Why we read the fine print from FSCO and OSFI

FSCO's announcement that it wants to get out of the P&C business may mean a new regulator for LawPRO.

Every insurance company operating in Canada today is regulated for solvency purposes at either the provincial or federal level.

As a company that is inextricably tied to the Ontario bar (and in fact is, through the Law Society's ownership, indirectly controlled by Ontario lawyers), it makes sense for LawPRO to be licensed and regulated provincially for all purposes, through the Financial Services Commission of Ontario (FSCO).

LawPRO said as much in its response to a FSCO consultation paper in which FSCO announced publicly that it is considering giving up the solvency (or financial) regulation of P&C (property & casualty) insurance companies such as LawPRO.

The reason? To meet the (much more prescribed and rigorous) requirements of the International Association of Insurance Supervisors (IAIS) would entail FSCO implementing a new form of regulatory regime – and with only seven Ontario-incorporated P&C companies left, the Ontario government may not be inclined to spend the money to implement its own program of IAIS compliance. However, staying in solvency regulation and failing to move in that direction may make Ontario appear as a weaker jurisdiction for insurance company compliance than some of its Canadian regulatory neighbours. No one wants the citizens of Ontario to suffer in the long term.

What would it mean for LawPRO to transfer from FSCO to the jurisdiction of the federal regulator, the Office of the Superintendent of Financial Institutions (OSFI) and IAIS compliance?

More layers of scrutiny and reporting, with related needs for more formalized controls, processes, monitoring and even additional functional areas. For example, we may have to create a more traditional internal audit function (not an inexpensive proposition) in addition to our normal reporting on internal controls to our board audit committee and paying for external auditors as we now do.

That's not to say that we are not now well regulated and supervised for our results and financial reporting by our present solvency regulator, FSCO, as well as our auditors and our board.

On the contrary, FSCO's current solvency and reporting requirements are rigorous. Taken together with new international financial reporting standards (IFRS), they already mean more controls, accountability and rigorous benchmarks than had been the case a decade ago.

Moving to OSFI – and even more extensive and rigorous IAIS compliance – would put added pressure on our overhead costs as we would likely have to expand the size of our organization and the skill sets needed to comply with OSFI requirements. Stay tuned: There's much more to come on this regulatory front.

New OSFI guidelines on mortgage underwriting by banks are music to our ears!

At the end of June, OSFI issued a new set of guidelines that set out its expectations for "prudent residential mortgage underwriting" among Canada's lending institutions. If you follow us on Twitter or LinkedIn, you'll know that we gave these guidelines – and OSFI's tighter control of lenders' mortgage lending practices – a solid thumbs up.

That's because we believe these new guidelines address the very issues that the legal community has been struggling with – and on which lawyers (and LawPRO) have often been left holding the ball.

Any one of the new measures described below could easily trip up someone looking to score a quick payout by stealing an owner's identity, or filing false income information, or trying to secure a mortgage using proceeds from another scam as the ostensible down payment on a purchase. Taken together, they will – we hope – make it very difficult for many fraud scams we've seen in both our E&O and TitlePLUS insurance portfolios to succeed.

Of the five principles for prudent mortgage underwriting and/or acquisition set out in the guidelines, we're particularly pleased with the principles related to verifying the

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identity of the borrower and the appraisal process used by lending institutions.

Knowing the borrower

One of the messages we've been sending out to real estate practitioners is the need to verify the identity of the person walking in your door and asking you to act for him or her on a transaction. Gone are the days when you could assume the driver's license was sufficient proof of the borrower's identity. Rule 2 of the Rules of Professional Conduct sets out that expectation of lawyers very clearly. It was this expectation that lawyers would verify the client's identity that the lending institutions often depended on when a mortgage transaction went sour.

Now, with the new OSFI guidelines, lenders themselves will be required to do their own due diligence. Principle 2 sets out that:

> [Institutions] *"should perform reasonable due diligence to record and assess the borrower's identity, background and demonstrated willingness to service his/her debt obligations on a timely basis."*

Specifically, lenders will need to ensure that they have made "reasonable enquiry into the background, credit history, and borrowing behaviour of a prospective residential mortgage loan borrower as a means to establish an assessment of the borrower's reliability to repay a mortgage loan." Lenders will be expected to verify the borrower's employment status, document credit checks, and have on hand documentation that verifies the source of the down payment.

Principle 3 goes on to require lenders to "adequately assess the borrower's capacity to service his/her debt obligations on a timely basis," again pointing to the need to verify employment status and the borrower's income history, and to take into account that individual's assets, other debt obligations and living expenses – all pieces of information that a scammer trying to create a false identity on the fly would have difficulty assembling.

Appraisals come in for extra attention

On this subject, the new guidelines are very clear. Principle 4 requires lenders to have "sound collateral management and appraisal processes for the underlying mortgage properties."

Specifically, lenders will be expected to use a risk-based approach and consider a variety of tools and appraisal processes that address value, including conducting on-site inspections of the property being mortgaged. As real estate lawyers have always known, these kinds of site inspections have many benefits beyond the valuation of the property: "… an on-site property inspection is beneficial in the process of validating the occupancy, condition and, ultimately, the existence of the property." If automated valuation tools are used, lenders will have to have in place processes that ensure these tools reflect the current market value of the specific property.

Gone, one hopes, are the days in which drive-by appraisals or appraisals based on computerized models or neighbourhood average values (that did not reflect that the mortgage being requested was on the one house on the block that had not been renovated and was a fixer-upper) were considered adequate by themselves.

The 17-page Guidelines document makes for interesting reading, especially for real estate practitioners who should familiarize themselves with the kind of information they may be able to expect lenders to possess going forward to be able to provide (or at least to know what information the borrowers need to provide to the lenders, so that lawyers in turn can also request the same information from their clients where helpful).

Beyond that, it reflects the new reality that all of us in the financial industry are dealing with: Heightened expectations and scrutiny by our regulators that in turn generate more rigorous and time-consuming work processes. ■

Understanding LAWPRO's regulatory filings:
It's all about context

Previously in this column, LAWPRO has reported on some of the changes being imposed on insurance companies. Regulators around the world want to ensure that insurance companies (and other financial institutions) are prudent in how they handle the funds in their care and cautious in making assumptions that affect their operations and planning.

One of these new rules requires a change in how we report LAWPRO's claims reserves. As of January 1, 2012, we are required to give more details on how we allocate certain estimated costs. Those costs include adjustments based on the discount rate (that is, the rising or sinking of our interest rate adjustments to reflect the time value of money), the estimate of future claims handling costs for policies already sold, and the provision for adverse deviation (that is, the cushion in case our actuarial estimates are off).

While we have always made the necessary adjustments to total claims reserves, the way they are presented on the regulator's forms has changed. For example, in our March 31st LAWPRO filings, the TitlePLUS claims reserve number includes adjustments that have accumulated since that program started. This makes it appear higher and out of proportion to the premium amount reported for the first quarter. It is important to understand the context of the reported numbers given this one-time catch-up adjustment. This is an example of how insurance regulatory reporting doesn't always exactly compare apples to apples. However, the regulators will understand the data presented on their form, and going forward the goal of enhanced precision will be achieved.

We are in changing times and expect that proposals from the International Association of Insurance Supervisors will bring even more changes to how we operate and report our numbers in future years.