

Complementarity

The AMF relies on the work of third parties, such as the independent auditor and other supervisory bodies, if the independence, scope and quality of their work is deemed adequate.

Interactivity

The institutions and the AMF maintain open, two-way communication, with the AMF informing the institutions on a timely basis of regulatory and supervisory developments and the institutions promptly advising the AMF of any new initiatives or developments that could affect their risk profile. Communications between the AMF and senior management and the Boards of Directors of systemically important financial institutions are more intensive.



The AMF's guidelines are principles-based, as opposed to rules-based. They inform financial institutions of measures that, in the AMF's opinion, may be established to satisfy their legal obligations. Institutions have an obligation to follow sound and prudent management practices and to adhere to sound commercial practices. The guidelines therefore provide guidance on the interpretation, performance, and application of these obligations. In light of the foregoing, the AMF employs a risk-based supervisory approach based on the three phases shown above.

Phases of the risk-based approach

This section describes the methodology supporting the risk-based supervisory approach. This methodology, which is tailored to the nature, size, and complexity of an institution's activities, is applied on an ongoing basis to determine and document a financial institution's Risk Profile.

Confidentiality of supervisory activities

In the context of the AMF's supervisory activities, financial institutions are required to disclose confidential, and sometimes sensitive, information about their operations. In order to encourage complete and honest disclosure, the law protects the confidentiality of certain types of information held by a financial institution in connection with the AMF's supervisory activities, including any AMF recommendations or reports relating to the institution, any reports prepared by an institution at the AMF's request (including self-assessments) and any correspondence between the AMF and the institution's officers and directors regarding such information. Note that a financial institution may not disclose such information in civil or administrative proceedings, except where provided by law.

Phase A
Risk profile

A Risk Profile is a rating of a financial institution's overall risk level. It is arrived at by assessing the risks inherent to the financial institution's Significant Activities, the quality of its risk management, its commercial practices and its financial condition.

A Risk Profile is dynamic because it is updated to reflect changes in the risks to which the institution is exposed and the results of supervisory activities. It is used by the AMF for internal purposes only and is not disclosed.

Step 1 – Identify Significant Activities

The first step in the methodology consists in identifying the institution's Significant Activities.

A Significant Activity is generally defined as a line of business or key business process; a business unit can also be included. Significant Activities are identified using multiple sources of information, including the institution's financial reports, strategic plans, and organization charts.

The criteria used to determine whether an activity is significant may include:

- assets generated by the activity in relation to total assets
- revenue derived from the activity in relation to total revenue
- net income before tax generated by the activity in relation to total net income before tax
- capital allocated to the activity in relation to total capital
- reserves held as a percentage of total reserves, if applicable
- potential impact of the activity on the institution's reputation (e.g., the protection of personal information) or its importance in achieving the institution's strategies and objectives
- impact that an interruption in the activity would have on the continuity of the institution's business

Step 2 – Identify and Assess Inherent Risks of Each Significant Activity

The second step consists in identifying and assessing the Inherent Risks of each Significant Activity. Inherent Risk is the probability and severity of potential loss intrinsic to a business activity, without considering control mechanisms.

The following Inherent Risks are typically assessed:

- credit risk
- market risk
- interest rate risk
- liquidity risk
- insurance risk
- operational risk
- compliance risk
- strategic risk
- reputational risk

These risk categories are described in Appendix 1.

Assessing Inherent Risks

The degree to which a financial institution's Significant Activities are exposed to these Inherent Risks is determined by considering a number of qualitative and quantitative factors specific to each risk. Those factors include: economic context, systemic importance, concentration in a particular market segment, the nature, and complexity of products offered, and entry into a new market. This assessment requires a thorough knowledge of the financial institution's activities and its financial group, where applicable.

