

OSFI Releases Final Reinsurance Guidelines

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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. As a result of this review, OSFI concluded that it was necessary to update its reinsurance governance framework. It was announced that this update would include the repeal of the reinsurance regulations, eliminating the 25% unregistered reinsurance limit and the 75% registered reinsurance limit.

In August 2010, OSFI released: (1) *Draft Guideline B-3: Sound Reinsurance Practices and Procedures* (“Draft Guideline B-3”), which set out OSFI’s expectations respecting sound reinsurance risk management practices and procedures and represented substantial changes to the former *Guideline on Unregistered Reinsurance*; and (2) *Draft Guidance for Reinsurance Security Agreements* (“Draft Guidance”), which set out OSFI’s minimum standards respecting collateral secured through the establishment of a reinsurance security agreement (“RSA”). The Draft Guidance also represented the adoption of the use of RSAs in place of the standard form reinsurance trust agreements in order for a federally regulated insurer to take credit for the reinsurance it has ceded to an unregistered reinsurer. We published an *e-COMMUNIQUÉ* dated August 9, 2010 summarizing the Draft Guideline B-3 and the Draft Guidance, which may be accessed by clicking [here](#).

On December 24, 2010, OSFI released: (1) *Guideline B-3 Sound Reinsurance Practices and Procedures* (“Guideline B-3”), the final form of the Draft Guideline B-3; and (2) *Guidance for Reinsurance Security Agreements* (“Guidance RSA”), the final form of the Draft Guidance. Guideline B-3 and Guidance RSA apply to all federally regulated insurers (including life insurers and property and casualty insurers, domestic insurers and foreign insurers in respect of their insurance business in Canada), registered reinsurers and fraternal benefit societies (collectively, “FRIs”), that are party to reinsurance cessions, retrocessions and, where applicable, to assumption reinsurance transactions.

Part I of this *e-COMMUNIQUÉ* sets out the required timing for implementation of the new reinsurance guidelines; Part II reviews in brief Guideline B-3, with a focus on the changes from the Draft Guideline B-3; Part III reviews in brief Guidance RSA, with a focus on the changes from the Draft Guidance; and Part IV sets out certain practical considerations for insurers and reinsurers.

PART I: Implementation

Guideline B-3

- OSFI encourages each FRI to implement the principles and expectations of Guideline B-3 as soon as practically possible. OSFI expects that each FRI will adopt, secure approval of the FRI’s board of directors (the “Board”), and implement a sound and comprehensive reinsurance risk management policy (“RRMP”) by July 1, 2011. Each

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FRI should file the approved copy of the RRMP with its designated Relationship Manager. Once the RRMP has been approved by the FRI, the FRI is expected to fully comply with the remaining principles of and implement Guideline B-3 (including the filing of its first reinsurance declaration to the FRI's Board) by July 1, 2012.

- For existing multi-year contracts that do not come-up naturally for renewal before July 1, 2012, OSFI expects the FRI to take all commercially reasonable efforts to ensure that these contracts are compliant with Guideline B-3 by July 1, 2012.
- Any FRI that has ceded business to an unregistered related party for which approval of the Superintendent had previously been obtained need not seek a new Superintendent approval so long as the only amendments to the cession agreements are to reflect the expectations set out in Guideline B-3.

Guidance RSA

- Ceding companies are encouraged to take steps to enter into RSAs that meet Guidance RSA's requirements as soon as possible. All new RSAs should comply with Guidance RSA beginning July 1, 2011 and OSFI expects FRIs to take all commercially reasonable efforts to replace existing multi-year agreements that do not naturally come-up for renewal before January 1, 2012.
- The designated OSFI Relationship Manager will follow each ceding FRI's efforts and progress.

