

OSFI Announces Major Reinsurance Regulatory Reforms

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In 2008, the Office of the Superintendent of Financial Institutions (“OSFI”) launched a comprehensive policy review of its regulatory and supervisory approach to reinsurance. Through this review, OSFI concluded it was necessary to update its reinsurance governance framework. In addition to repealing the reinsurance regulations which will result in the elimination of the 25% unregistered reinsurance limit and the 75% registered reinsurance limit, this update to the reinsurance governance framework is to include substantial changes to *Guideline B-3: Sound Reinsurance Practices and Procedure* (“Guideline B-3”) (formerly the *Guideline on Unregistered Reinsurance*) as well as the adoption of the use of reinsurance security agreements in the place of standard form reinsurance trust agreements in order for a Canadian cedant to take credit for the reinsurance it has ceded.

Part I of this e-Communiqué reviews in brief the proposed draft of the amended Guideline B-3 released by OSFI on August 6, 2010 for review and comment. Part II provides a summary of the *Draft Guidance for Reinsurance Security Agreements* (“Draft Guidance”), released by OSFI on August 9, 2010 for review and comment.

PART I - Draft Guideline B-3

Guideline B-3 sets out OSFI’s current expectations with respect to sound reinsurance risk management practices and procedures, and applies to all federally regulated insurers, including life insurers and property and casualty insurers. Guideline B-3 is an attempt to move the reinsurance governance framework from a rules-based approach to a principles-based approach.

A. Key Principles

Guideline B-3 sets out OSFI’s expectations for risk management practices and procedures regarding the use of reinsurance in Canada. The following reinsurance principles, which are intended to provide guidance to insurers in developing an approach to managing reinsurance risk:

1. *An insurer should have a sound and comprehensive reinsurance risk management plan (“RRMP”), subject to oversight by the Insurer’s Board of Directors and implementation by senior management.*

RRMP

An insurer’s RRMP should be an integral part of its overall enterprise-wide risk management plan and procedures, and should reflect the scale, nature and complexity of the insurer’s business. The RRMP should also document the insurer’s objectives for seeking reinsurance, risk diversification objectives, risk concentration limits, ceding limits and the practices and procedures for managing and controlling its reinsurance risks.

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Specifically, the RRMP should detail the following:

- Insurer's policy on the use of registered and unregistered reinsurance;
- Roles and responsibilities for those charged with implementing the RRMP;
- Methodologies and processes for selecting, documenting, approving, implementing, monitoring and reporting on reinsurance arrangements; and
- Process for ensuring the RRMP is updated to reflect changing market conditions.

The insurer must assess the adequacy and effectiveness of the reinsurance arrangements under its RRMP as well as all material reinsurance contracts to ensure that exposures to large and catastrophic losses are adequately mitigated by reinsurance and that there are no gaps in reinsurance coverage. This may require the insurer to implement stress testing of extreme, yet plausible, scenarios to determine if the reinsurance arrangements are effective at mitigating losses to acceptable levels given the insurer's risk appetite and risk tolerance.

Generally, an insurer should not, in the normal course, cede 100% or substantially all of its risks in the main areas where it conducts business. An insurer may, however, cede 100% of a specific line of business or a particular type of risk that is ancillary to its core business.

Management Oversight

For a domestic company, the RRMP should be overseen by the Board (or a committee of the Board), and implemented by senior management. For a foreign company operating in Canada as a branch, the reinsurance managerial and governance standards should be applied to its Canadian operations through its Chief Agent and the senior management of its foreign head office responsible for the Canadian operations. At a minimum, the Board should review and approve the RRMP as part of its annual review of the enterprise-wide risk management plan. Senior management is responsible for ensuring that adequate resources are allocated for the operation of the RRMP and implemented by personnel charged with the day-to-day responsibility for the RRMP on an on-going basis. Senior management must have the appropriate experience and expertise to develop an RRMP and to establish internal controls and procedures to monitor the effectiveness of, and compliance with, the RRMP.