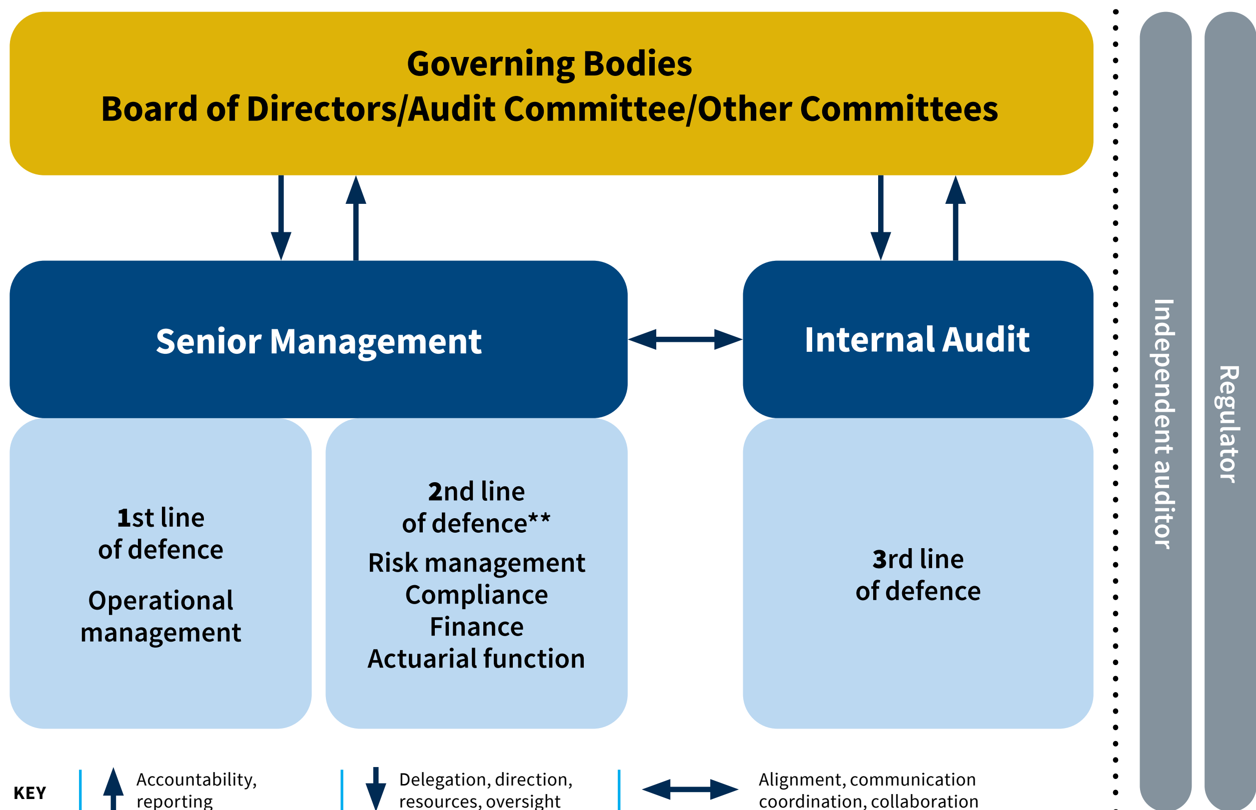
The level of Inherent Risk for each Significant Activity is assessed as "Very High," "High," "Moderate," or "Low":

- Very High Inherent Risk – Very high probability of a material adverse impact on an institution's capital, earnings and business continuity due to exposure to and uncertainty from potential future events
- High Inherent Risk – High probability of a material adverse impact on an institution's capital, earnings, and business continuity due to exposure to and uncertainty from potential future events
- Moderate Inherent Risk – Moderate probability of a material adverse impact on an institution's capital, earnings and business continuity due to exposure to and uncertainty from potential future events
- Low Inherent Risk – Low probability of a material adverse impact on an institution's capital, earnings and business continuity due to exposure to and uncertainty from potential future events

Step 3 – Assess Quality of Risk Management

Assessing the quality of risk management helps measure the extent to which Inherent Risks are mitigated. An institution's quality of risk management is assessed through the effectiveness of the lines of defence, senior management, and governance bodies and their interactions. An assessment of the quality and effectiveness of these functions is based, in particular, on legal, regulatory and normative compliance, the results of previous supervisory activities, and the work of third parties, as applicable.

The scope of supervisory activities relating to operational management in respect of a Significant Activity may be adjusted based on the effectiveness of the functions of the second and third lines of defence, senior management and the governance bodies.



* Adapted from IIA's Three Lines Model, The Institute of Internal Auditors, July 2020
** The individuals in charge of the 2nd line of defence are integral members of senior management.