Part II: Guideline B-3 – Changes from the Draft Guideline B-3

OSFI sets out in Guideline B-3 its key reinsurance principles, which are intended to provide guidance to insurers and reinsurers in developing an approach to managing reinsurance risks. We have set out below the changes in respect of each of the four key principles from the Draft Guideline B-3:

1. *An FRI should have a sound and comprehensive reinsurance risk management policy subject to oversight by the FRI's Board of Directors and implementation by senior management.*
 - OSFI now requires FRIs to implement a reinsurance risk management policy rather than a reinsurance risk management plan. A policy is a set of guidelines and rules whereas a plan is a set of actions to be undertaken. Reflecting a more principled-based approach to reinsurance, FRIs are no longer required to detail within the RRMP the methodologies and processes for selecting, documenting, approving, implementing, monitoring and reporting on

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reinsurance arrangements. FRIs are required to implement an RRMP by July 1, 2011 and the RRMP must be approved by the FRI's Board.

- OSFI has clarified that, along with an FRI's Board, it is now the responsibility of an FRI's senior management to ensure that appropriate policies, procedures and internal controls exist to monitor the effectiveness of, and operational compliance with, the RRMP on an on-going basis.
2. *An FRI should perform a sufficient level of due diligence on its reinsurance counterparties on an on-going basis to ensure that the FRI is aware of its counterparty risk and is able to assess and manage such risk.*
- OSFI clarified that the level of due diligence required of any reinsurance counterparty (i.e. either an FRI cedant of its reinsurer or of an FRI reinsurer of its cedant) should be commensurate with its level of exposure to that counterparty. The level of due diligence should not be any less thorough if the counterparty is a related party of the FRI.
 - OSFI continued to reiterate that when an FRI is conducting this due diligence, it should not generally rely solely on third parties, including rating agency assessments, or broker analysis and assessments. An FRI is expected, to an extent proportional to the importance of such counterparty, to conduct its own due diligence on the financial strength and capabilities of all reinsurance counterparties.
 - Any outsourcing of the due diligence function to a third party must be in accordance with OSFI's *Guideline B-10: Outsourcing of Business Activities, Functions and Processes*.
3. *The terms and conditions of the reinsurance contract should provide clarity and certainty on reinsurance coverage.*
- OSFI acknowledges that there may be situations where it is necessary and appropriate for an FRI to enter into a supplemental or *subordinated* reinsurance contract, a side letter or other type of arrangement that is ancillary to and form part of the main reinsurance contract. In addition to ensuring that such arrangements meet the requirements of Guideline B-3, the FRI is expected to be transparent with its stakeholders regarding these arrangements, reflect the arrangements in its financial statements and ensure that these ancillary arrangements do not adversely impact the terms and conditions of the original reinsurance contract to the detriment of policyholders.

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- OSFI expects that all final comprehensive reinsurance contracts, including any amendments to such reinsurance contracts, bear the duly authorized signature of the ceding company and the reinsurer(s). OSFI would generally not consider an agreement bearing the signature of the reinsurance intermediary as acceptable unless the intermediary can support a finding that it has authority to act for, or on behalf of, the cedant or the reinsurer, as the case may be.
4. *A ceding FRI should not be adversely affected by the terms and conditions of a reinsurance contract.*
- This key principle has been revised to provide that *a ceding FRI* should not be adversely affected by the terms and conditions of a reinsurance contract.
 - OSFI expects all contracts related to reinsurance coverage expressly provide a choice of forum, a choice of law and the appointment of agents for service of legal processes. Although OSFI prefers that reinsurance contracts and any disputes arising from such contracts are subject to the laws and courts of a Canadian province, an FRI is permitted to select the laws and courts of another jurisdiction. However, any such other jurisdiction stipulated within a reinsurance contract as the proper law and forum for disputes arising from that reinsurance contract must be, in the reasonable opinion of the FRI, a jurisdiction of equivalent or greater reliability and have a natural connection to the transaction. Under the Draft Guideline B-3, an FRI would have had to seek OSFI's approval respecting such other jurisdiction, which is no longer the case.
 - OSFI continues to expressly state that all reinsurance contracts should include an insolvency clause so that funds will be available to cover policyholder claims in the event of a cedant's or reinsurer's insolvency. In particular, the insolvency clause should ensure that the reinsurer is required to continue to make full payments to an insolvent cedant without any reduction resulting solely from the cedant's insolvency. Such a clause provides greater certainty that reinsurance receivables remain within the overall general estate of the insolvent ceding company, or as part of the assets in Canada of a foreign insurance company as defined under the *Winding-Up and Restructuring Act (Canada)* and the *Insurance Companies Act (Canada)*, rather than being allocated toward the payment of specific claims of creditors or policyholders.
 - Reinsurance contracts should not contain terms or conditions that limit a troubled or insolvent cedant's ability to enforce the contractual obligations of a reinsurer or that may adversely affect the treatment of any claims in respect of the cedant's policyholders. Reinsurers and cedants should pay "particular