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- 2. An insurer should perform a sufficient level of due diligence on its reinsurance counterparties on an on-going basis to ensure that the insurer is aware of its counterparty risk and is able to assess and manage such risk.*

An insurer will now be required to perform and document due diligence on its reinsurer in order to assess and evaluate the ability of the reinsurer to meet its liabilities on an on-going basis. OSFI expects that an insurer should consider the reinsurer's:

- Claims payment record;
- Expected future claims obligations;
- Balance sheet strength;
- Funding resources, including its level of and access to capital;
- Management, including the quality of its governance practices; and
- Retrocession arrangements and the direct or indirect impact they may have on the insurer's own arrangement with the reinsurer.

OSFI requires the level of due diligence to be reflective of the level of exposure to the reinsurer (current or prospective), and expects an increased level of due diligence in respect of any reinsurance with an unregistered reinsurer. This evaluation, however, should not generally rely solely on third parties, including rating agencies or broker analysis and recommendations.

- 3. The terms and conditions of the reinsurance contact should provide clarity and certainty on reinsurance coverage.*

An insurer must have a process in place to ensure that a comprehensive, written and binding contract is executed for all reinsurance arrangements prior to the effective date of reinsurance coverage. OSFI requires that the terms and conditions of the reinsurance contract relating to Canadian risks be governed by Canadian law and any disputes arising out of the reinsurance contract should be heard in a Canada court. OSFI does recognize that situations may arise where a comprehensive reinsurance contract is only duly executed by the parties after the effective date, and the parties operate pursuant to a summary document such as a letter of proposal or binding letter of intent until the reinsurance contract is executed.

Where this is the case, the insurer should obtain contractually binding summary documents prior to the effective date of the reinsurance coverage, which should set out those material terms generally found in such agreements (i.e. premium, percentage of risk assumed, duration of coverage etc.). The insurer should also ensure that all

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comprehensive reinsurance contracts are executed by both the ceding company and the reinsurer within a relatively short timeframe having regard for the complexity and materiality of the agreement (e.g., within 120 days of execution).

4. *A ceding company, its policyholders and its creditors should not be adversely affected by the terms and conditions of a reinsurance contract.*

The terms and conditions of a binding reinsurance contract should include: insolvency clauses, off-set and funds withheld arrangements.

B. Guideline B-3 Administration

Insurers are required to maintain and provide to OSFI upon request, its RRMP and a complete description of all its reinsurance arrangements, including levels of reinsurance, the due diligence performed on reinsurance counterparties, and the proportion of registered and unregistered cessions. Any material change to an RRMP should be promptly reported to OSFI.

If an insurer fails to meet the principles set out in Guideline B-3, OSFI may not grant a capital/asset credit for the reinsurance, or may adjust the insurer's capital/asset requirements or target solvency ratios to compensate for reinsurance that is not wholly effective or reliable. Insurers may lose their status if they fail to meet the minimum expectations on sound reinsurance practices and procedures set out in Guideline B-3.

OSFI is targeting the release of the final version of Guideline B-3 in the fall of 2010, with the Guideline to be effective January 1, 2011, and to be coordinated with OSFI's recommendation to the Governor-in-Council to repeal the Regulations. OSFI has invited all interested parties to provide comment on Guideline B-3 by October 1, 2010. Comments may be provided through industry associations or directly to Mr. Philippe-A. Sarrazin by telephone: (613) 998-4190 or by email: Philippe.Sarrazin@osfi-bsif.gc.ca.

PART II - Reinsurance Security Agreements

As part of the overhaul of the reinsurance governance framework, OSFI has abandoned the use of standard form reinsurance trust agreements in favour of reinsurance security agreements. OSFI has had concerns for a number of years, based on legal opinions it had received, that assets vested in trust as security for reinsurance arrangements may not create valid security interests. In Ontario, generally a security interest is perfected by registering under the *Personal Property Security Act* (Ontario). Such a registration is not generally made against assets held in trust as security for reinsurance. The concern is that in the event of an insolvency, a challenge could be made against the assets held in trust. In order to address this concern, OSFI will require ceding companies to enter into reinsurance security agreements and create and maintain a valid first-ranking security interest in the assets of an

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unregistered reinsurer that are held in Canada. Ceding companies will also be required to provide a legal opinion addressed to the ceding company and OSFI, asserting that such an interest has been created in their favour.

