Discussion Paper on OSFI's Regulatory and Supervisory Approach to Reinsurance

Office of the Superintendent of Financial Institutions (OSFI)
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A. CONTEXT AND PURPOSE

Reinsurance is a key risk-mitigating tool that can provide business and economic benefits for primary insurers (and their policyholders) through risk diversification and the more efficient use of capital. It can reduce insurers' insolvency risk by stabilizing loss experience, increasing capacity, limiting exposure on specific risks, and/or protecting against catastrophes.

The majority of world reinsurance capacity is provided by a relatively small number of large global reinsurance enterprises operating out of select countries.[1] The Canadian reinsurance landscape reflects this trend and comprises mostly foreign-based enterprises, with only a limited number operating through a subsidiary and the majority conducting business in Canada through a branch. In some instances, business activities are performed directly from abroad.

Standards and practice in reinsurance regulation and supervision vary considerably around the world. Until recently, for example, reinsurers were not regulated at all in certain jurisdictions.[2] Given its international and increasingly complex nature, however, there is an acknowledgment on the part of regulators worldwide that the regulatory and supervisory approach to reinsurance needs to adapt to allow reinsurance companies to operate more effectively at the global level, while at the same time maintaining strong prudential safeguards to protect the financial system and policyholders.

The benefits of reinsurance are balanced with a need to address counterparty risk and the ability of the reinsurer to cover its obligations on a timely basis. Past experience has shown that unenforceable reinsurance contracts can contribute to the ultimate failure of an insurer. In particular, it is imperative for reinsurance contracts to be clear, and for the ceding insurer to adequately assess the strength of the reinsurer to whom it pays a premium, as well as the adequacy of the capital provision and/or vested assets associated with its assumed counterparty risk.

From the perspective of insurance supervision, regulators need to be cognizant of the accounting and actuarial treatment of reinsurance arrangements by all parties involved – i.e., that it is fair and consistent.[3] Regulators also need to be

[1] According to the International Association of Insurance Supervisors (IAIS), reinsurance companies in Bermuda, France, Germany, Ireland, Japan, Switzerland, the United Kingdom and the United States provide approximately 90 per cent of world reinsurance capacity.

[2] The IAIS, through various initiatives, and the European Union (EU), through the process to create common capital rules for insurance companies in the EU (i.e., "Solvency II"), have encouraged the adoption of regulatory and supervisory standards for reinsurance.

[3] It is particularly important that the appropriate parties are maintaining adequate financial resources commensurate with the risk of potential losses, and that the appropriate parties are benefiting from the corresponding capital relief as a result of the reinsurance.

wary that reinsurance can be used by insurers to avoid (or arbitrage) domestic valuation or capital requirements.

As well, regulators and ceding insurers should have some level of comfort that home regulators of reinsurers operating from abroad have robust regulatory and supervisory regimes, and can be relatively assured that the foreign reinsurers are in a position to cover their potential obligations to domestic insurers.

Recent developments in global markets have served as a stern reminder that insurers can face severe financial difficulties resulting from the business risks they assume. It has become increasingly clear that the regulation and supervision of insurers and reinsurers – whether operating in Canada directly or underwriting Canadian risks from abroad – should be balanced to reflect these risks.

The International Association of Insurance Supervisors (IAIS) recently published a paper that initiated the discussion on possible mutual recognition arrangements for reinsurance supervision. [4] The IAIS aims to provide further guidance in this area in the near future.

In tandem with the IAIS initiative, the National Association of Insurance Commissions (NAIC), which represents the fifty state insurance regulators of the United States (US), is currently examining proposals for revising its reinsurance regulatory and supervisory framework. Similarly, the Australian Prudential Regulation Authority (APRA) has finalized its position on possible refinements to general insurance (and reinsurance) regulation and supervision in Australia.[5] As well, the European Union (EU) implemented in 2007 its *Reinsurance Directive*, which harmonized reinsurance rules for EU member states.

With these international developments in mind, OSFI is of the view that it is appropriate to assess our own regulatory and supervisory approach to reinsurance. The purpose of this paper is to:

- Outline, in general terms, OSFI's current regulatory and supervisory approach to reinsurance;
- Identify, and provide an update on, a number of OSFI initiatives relating to reinsurance currently underway; and
- Consult on the overall policy direction of reinsurance regulation and supervision in Canada.

[4] *Discussion Paper on the Mutual Recognition of Reinsurance Supervision* (IAIS, October 2007).

[5] *Response Paper: Refinements to the General Insurance Prudential Framework – Final Response to the Industry* (APRA, June 2008).

Although OSFI has conducted various consultations with individual companies (or sectors) on more specific issues, this review represents an effort to assess the reinsurance regulatory and supervisory regime at a broader level and to consult more widely. All interested stakeholders are invited to provide their views throughout this process.

