



## The New Canadian Reinsurance Landscape

April 1, 2010

The Office of the Superintendent of Financial Institutions (“**OSFI**”) issued on March 31, 2010 its Response Paper: Reforming OSFI’s Regulatory and Supervisory Regime for Reinsurance to the Discussion Paper on OSFI’s Regulatory and Supervisory Approach to Reinsurance released in December 2008. This Response Paper outlines OSFI’s policy decisions and impending reforms to its reinsurance regulatory and supervisory framework. OSFI anticipates being in a position to implement many of the proposed changes to its reinsurance regulatory and supervisory framework applicable to federally regulated insurers and reinsurers by the end of 2010. Until such implementation, however, existing OSFI rules and regulations remain in effect. OSFI does expect insurers and reinsurers to take into account the pending changes in their planning and business activities in order to be prepared for the changes.

The Response Paper represents the results of a lengthy review by OSFI of how reinsurance is regulated and involved a significant amount of consultation with insurers and reinsurers in Canada. The changes announced in the Response Paper are broad and will have a significant effect on both insurers and reinsurers writing Canadian business in the future.

### A. OSFI’s REFORMS:

The key areas of change are as follows:

#### 1. Elimination of the 25% Unregistered Reinsurance Limit

Under the current *Reinsurance (Canadian Companies) Regulations* and the *Reinsurance (Foreign Companies) Regulations* (together, the “**Reinsurance Regulations**”), a federally regulated property and casualty insurer cannot cause itself in any year to be reinsured by unregistered reinsurers against more than 25 percent of its risks insured (the “**25% limit**”).

OSFI will recommend changes to the Reinsurance Regulations to repeal in its entirety the 25% limit once certain prudential regulatory and supervisory safeguards are established. In particular, OSFI will be revising Guideline B-3 to be renamed Guideline on Sound Reinsurance Practices and Procedures (“Guideline B-3”) so that, among other things, insurance companies are explicitly required to consider the likelihood of recoverability of reinsurance claims from registered and unregistered cessions as part of the insurer’s overall risk management program. In addition, insurers will be required to provide to OSFI, if requested, a description of all their reinsurance arrangements,



including the levels of reinsurance and the proportion of registered and unregistered cessions.

OSFI is targeting revising and reinstating Guideline B-3 and adopting a new reporting regime for reinsurance by the end of 2010. OSFI will then recommend the repealing of the 25% limit from the regulations at the first available opportunity.

## **2. Elimination of the 75% Fronting Limit**

Under the Reinsurance Regulations, a property and casualty insurer cannot cede more than 75% of all its risks insured in any given year (the "**75% fronting limit**").

OSFI will recommend repealing the 75% fronting limit once certain regulatory and supervisory protections are in place; including:

- Guideline B-3 will be revised to explicitly set out OSFI's expectations with respect to insurance fronting/ceding arrangements and underlying underwriting standards for federally regulated ceding insurers;
- Insurers will be required to disclose all fronting/ceding arrangements to OSFI, if requested;
- A minimum operational risk capital requirement will be imposed on property and casualty insurers in the Minimum Capital Test ("**MCT**") that is parallel to the one being imposed on life insurers through the Minimum Continuing Capital and Surplus Requirements ("**MCCSR**").

OSFI is targeting revising and reinstating Guideline B-3 and adopting new disclosure requirements for fronting arrangements by the end of 2010. OSFI will then recommend the repealing of the 75% fronting limit from the regulations at the first available opportunity. OSFI will also implement a gross minimum capital requirement in the next round of general amendments to the MCT, which is scheduled for 2012.

## **3. Introduction of MCCSR Capital Charge for Reserves Ceded to Registered Reinsurers**

Under the existing MCCSR guideline, life insurers are not required to hold any capital for recoverables from federally regulated insurers or approved provincial reinsurers. In addition, reserves ceded to such entities are not considered as a distinct asset with the MCCSR test, and are not subject to any capital charge.

OSFI has determined that a counterparty risk capital charge will be developed and applied to life insurers in the MCCSR, which charge will be implemented in the next round of amendments scheduled for 2012.



#### 4. More Reinsurance Governance

Corporate Governance for reinsurers is regulated by OSFI through three guidelines (one of which was recently revoked and another remains in draft).<sup>1</sup> OSFI believes that enhanced guidance is required to ensure an effective regulatory and supervisory regime for reinsurance. Guideline B-3 will apply to all insurance companies with respect to effective risk management practices and procedures (including underwriting) of insurers. Adequate internal controls will be required when originating and ceding insurance business. Pure fronting will not be acceptable. OSFI will now require that insurers integrate their reinsurance program into their broader enterprise-wide risk management practices and procedures. Specifically, the Board of Directors of insurance companies will be required to review and approve an insurer's overall reinsurance strategy, processes and procedures, and material reinsurance contracts. OSFI will also require an insurer to conduct some level of due diligence on the ability of its reinsurers (specifically unregistered reinsurers) to meet its claims obligations, in order to manage legal and counterparty risks. Furthermore, a ceding insurer will be required to consider, to the extent possible, the retrocession arrangements of its reinsurance partners.