OSFI has released the Draft Guidance, which sets out the minimum standards with respect to reinsurance security agreements and accompanying legal opinions. These minimum standards are generally outlined below.

A. Draft Guidance

Generally, a valid first-ranking security interest will be obtained by means of a reinsurance security agreement. OSFI will permit a capital/asset credit for reinsurance security agreements in certain circumstances where specific criteria are met, including:

- the assets of an unregistered reinsurer are pledged to the ceding company to secure the payment of the potential liabilities of the reinsurer under one or more reinsurance agreements pursuant to a binding and legally enforceable security agreement made under provincial law;
- pledged assets are held in Canada by a ‘Collateral Agent’, who must be a Canadian financial institution that is not affiliated to the unregistered reinsurer;
- the ceding company must create and maintain a valid first-ranking security interest in the collateral;
- the ceding company must have the right to liquidate or take legal possession of these assets in the event of the default of the reinsurer; and
- the ceding company provides OSFI with a legal opinion, addressed to the ceding company and OSFI.

B. Minimum Standards for Security Agreement

OSFI will require reinsurance security agreements to contain all terms and conditions that are standard to security agreements (i.e. the creation of the security interest, maintenance of separate and distinct accounts, events of default, remedies upon default, etc.). In addition to these standard terms and conditions, OSFI expects that security agreements for security held in Canada to include certain other required terms, including:

- a reference to the applicable provincial statute pursuant to which the security agreement is made;
- that the pledged assets shall be held in the province pursuant to which the security agreement is made; and

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- that the ‘Collateral Agent’, acting as agent for the ceding company, shall file with OSFI, for and on behalf of the ceding company, a duly completed declaration together with all the related information as required below.

C. Minimum Standards for Legal Opinion

A ceding company must provide OSFI with a legal opinion in order to take credit for the reinsurance ceded. The legal opinion addressed to the ceding company and OSFI must provide, among other things:

- an assertion that the security interest in the pledged assets is valid and enforceable against all other creditors of the unregistered reinsurer, including in the event of insolvency;
- a statement as to the validity and enforceability of the security interest in the context of the applicable rules governing conflict of laws; and
- an assertion that a first-ranking priority is created by such security interest.

D. Implementation and Supervision

All newly entered security agreements should follow this new approach beginning January 1, 2011. OSFI recognizes this transition will take time, however expects that all existing reinsurance trust agreements will be replaced by January 1, 2012.

OSFI requires regular reporting with respect to market value of assets subject to each reinsurance security agreement, which shall involve the “Collateral Agent” of the ceding company filing with OSFI’s Securities Administration Unit a prescribed declaration as well as certain information, including the market value of individual assets held by the ‘Collateral Agent’ under the specific reinsurance security agreement as at the close of business of the ‘Collateral Agent’s’ last business day in the immediately preceding month.

PART III – Implications for Insurers and Reinsurers

The changes resulting from the elimination of the 25% and 75% limits on reinsurance as well as the introduction of the draft Guideline B-3 and the Draft Guidance will have a significant effect on insurers and reinsurers doing business in Canada.

