Navigating Choppy Waters:
Part XIII

Canada’s solvency regulator, OSFI, has introduced changes to Part XIII of the Insurance Companies Act to clarify vesting of assets, but confusion about the clarification abounds.

Changes to Part XIII of the Insurance Companies Act (ICA) are scheduled to come into effect on Jan. 1, 2010. The basic test for what is considered to be a Canadian licensed policy will be changed from the location of risk to where the activity of insuring occurred (based on a number of factors mostly related to the interaction between the insurer and the insured). Most foreign insurers and reinsurers are now aware that the Part XIII changes are coming and they might have significant effect on their operations in Canada.

The Part XIII changes were intended to resolve a relatively simple issue. The Office of the Superintendent of Financial Institutions (OSFI) was concerned that the concept of a “policy in Canada” in the ICA was different than the concept of “insurance business in Canada” in the Winding-Up and Restructuring Act (WURA), thus resulting in misalignment between the two pieces of legislation. The concern was that the misalignment might result in problems in the event of an insolvency of a foreign insurer or reinsurer. Pursuant to the ICA, the vesting of assets was being made by foreign insurers and reinsurers for most risks located in Canada. However, if an insolvency occurred, foreign policyholders could also make a claim under the WURA for part of the vested assets under OSFI’s control to the extent that they had been insured in Canada as part of the insurance activities in Canada of the foreign insurer or reinsurer. Under such circumstances, there might not be sufficient vested assets for all of the liabilities to Canadian policyholders to be satisfied.

The Part XIII changes were, among other things, made to clarify the vesting regime in the ICA and align it with the winding-up regime in the WURA. The Part XIII changes were intended to ensure that there would be vesting of assets
for risks located outside of Canada but insured in Canada and to move to a uniform "location of business regime."

OSFI attempted to provide clarity on how the Part XIII changes will be implemented by issuing an advisory on the Insurance in Canada of Risks in September 2007. The approach OSFI takes in the advisory is based on the common law test for carrying on business and for the formation of contracts. It reflects a number of traditional tests that have been used (particularly by Canada Revenue Agency) to determine whether a foreign company is carrying on business in Canada. These tests include criteria such as the location of the subject matter of the contract, where the offer and acceptance of the contract occurs and whether the foreign company maintains a permanent establishment (usually an office) in Canada.

At the National Insurance Conference of Canada in Ottawa-Gatineau in early October, Philippe Sarrazin, the director of legislation and policy initiatives at OSFI, made a number of useful comments about the implementation of Part XIII. Sarrazin advised it is generally only necessary for two of the four criteria listed in Section 2 of the advisory to be met in order for a policy to be considered to be the insurance in Canada of a risk. It is still uncertain which of the criteria in that section should be given greater importance. OSFI has indicated one of the most important criteria is whether some of the negotiation or interaction with

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Much of the uncertainty with respect to the Part XIII changes comes as a result of how the four criteria included in Section 2 of the advisory should be applied to the business models of Canadian branches of foreign insurers and reinsurers. Many foreign insurers and reinsurers are operating in Canada through local branches, each of which has a slightly different business model.

PART XIII ISSUES
A number of different issues have been identified with respect to the implementation of Part XIII. These issues include the following:

Interpretation of the advisory
Part of the uncertainty with respect to the Part XIII changes has occurred as a result of certain ambiguities in the advisory.
respect to a policy will have actually occurred in Canada. However, it is still uncertain which of the other criteria would also be considered to have significant importance. It appears that the flexibility of the criteria listed in the Advisory — criteria that were intended to reflect the fact that foreign insurers and reinsurers operate in Canada using many different business models — has resulted in some of the uncertainty about how the Part XIII changes will be implemented.

Audit issues
It might be difficult for foreign insurers and reinsurers to be able to obtain sufficient information in order to provide an audit confirmation. This audit confirmation would support a decision either to include or exclude a policy for the purpose of OSFI reporting.

No grandfathering
The lack of any grandfathering for risks written prior to the implementation of the Part XIII changes is a major issue. It will likely be relatively easy for a majority of foreign companies to determine whether risks written after Jan. 1, 2010 should be reported to OSFI. However, there may be significant difficulties in making an appropriate determination for policies written prior to that date, due to a lack of information being available.

Release of vested assets
Most cedents would assume that if they are reinsured by a reinsurer with a licensed Canadian branch, they would have licensed reinsurance. But if the reinsurance was underwritten and negotiated entirely outside of Canada, it would be required to be excluded under the Part XIII changes. The result is that the foreign reinsurer might be able to obtain a release of its vested assets and the Canadian cedent would lose its security. Under such circumstances, it would be necessary for alternative security — such as an unlicensed reinsurer trust account — to be arranged. OSFI will soon notify cedents of this fact — a year in advance of the coming into force of the provisions.

Multiple jurisdiction reporting
One possible result of the Part XIII changes is that policies might have to be reported in more than one jurisdiction. For example, it will be necessary for a foreign insurer that insures a U.S. risk from its Canadian branch to report the business to OSFI. However, the reporting rules in the United States — if they are based on the location of the risk — might also require the business to be reported.