Risk management quality is assessed as "Strong," "Acceptable," "Needs Improvement" or "Unsatisfactory." The factors considered in this assessment include:

- implementation of a strong risk management culture which includes clear communication of expectations by senior management and the Board of Directors as well as the identification of employees' duties
- whether senior management has identified, assessed, quantified, controlled, mitigated and ensured the monitoring of its Inherent Risks, based on the systemic importance of the institution, where applicable
- the ability of senior management to identify and control new risks as they arise in a changing environment, taking into account the institution's strategic plan
- the implementation of appropriate policies, procedures, and limits
- whether management information systems and other forms of communication are consistent with the level of business activity and complexity of products

Step 4 – Evaluate the Net Risk of a Significant Activity and the Aggregate Net Risk

Net Risk of a Significant Activity

The Net Risk of a Significant Activity is evaluated as a function of its Inherent Risk (Step 2), mitigated by its Quality of Risk Management (Step 3).

Aggregate Net Risk

A financial institution's Aggregate Net Risk is the weighted Net Risk of its Significant Activities, based on their relative significance.

Step 5 – Assess Commercial Practices

The commercial practices, or conduct of business, of financial institutions mean their behaviour in their relationships with customers, from before a contract is entered into until all the institution's obligations under the contract are fulfilled.

Deficient conduct can cause serious harm to customers and damage an institution's reputation to the point of threatening its solvency.

At this step, the AMF determines whether:

- the institution is acting in customers' interests, from product design to after-sales service
- the institution is exposing customers to risks or situations that could negatively impact them
- fair treatment of customers (FTC) is a core component of its business culture

This assessment is conducted for both the institution as a whole and each of its Significant Activities. It includes the following:

- assessing governance and the business culture in respect of the obligation to adhere to sound commercial practices, including in terms of FTC
- analyzing the strategies, policies, procedures and controls implemented with respect to FTC in order to achieve the following outcomes:
  - developing, marketing and offering products in a way that pays due regard to the interests and needs of customers
  - providing customers with timely, clear and sufficient information before, during and after the point of sale, allowing them to make informed decisions
  - ensuring compliance of the product and service offering process
  - minimizing the risk of sales that are not suited to customers' needs and circumstances
  - avoiding or properly managing any existing or foreseeable conflicts of interest and ensuring they do not affect customers' interests
  - examining claims and complaints in a fair and timely manner
  - protecting information privacy
- examining complaints and reports

Step 6 – Analyze the Institution's Financial Condition

This step, which focuses on an assessment of the institution's capital, liquidity, and earnings, is critical to the supervisory approach. It takes into account the capacity of the institution's capital, liquidity and earnings to sustain and contribute to the long-term viability of current and future operations.

The assessment of an institution's current and projected capital and its liquidity includes a review of capital and liquidity quality, quantity, availability and compliance with laws, regulations, and guidelines.