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attention” to the “appropriate” use of off-set or cut-through clauses, the structure of “funds withheld arrangements” and such other types of terms or conditions that may frustrate the scheme or priorities under the *Winding-Up and Restructuring Act (Canada)*. OSFI has specifically recognized that there may be situations where the interests of a ceding FRI and its policyholders may be better served by the use of off-set and cut-through clauses. OSFI will not restrict the use of such terms or conditions where they do not give preferential treatment over other claims under the scheme of distribution in the *Winding-Up and Restructuring Act (Canada)*.

- If a reinsurance contract provides for a “funds withheld arrangement,” such reinsurance contract must clearly provide that, in the event of the cedant’s or reinsurer’s insolvency, the funds withheld, less any surplus due back to the reinsurer, must form part of the property of the cedant’s general estate, or part of the assets in Canada of a foreign insurance company as defined under the *Winding-Up and Restructuring Act (Canada)* and the *Insurance Companies Act (Canada)*.

5. Guideline Administration

- A FRI is no longer required to report a material change to its RRMP; however, it must promptly inform OSFI if it becomes aware of any reinsurance issues that could materially impact its financial condition.
- A senior officer of an FRI should make annual reinsurance declarations confirming that the FRI’s reinsurance risk management practices and procedures meet Guideline B-3’s standards, except as specifically set out in the declaration. The declaration should also include an attestation that the FRI’s reinsurance arrangements effect a risk transfer and *they are accounted for in the appropriate manner*. No longer is Guideline B-3 specifically requiring an attestation that the FRI’s reinsurance arrangements are properly documented and binding and that any arrangements with related parties are on terms and conditions at least as favourable to the FRI as market terms and conditions. Any deviations set out in the declaration must detail the nature and extent of the deviation, measures taken or proposed to correct or mitigate the risk associated with the deviation and should be documented and disclosed to the Board and OSFI in full.

PART III: Guidance RSA – Changes from the Draft Guidance

The Guidance sets out OSFI’s minimum standards with respect to collateral secured through the establishment of a Reinsurance Security Agreement. We have set out below the

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changes from the Draft Guidance in respect of the minimum standards and expectations of OSFI with respect to reinsurance security agreements:

Valid and Enforceable Security Interest

- A capital/asset credit in respect of unregistered reinsurance is allowed where a ceding FRI obtains and maintains a valid and enforceable security interest in collateral held in Canada supporting reinsurance ceded to an unregistered reinsurer that has priority over any other security interest in such collateral.
- A legal opinion must be obtained by the ceding FRI confirming that a valid and enforceable security interest (one that has priority over any other security interests of creditors in the pledged assets) has been or will be created in the ceding FRI's favour (subject to customary and appropriate qualifications). OSFI must be able to rely on the opinion and a copy of the RSA must be filed with OSFI within 15 days of the ceding FRI obtaining the opinion.
- Where a new type of asset not already covered by the legal opinion is approved by a ceding FRI, OSFI expects the ceding FRI will obtain an additional legal opinion asserting that, with respect to the new type of asset, a valid and enforceable security interest has been or will be created in the ceding FRI's favour.