OSFI anticipates that there could be a significant increase in the use of unregistered reinsurance as a result of these reinsurance reforms. As a result, OSFI will be more vigilant in its oversight of reinsurance programs. Guideline B-3 will require an insurer to provide more disclosure and transparency in its reinsurance programs. An insurer will need to:

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1. Immediately adopt a RRMP (similar to the outsourcing, capital management and investment policies it has adopted) ensuring compliance with OSFI's guidelines and requirements, which RRMP must be then approved by the Board. Although the draft Guideline B-3 was put to the industry for consultation, it is likely that OSFI will implement Guideline B-3 with only minor changes. Therefore, insurers should develop their RRMP based on the current draft of Guideline B-3.
2. Conduct sufficient due diligence, and maintain documentation regarding its due diligence efforts, of its reinsurance partners in order to be certain their reinsurance arrangements comply with Guideline B-3 and that it will be able to prove any required attestation. However OSFI has not provided guidance regarding its expectation with respect to this investigation, other than to require that insurers not rely solely on third party reports.
3. Ensure that a senior officer declares annually to the Board that its reinsurance risk management practices and procedures meet the standards set out in Guideline B-3 and provide to OSFI annually an attestation that the reinsurance arrangements are properly documented and binding and that all reinsurance arrangements with related parties are on terms and conditions at least as favourable to the insurer as market terms and conditions.
4. Ensure that all January 1, 2011 renewal reinsurance arrangements are compliant with Guideline B-3. As there will be no grandfathering of existing reinsurance arrangements pursuant to Guideline B-3; all reinsurance arrangements will be subject to the new requirements when they come into effect, which is anticipated will be January 1, 2011. Therefore, all January 1, 2011 renewals (which in reality will be placed during October and November of 2010), must be in compliance with Guideline B-3. In addition, all existing reinsurance trust agreements must be converted to reinsurance security agreements by January 1, 2012.

Although the 25% and 75% limits on reinsurance have been eliminated, it is unclear as to how much unregistered reinsurance will be used and what forms of security will be placed. Guideline B-3 linked capital credits with the amount, quality and type of reinsurance obtained. However, no specific guidance was provided with respect to its effect on capital. For example there has been no guidance on what, if any, capital charges will be imposed and their effect on either the MCT or BAAT. Therefore, until OSFI releases new guidance on MCT or BAAT, it will be difficult to assess what reinsurance to use because of the risk of an increase in capital charges.

The Draft Guidance made it clear that the standard form reinsurance trust agreement will no longer be able to be used by cedants, and OSFI will not be a party to the new reinsurance security agreements – presumably because it wished to avoid being drawn into

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disputes regarding priority of security interests relating to the assets held in trust. Although OSFI has provided guidance as to the content of the reinsurance security agreement, the adoption of a true third party security agreement will introduce a greater level of complexity and uncertainty. Insurers will be required to negotiate the terms of each reinsurance security agreement, which could potentially lead to more complicated security agreements and longer timelines in putting reinsurance arrangements into place. In addition, there is uncertainty as to what OSFI may find acceptable in terms of the actual provisions of the reinsurance security agreements. Further, OSFI has the ability to challenge the form of a negotiated reinsurance security agreement, even after it has been entered into by the parties. However, over time precedent reinsurance security agreements will be developed and used in future reinsurance security arrangements. On a practical level, it is important to note that the amount of actual security required will not change.

The Draft Guidance also provides that insurers will be required to obtain a legal opinion asserting that a valid first-ranking security interest has been created in their favour and that that security interest is legally enforceable. Obtaining such a legal opinion is a costly and time consuming additional requirement that insurers must consider when ceding insurance to a reinsurer.

Lastly, it is important to note that some foreign head office jurisdictions that permit the vesting of assets in trust accounts in Canada may not permit the creation of a charge or security interest against its assets because it would create a first-ranking security interest in another jurisdiction.

Despite all of these reforms to the Canadian reinsurance regime, it is likely that both registered and unregistered reinsurance will continue to be placed in Canada in generally the same manner as they have always been placed. Industry players anticipate these changes will result in an increased use of unregistered reinsurance; however, any such increase will largely depend upon the capital charges that OSFI will impose. It stands to reason that if a high capital charge is imposed, it is unlikely that the industry will see a marked increase in the use of unregistered reinsurance; particularly if there is available capacity in the Canadian registered reinsurance market.