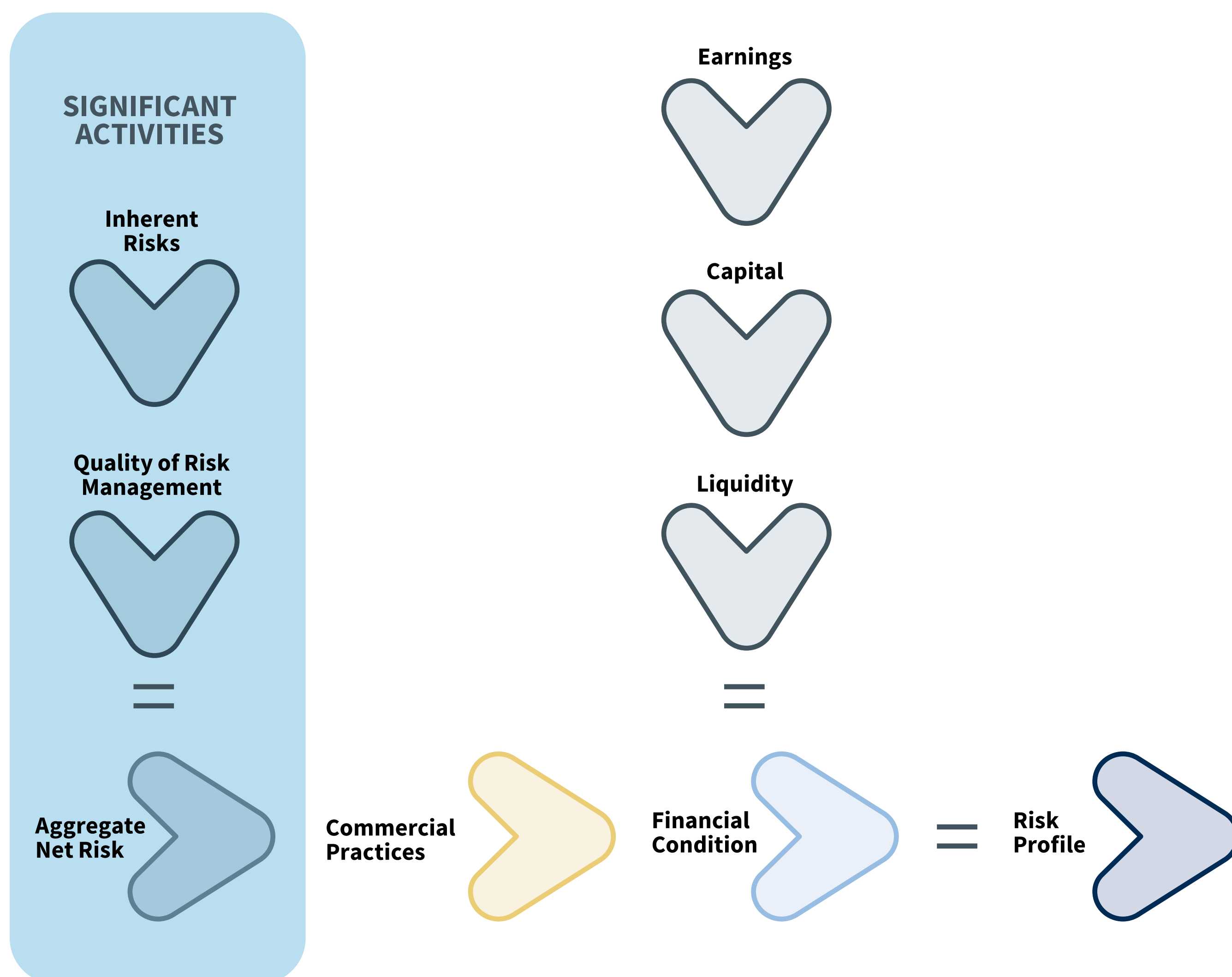
Earnings are assessed to determine their contribution to internally generated cash flows. They are assessed by analyzing the level and historical record of earnings using different indicators and performance measurements. An analysis of earnings sources, financial forecasts, and peer benchmarking further supports the earnings evaluation.

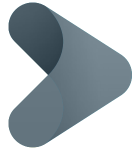
Step 7 – Determine the Risk Profile

After the institution's Significant Activities have been identified (Step 1), the risks inherent to them and the management of those risks have been assessed (Steps 2 and 3), and each activity's Net Risk and the institution's Aggregate Net Risk have been determined (Step 4), Steps 5 and 6 are carried out to adjust the Aggregate Net Risk to determine the institution's Risk Profile.

The Risk Profile is the combined assessment of the institution's Aggregate Net Risk, commercial practices and financial condition. It may also be updated following an analysis of the financial condition of the group, where applicable, of which the institution is a part.

The evaluation of an institution's Risk Profile is illustrated by the following diagram:





Phase B
Supervisory plan

A three-year Supervisory Plan is developed using the institution's Risk Profile while taking into account the size, nature and complexity of its activities and, where applicable, its systemic importance. The plan also takes into account the orientations and priorities set by the AMF. It is updated annually.

The Supervisory Plan may be modified at any time when the AMF becomes aware of an event that could have an impact on the institution's Risk Profile. For instance, a management practice or commercial practice which could have a material impact on customers would cause the Risk Profile to be updated and appropriate supervisory work to be performed.

Moreover, the Supervisory Plan includes an analysis of the financial and non-financial information set forth in an institution's various statutory disclosures sent to the AMF, regardless of its Risk Profile.

Relationships with Financial Institutions

A Relationship Manager ("RM") is appointed from within the AMF for each institution to oversee supervisory activities. Other members of the supervisory team contribute to the activities by providing expertise in various fields.

The RM is responsible for co-ordinating communications with the institution and its financial group, where applicable. In this capacity, the RM establishes and maintains relationships with senior management as well as with the institution's key internal and external experts.

The RM generally participates in meetings between the institution's officers and directors and the AMF.

Phase C
Supervisory activities

Phase C results from the activities necessary to identify the institution's Risk Profile (Phase A) and develop the Supervisory Plan (Phase B).