B. OSFI MANDATE AND GUIDING PRINCIPLES

Created in 1987 by an Act of Parliament, OSFI is the primary regulator and supervisor of federally registered deposit-taking institutions, insurance companies, and private pension plans. Its mandate is to:

- Determine whether federally regulated financial institutions (FRFIs) and private pension plans are in sound financial condition and are meeting minimum plan funding requirements respectively, and are complying with their governing law and supervisory requirements;
- Promptly advise institutions and plans in the event there are material deficiencies and take, or require management, boards or plan administrators to take, necessary corrective measures expeditiously;
- Advance and administer a regulatory framework that promotes the adoption of policies and procedures designed to control and manage risk; and
- Protect depositors and policyholders by monitoring and evaluating system-wide or sectoral issues that may impact institutions negatively.

Consistent with this mandate, there are five guiding principles underlying OSFI's regulatory and supervisory approach to reinsurance. They are:

1.) ***Policyholders of FRFIs must be adequately protected*** – This is a fundamental and explicit element of OSFI's mandate. Although OSFI's mandate recognizes that FRFIs can fail, OSFI administers a regulatory framework that requires FRFIs to maintain adequate financial resources that are available to absorb unexpected losses and to cover liabilities in the event of a failure, thus safeguarding the rights and interests of policyholders.

2.) ***Regulation and supervision should be proportionate to risk*** – In its regulatory and supervisory functions, OSFI must provide flexibility for insurance and reinsurance companies to take on reasonable risks and to compete domestically and internationally. However, it must also encourage companies to focus on prudently managing the increasingly complex risks of the insurance and reinsurance sectors. In particular, OSFI takes a risk-based approach to supervision that emphasizes the need for adequate risk management practices in FRFIs, and provides principles-based guidance and specific rules, where appropriate.

3.) ***OSFI must have the ability to effectively assess those risks*** – In order to fulfil its mandate, OSFI must have the right supervisory "tools" at its disposal. OSFI's approach depends on sound internal controls, reporting, auditing, accounting and actuarial standards.

4.) ***A level playing field among financial sector players should be maintained where appropriate*** – It is important to maintain a relative consistency, according to the risks addressed, in the development and application of regulatory guidance, standards and rules between lines of business, sectors, and for domestic and foreign players. Gaps in the regulatory framework, which can inadvertently create opportunities for regulatory arbitrage, should be avoided.

5.) ***Effective coordination with other insurance regulators is critical*** – OSFI is not alone in regulating and supervising insurance and reinsurance activities. Effective coordination with provincial and international counterparts is crucial to ensuring a focused and efficient regulatory system.

In addition to the legal framework governing federally-regulated insurance and reinsurance companies – i.e., the *Insurance Companies Act* (ICA) and associated regulations – these five general principles guide OSFI's regulatory and supervisory approach to reinsurance. They emphasize prudent capital allocation, sound risk management, and strong FRFI governance. Any proposed changes to OSFI's regulatory and supervisory framework must also be assessed against these guiding principles.

C. REGULATORY AND SUPERVISORY APPROACH TO REINSURANCE

OSFI's regulatory approach to reinsurance is based on rules regarding the adequacy of capital or assets available in Canada to cover the claims of policyholders/creditors in the event of an insurer or reinsurer failure.

When a federally regulated insurance company (i.e., FRFI) obtains reinsurance, it receives relief from OSFI's capital or required vested asset requirements to recognize that there is no need for both the insurer and reinsurer to maintain a financial "cushion" to cover the same underlying risk. The FRFI's overall (net) liability is therefore reduced as a result of the reinsurer's liability to the ceding company.

The manner in which this regulatory “transfer” of capital or vested asset requirements takes place depends on whether the reinsurer is operating in Canada as a company or branch under the ICA (a “registered” reinsurer) or is a foreign entity that does not have a presence in Canada (an “unregistered” reinsurer).

A FRFI that reinsures with a registered reinsurer is able to obtain capital/vested asset relief because it has reduced or removed its overall insurance risk. At the same time, the registered reinsurer, which is regulated and supervised by OSFI, must increase its capital or vested assets held in Canada because it is exposed to more insurance risks and has increased its potential insurance liability. The net result of this “balancing out” is that where the risk of being “out of pocket” in respect of an underlying risk is hedged, capital and vested asset requirements are also transferred.

Unregistered reinsurers, however, are not subject to OSFI regulation and supervision and, hence, cessions by FRFIs to unregistered reinsurers are treated differently, but follow the same fundamental principle.