Lack of harmonization
There is a lack of harmonization between the definition of “carrying on business” in provincial insurance legislation and the “insuring in Canada of a risk” as provided in the Advisory.

For example, it is possible that a foreign insurer might not meet a sufficient number of criteria under the Advisory to be considered to be “insuring in Canada of a risk.” But the provincial definition of “carrying on business” is broader and would partially cover activities not included under the Advisory, such as delivering a policy into Canada.

Tax issues
There are numerous tax issues with respect to implementation of the Part XIII changes. Provincial premium tax is assessed based upon the location of the risk, not where the underwriting occurs. As a result, foreign insurers and reinsurers would be required to keep two sets of books in order to do both regulatory and tax reporting.

The provinces have traditionally relied on OSFI reporting as the basis for determining premium tax obligations. The Part XIII changes might make it more difficult for the provinces to be able to track premium tax obligations.

Systems changes
There will likely need to be systems changes made by many companies in order to be able to comply with the Part XIII changes. System changes can take long periods of time to be implemented; it will therefore be important to determine as soon as possible what changes are actually required to be made.

**APPROACHES TO OBTAINING CERTAINTY**

It will be important to achieve certainty about whether a policy or reinsurance agreement is actually licensed. Previously it was simple to confirm a company’s licensing status by reviewing the OSFI Web site. Now, however, based on the Part XIII changes, it might be necessary for policyholders to ask a number of questions in order to determine the licensing status of a company. This type of approach is awkward and would not be practical under most circumstances.

Many foreign insurers and reinsurers
are uncertain whether their business models will comply with the criteria in the Advisory. The following available alternatives might help to obtain some level of certainty:

**Participating in the IBC process**
In an attempt to obtain more certainty with respect to how the advisory should be applied, the Insurance Bureau of Canada (IBC) has provided OSFI with some sample business models and asked OSFI to comment on them. IBC’s approach has been on a no-names basis and may not be binding on OSFI. In particular, some questions being asked are general in nature and may not be sufficiently specific to provide certainty with respect to the particular business model of a specific company.

**Obtaining a ruling from OSFI**
Sarrizin has confirmed it is possible for a foreign insurer or reinsurer to obtain a ruling or interpretation from OSFI with respect to its business model. However, it is likely OSFI will only be able to process a relatively small number of rulings during the period leading up to Jan. 1, 2010 and could easily become backlogged with requests.

**Obtaining a legal opinion**
Sarrizin has encouraged foreign insurers and reinsurers to obtain a legal opinion with respect to their business models. A legal opinion will provide some level of certainty to a foreign insurer or reinsurer, as well as a good faith defence in the event that OSFI challenges the status of the business model of the company. However, a legal opinion will always be limited in its usefulness since OSFI will retain discretion as a regulator to provide its own interpretation of the applicable facts.

**Court application**
It is possible an application could be made to the courts to obtain their interpretation or a declaration with respect to how Part XIII would apply to a particular business model. Court applications would be expensive and time-consuming. In addition, they still might not provide total certainty, since the courts would likely want to provide deference to OSFI with respect to regulatory matters. It is likely court applications would only be used in situations in which: (1) there was a major disagreement with OSFI, or (2) a bankruptcy had occurred.

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**NEXT STEPS**
Sarrizin has advised that OSFI will be flexible with respect to how foreign insurers and reinsurers comply with the Part XIII changes. He has suggested that companies should adjust their business models to either minimize or take advantage of the effects of the Part XIII changes.

Once the dust has settled, it is likely Part XIII changes will result in greater certainty for foreign insurers and reinsurers with respect to their Canadian licensing status and reporting obligations. However, it is possible that a lengthy adjustment period will occur for many companies; a certain degree of uncertainty may be inevitable.

Sarrizin has announced that OSFI will release transition instructions towards the end of 2008. These instructions are intended to provide guidance to foreign insurers and reinsurers with respect to their reporting obligations under the Part XIII changes. They may also provide some additional clarification with respect to OSFI’s expectations for the reporting of business.

It is likely the vast majority of insurers and reinsurers currently operating Canadian branches will want to remain licensed in Canada and continue their business on as much as of status quo basis as possible. As a result of the Part XIII changes, it may be easier for certain foreign insurers and reinsurers to insure risks located in Canada on an unlicensed basis. However, they still might have to be licensed due to provincial insurance regulatory requirements. In addition, the clients of the unlicensed insurers will be required to pay excise tax. Also, Canadian insurers will still be subject to the limitations of the Reinsurance Regulations, which prohibit ceding more than 25% of premiums to unlicensed reinsurers.

Total certainty for many foreign insurers and reinsurers may not be possible with respect to the Part XIII changes. OSFI will likely provide more guidance with respect to its expectations on reporting of business prior to Jan. 1, 2010.

The Part XIII changes will ultimately be implemented and everyone will learn to live with the new reporting system. However, foreign insurers and reinsurers should expect to experience at least some choppy waters before calm weather once again returns. 

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