Step 1 – Collect and Analyze Data

Collection and analysis of data are an integral part of off- and on-site supervisory activities and help maintain and enhance knowledge of an institution's activities and the sector in which it operates in order to update the Risk Profile.

In addition, under the methodology, the RM is required to assess the extent to which he or she can rely on the work of the independent auditor and the institution's home regulator, where applicable. It is the responsibility of the institution to inform these bodies of the supervisory activities and the possibility of being contacted by the RM.

Off-Site Supervisory Activities

Off-site supervisory activities include qualitative and quantitative analyses of data collected in connection with laws, regulations and guidelines and regular communications with the institution's officers. Within the scope of its activities, the AMF may also request additional information, including through correspondence, questionnaires and self-assessment forms, in order to conduct a more in-depth examination of the financial institution's or industry's activities.

On-Site Supervisory Activities

On-site activities are a critical part of the supervisory process. The scope of these activities depends on the Risk Profile of an institution, its systemic importance, where applicable, and the Supervisory Plan. These activities and interactions with individuals operating in the institution's lines of defence, senior management and governance bodies also provide further insight into the workings of the institution and serve as a basis for an enhanced assessment of the Risk Profile.

In the normal course of its activities, the AMF sends the institution at least four weeks' advance written notice, informs it of the date and scope of the on-site activities and the name of the RM, and provides it with a list of required documents. The institution must appoint a resource person to co-ordinate the activities. The AMF may, if necessary, ask the institution to provide additional information in order to complete of the supervisory activities.

Exceptionally, on-site supervisory activities may be conducted virtually through technological systems with an appropriate level of security.

Step 2 – Report Results of Supervisory Activities

The AMF may notify the institution of the results of off-site supervisory activities in the form it determines. The results of the on-site supervisory activities are presented in a Supervisory Report or letter.

The on-site Supervisory Report generally includes:

- a summary of the Supervisory Activities that were carried out
- an overall assessment
- a discussion of the findings
- a presentation of the associated recommendations

It may also give details about the assessment of the effectiveness of any corrective actions previously taken by the institution. The report is sent to the chief executive officer, with a copy to the audit committee chair, if applicable.

The findings and recommendations are discussed with the relevant principal managers of the institution before the report is released and the points discussed are considered in drafting the report, particularly if they clarify the findings and recommendations that were presented.

The AMF may, if it deems it necessary, meet with the institution's Board of Directors to present the report's contents and discuss other supervisory matters, including its assessment of the institution's financial condition.

With respect to supervisory activities relating to practices pertinent to the industry as a whole, the AMF may publicly disclose the overall results of the activities when it so determines. Such disclosure is used, among other things, to provide direction on good practices the AMF expects financial institutions to adopt.

Prioritization of Recommendations

The recommendations are prioritized from 1 through 4 based on the degree of urgency of the corrective measures expected to be taken regarding:

- weaknesses noted with respect to the implementation and application of policies and procedures
- repeated non-compliance with internal and external rules governing the financial institution
- deficient internal controls
- inappropriate management and commercial practices
- weaknesses noted when assessing the supervisory functions represented by the lines of defence, senior management and the governance bodies
- the institution's distressed financial condition

The prioritization of the recommendations is defined below:

Priority	Description
1.	The recommendation involves one or more deficiencies which are not expected to have a material impact on the assessment of one or more components of the institution's Risk Profile but which require improvement. The AMF will require that corrective measures be applied according to a schedule determined by the institution.
2.	The recommendation involves one or more deficiencies which are not expected to have a material impact, in the short term, on the assessment of one or more components of the institution's Risk Profile. The AMF will require that corrective measures be applied according to a schedule determined by the institution.
3.	The recommendation involves one or more deficiencies which are repeated or which have a material impact and which, if not corrected, could change the assessment of one or more components of the institution's Risk Profile. The AMF will require that corrective measures be applied within the prescribed time period. If considered necessary, approval of an action plan by the Board of Directors or a Board committee will be required.
4.	The recommendation involves one or more deficiencies which have a material impact and which, if not immediately corrected, could change the assessment of one or more components of the institution's Risk Profile. An action plan will have to be carried out within the time period prescribed by the AMF, which will evaluate the action taken and may require that adjustments be made. Approval of the action plan by the Board of Directors or a Board committee will also be required.