The Guidelines will also stipulate that reinsurance agreements should be in writing and provide clarity and certainty in insurance coverage. The reinsurance contracts must be legally binding, be governed by Canadian laws, and not in any way adversely affect the Policyholder (for example, any insolvency clause must meet OSFI's expectations).

Finally, the new guidance set out in the revised Guidelines will be linked to OSFI's provision of a capital credit to ceding insurers. A capital credit will not be provided by OSFI to the federally regulated ceding insurer unless it meets the expectations set out in the new Guideline B-3. In addition, insurers may be asked to provide an attestation to OSFI (prior to receiving a capital credit) that the reinsurance arrangements meet the criteria outlined in the new Guideline B-3.

OSFI anticipates that the new Guideline B-3 will be issued by the end of 2010.

#### 5. Collateral Requirements NOT Changed and Mutual Recognition Postponed

If a company cedes its business to an unregistered reinsurer, it can enter into a contract with that reinsurer to maintain enough collateral to cover 100% of the ceded liability and the associated capital requirement for the ceding company. By posting such collateral,

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<sup>1</sup> Guideline on Corporate Governance, which is applicable to all federally regulated financial institutions and emphasizes the need for an effective Board of Directors and the development of sound risk management practices; Guideline B-3 (Unregistered Reinsurance -- revoked) which only applied to unregistered life reinsurance cessions; and Draft Guideline B-13 (Reinsurance Agreements) which addresses the issue of time lags between the initiation of a reinsurance arrangement and the execution of the definitive agreement.



the ceding insurer can avoid or reduce the regulatory capital/asset requirements associated with the business it underwrites.

OSFI is of the view that it would be imprudent to discontinue its collateral regime for unregistered reinsurance cessions at this time due to the recent financial crisis. OSFI will undertake developmental policy work to identify the issues and parameters associated with establishing a more sophisticated, graduated, and risk based capital/collateral framework for unregistered reinsurance. Such a regime would focus on the strength of the reinsurer and the protection provided by collateral and could allow some flexibility for a reinsurer to place a greater or lower amount of collateral in Canada based on the reinsurer's financial strength. Collateral requirements could also be replaced with a capital charge.

## **6. Types of Collateral and Increase Use of Letters of Credit**

OSFI promises to continue to review its capital rules and to assess its rules with respect to the quality of collateral that is being posted by unregistered reinsurers.

Currently, the MCCSR provides for reductions or haircuts in the credited value based on the type of collateral posted. In 2011, the MCCSR will require life insurers to capitalize for credit and market risk related to collateral rather than requiring a haircut.

There is no capital requirement for unregistered reinsurer default risk in the MCT. However, effective January 1, 2011, a 0.5% capital charge will be in place for letters of credit used to obtain a capital credit for unregistered reinsurance. Note that the use of letters of credit as collateral was until recently limited to 15% of the risks ceded to unregistered reinsurers. This limit was recently increased to 30% in both the MCCSR and MCT.

## **7. No Changes to Current Regulatory Approvals Regime**

OSFI does not plan to propose amendments to the regulatory approvals regime at this time. However, OSFI has indicated that it will re-examine the requirement for Superintendent's approval for unregistered related party reinsurance transactions once the new Guideline B-3 is in force.

## **B. IMPLICATIONS FOR INSURERS AND REINSURERS**

These reforms will have significant effect on insurers and reinsurers. Of note, the following will likely occur in the immediate term

- The removal of the 25% limit will likely result in the additional use of non-registered reinsurance. Insurers may introduce significant changes to their reinsurance models to include more unregistered reinsurance. OSFI has indicated that they will be closely monitoring the effects of such changes on the overall risk profile as a result of the increase in counterparty and legal risks. OSFI will exert its discretion to address situations deemed prudentially unsound.



It is important to note that the OSFI collateral requirements will still be in effect in order for a Canadian cedant to be able to take credit for the reinsurance.

- With the elimination of the 75% limit on licensed reinsurance, insurers can now abandon complicated and costly reinsurance arrangements and schemes between affiliated financial institutions. Insurers will be incentivized to establish simplified and more transparent reinsurance arrangements or pooling arrangements that may in fact reduce the risk to individual financial institutions. It is possible that more foreign insurers will attempt to rely on fronting arrangements rather than becoming directly licensed in Canada.
- OSFI will be more vigilant with respect to reinsurance programs. Guideline B-3 will require an insurer to provide more disclosure and transparency of its reinsurance arrangements.
- The linking of the capital credit with the quality and type of reinsurance obtained will force an insurer to due diligence its reinsurance partners so that the insurer can be certain that its reinsurance arrangements comply with Guideline B-3 and that it will be able to provide any required attestation.

The fact that there was no lessening of the collateral requirements for unregistered reinsurance should not be surprising to anyone. However, OSFI appears to have listened to the insurance community by recommending and implementing sweeping changes to the reinsurance regulations that recognize the international nature of reinsurance. OSFI is now providing more flexibility to federally regulated insurers to manage their own risk as they see fit, subject of course to OSFI's prudential oversight.

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