Reinsurance Security Policy

- A ceding FRI should have a Board (or Board committee) approved policy requiring management to confirm to the Board (or Board committee) every two years (at a minimum) that a valid and enforceable security interest (one that has priority over any other security interest in the pledged assets) continues to be created in the ceding FRI's favour, including where changes have been made to personal property security legislation or securities transfer legislation in the province or territory of Canada where the assets are held. The confirmation must state that the legal opinion may still be relied upon or that subsequent changes to the legislation do not affect the validity of the opinion, or alternatively, a new opinion can be provided.
- OSFI has eliminated the list of acceptable assets to be pledged (Schedule A to the Draft Guidelines) and will not be providing such a scheduled list of approved assets to be pledged, but will expect the ceding FRI to exercise a prudent person standard when determining the types of assets it will accept as pledged assets. OSFI expects that the FRI's policy regarding reinsurance security arrangements will reference the types of "prudentially acceptable pledged assets and the limits" (e.g. credit ratings as outlined in the capital/asset guidelines; counterparty concentrations; foreign denominated securities) as well as the practices and procedures for managing and controlling risks

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related to the pledged assets. In particular, this Reinsurance Security Policy should also likely include an investment policy relating to the assets that can be pledged.

Collateral Agent and Monthly Reporting

- It is no longer a minimum requirement of an RSA that it:
 - State the ‘Collateral Agent’ will act solely as agent for the ceding company and not as agent for the reinsurer; or
 - Provide that the pledged assets will be held by the ‘Collateral Agent’ in one or more accounts identified in its records as separate and distinct from other accounts of the ‘Collateral Agent.’
- FRIs are now required to cause their ‘Collateral Agent’ to provide (both in an electronic and paper format) a specified form of declaration to OSFI’s Securities Administration Unit monthly (on or before the 15th day of each month or at some other time as requested by notice in writing) with respect to the market value of the individual assets held by the Collateral Agent under each RSA as at the close of business of the Collateral Agent’s last business day in the immediately preceding month. The filing of such a declaration remains the responsibility of the ceding FRI.

PART IV: Practical Considerations

- If a ceding FRI does not comply strictly to the principles of Guideline B-3 when structuring its RRMP or negotiating reinsurance contracts, OSFI, on a case by case basis, may not grant a capital/asset credit for the reinsurance arrangement or may, commensurate with risk, use its discretionary authority to adjust the FRI’s capital asset requirement or target solvency ratios. Federally approved provincial reinsurers may lose their status if they fail to meet the standards set out in Guideline B-3.
- As OSFI is not a party to the RSA, ceding FRIs and their reinsurance counterparty do not need to obtain approval from their designated Relationship Manager (or such other person as required by OSFI) for the withdrawal of pledged assets or for any transaction involving foreign currency assets. A ceding company should negotiate in its RSA the terms and conditions of an investment policy relating to the pledged assets.
- Many cedants and unlicensed reinsurers have expressed concerns about the new rules and the uncertainty regarding them. It is our expectation that once the new forms of reinsurance security agreement and legal opinions have become standardized, these new arrangements will be relatively easy to implement.
- Although OSFI has introduced a significantly different set of rules regarding the form of agreement and arrangements necessary in order for a cedant to be able to take credit

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for unlicensed reinsurance, it is unlikely that that they will result in fundamental changes regarding how unlicensed reinsurance is used in Canada.

We have worked closely with OSFI and other parties over the past several weeks to finalize and implement documentation relating to a new reinsurance security arrangement in a form satisfactory to OSFI and would be pleased to assist you in your efforts to comply with the new OSFI Guidance for Reinsurance Security Agreements and Guideline B-3.

This *e-COMMUNIQUÉ* is published by the Insurance — Corporate & Regulatory Group at Cassels Brock to keep our clients and friends informed of new and important legal issues. It is not intended to provide legal advice as individual situations will differ and should be discussed with a lawyer.