Follow-up by Financial Institution on AMF Recommendations

Generally, within 30 to 45 days of receipt of the Supervisory Report, the institution must respond to the recommendations with a corrective action plan, including a timetable and/or a description of actions already taken. The action plan must be drawn up by a representative of the institution's senior management and approved by the Board of Directors or a Board committee, when required by the AMF. Depending on the significance of the recommendations and/or the response provided, either a shorter timetable or additional or alternative corrective actions to those presented in the action plan may be required.

Step 3 – Follow up on Action Plans Resulting from Recommendations in the Supervisory Report

The RM follows up on the progress being made with the action plan drawn up by the institution in response to the recommendations in the Supervisory Report. This follow-up is part of an ongoing process and is done to ensure the consistency and adequacy of the measures adopted on the basis of the recommendations and their implementation according to the timetables set out in the institution's action plan. Any changes made by the institution that affect the corrective measures or the timetables must be communicated to the AMF.

Additional Measures under Applicable Legislation

Where the corrective actions proposed or taken are considered inadequate, the institution fails to implement the required corrective actions or does not respect the timetables, the AMF may take progressive actions as provided for in applicable legislation.

APPENDIX 1 – RISK CATEGORIES

The following definitions illustrate some of the most common concepts of risk for financial institutions. This is not an exhaustive list of the risks monitored by the AMF or the risks faced by institutions.

Credit Risk

Credit risk is the risk of loss if a borrower or counterparty does not meet its financial or contractual obligations to an institution. This risk arises from uncertainty about the counterparty's or client's capacity or willingness to meet its obligations. Counterparties include issuers, debtors, borrowers, brokers, underwriters, reinsurers, guarantors, and the contracting parties for OTC derivatives.

Market Risk

Market risk is the risk of loss from fluctuations in market prices and rates, the correlation between them and the range of volatility. Exposure to this risk can result from market-making, dealing, and position-taking activities as well as foreign exchange. The related parameters can include interest and foreign exchange rates, and the prices of securities, commodities, and real estate.

Interest Rate Risk

Interest rate risk is the risk of loss from changes in interest rate levels, or yield curve shapes, interest rate spreads, and mortgage loan prepayments. It stems primarily from a balance sheet mismatch in rates and basis risk on off-balance-sheet products.

Liquidity Risk

Liquidity risk arises from an institution's inability to meet its financial obligations within the time prescribed and at a reasonable price. Financial obligations include:

- commitments to depositors and policyholders
- payments due in relation to derivatives contracts
- settlement of securities borrowing and securities redemption
- lending and investment commitments
- any other payment due

Insurance Risk

a. Product Design and Pricing Risk

Product design and pricing risk arises from transacting insurance and/or annuity business where costs and liabilities assumed in respect of a product line exceed expectations in pricing.

b. Underwriting and Liability Risk

Underwriting and liability risk is the exposure to financial loss resulting from the selection and approval of risks to be insured, the reduction, retention and transfer of risk, the reserving and settlement of claims, and the management of contractual and non-contractual product options.

Operational Risk

Operational risk is defined as the risk of loss resulting from faults or inadequacies in processes, people or systems, or from external events, and it includes legal risks.

a. Legal Risk

Legal risk is the risk of harm to which a financial institution is exposed due to the application of a legal standard or the performance of a contractual commitment in combination with the occurrence of an event (internal/external) that could impact its civil, contractual or penal liability. Such harm could arise from the misinterpretation or misapplication of contractual provisions. Legal risk covers exposure to fines, penalties, damages, and class actions.

b. Information and Communication Technologies Risk

Information and communication technologies (ICT) risk is the business risk associated with the use, ownership, operation and implementation of ICT within an institution. This risk covers the risks relating to availability and continuity, security (including cyber security), ICT system changes, data integrity, and IT outsourcing.

Compliance Risk

Compliance risk means the risk of regulatory non-compliance with the laws, regulations and guidelines governing financial institutions. This risk does not however include risks related to ethics and professional conduct.

Strategic Risk

Strategic risk arises from an institution's inability to implement appropriate business plans, strategies, decision-making processes, and resource allocation methods adapted to changes affecting the commercial context and to changes in its business environment.

Reputational Risk

Reputational risk means the risk faced by institutions with respect to their brand image. The risk factors stem primarily from their social and environmental practices, ethics and professional conduct, and integrity. Reputational risk is the current and future impact on the institution's business conduct arising from negative public opinion. Exposure to this risk may cause a significant decline in earnings or capital and may ultimately undermine the institution's viability.