1. Unregistered Reinsurance

Some FRFIs may cede some of their risks to unregistered reinsurers for risk-management and other purposes. An unregistered reinsurer may be able to limit the potential liability of the insurer to specific or regional risks that cannot otherwise be reinsured domestically. In some cases, jurisdictional arbitrage can be a main driver for insurers to cede business to unregistered reinsurers.

Given that unregistered reinsurers are not subject to OSFI oversight, OSFI’s regulatory and supervisory approach for unregistered reinsurance is based on collateral requirements, a prudential limit for business ceded to unregistered reinsurers, and a regulatory approval associated with related-party transactions.

a.) Collateral Requirements for Unregistered Reinsurance

OSFI’s regulatory approach for unregistered reinsurance in Canada is premised on collateral requirements (versus counterparty credit risk charges in the case of registered reinsurance). If a federally-regulated insurer chooses to cede its business to an unregistered reinsurer, it can enter into a contract with that reinsurer to maintain enough collateral to cover 100 per cent of the ceded liabilities and the associated capital requirement for the ceding company. By entering into such a contract, the ceding insurer can avoid or reduce the regulatory capital/asset requirements associated with unregistered cessions.

Rationale for Collateral Requirements

The collateral requirement is, in essence, an alternative to OSFI's capital or vested asset requirements for FRFIs. Since unregistered reinsurers do not have a presence in Canada, they are not subject to the same regulation and supervision, or to asset or capital requirements applied to FRFIs. Therefore, in order to obtain the "balancing out" referred to above, OSFI requires unregistered reinsurers to post collateral in Canada. This ensures that, if the unregistered reinsurer fails to honour its obligations, there are funds available in Canada to protect the FRFI and its policyholders.

The collateral requirement is a critical safeguard for policyholders of the ceding company, who would not otherwise have the same legal recourse or access to capital of a potentially insolvent reinsurer abroad. Further, the legal claims of ceding companies would only form part of a global "pool" of claims in the event of liquidation of an unregistered reinsurer.

The intent of the collateral requirement, which is also common practice in the US, is neither to encourage nor discourage reinsurance with registered or unregistered reinsurers, but rather that the capital/collateral in the system is sufficient to protect the ultimate policyholder who has a claim.[6]

b.) 25 Per cent Limit on Risks Ceded to Unregistered Reinsurers

Coupled with collateral requirements for unregistered reinsurance business, a 25 per cent limit is currently applied on property and casualty insurance (P&C) premiums ceded to unregistered reinsurers. The 25 per cent limit is not imposed on the life insurance ("Life") sector. Historically, life insurers have not reinsured as much business as have P&C insurers. However, this trend appears to be changing, as increasingly more mortality risk of the Canadian Life sector is being reinsured.

The 25 per cent limit was imposed on the P&C sector as it was observed that imprudent reliance on unregistered reinsurers was a contributing factor in the failure of many P&C insurers in the 1980s. Some reinsurers, in certain instances related parties, refused to pay claims as a result of either disagreements regarding the coverage stipulated by the contract (stemming from loose wording and/or faulty documentation) or the non-existence of a written contract altogether. As well, although it appears that collateral may have been required to obtain capital credit for reinsurance, no standard form collateral agreements were in existence at the time.

[6] It is important to note that collateral posted is generally based on known claim liabilities. Given the long-tail exposures and latent claims development in property and casualty insurance, such collateral can at times still be insufficient to cover claims in the event of a failure of an unregistered reinsurer.

The limit was also intended to address concentration risk to unregistered (and potentially unenforceable) reinsurance. It serves to mitigate the risk of relying on reinsurers operating in other jurisdictions, which may have supervisory and legal regimes that are substantially different from those in Canada. This may ultimately lead to difficulties for the Canadian insurer gaining access to the capital of distressed reinsurers based in these jurisdictions.

It has been argued, however, that the 25 per cent limit on unregistered reinsurance is inconsistent with the international nature of reinsurance business, and constrains some insurers from appropriately managing their risks through diversification and from having full access to very strong reinsurers.

As well, a premiums-based limit may not be appropriate in all circumstances, as it is not necessarily calibrated to the level of risk underwritten in the reinsurance policy. For example, a proportional reinsurance program involving a relatively large amount of premiums ceded may transfer less risk than an excess of loss reinsurance program with a relatively low level of premiums ceded.

One option that has been suggested is to replace the limit with a general principle in a guideline (Guideline B-3 is discussed in a later section) requiring companies to adopt adequate reinsurance cession practices and procedures. This can be further bolstered with guidance on clear wording and the inclusion of specific clauses in reinsurance contracts (Guideline B-13 and insolvency and other clauses are also discussed in a later section).

We welcome the views of the industry on the 25 per cent limit, and whether alternatives exist for addressing concentration and other risks. Following the consultation process, OSFI intends to finalize its position on this issue.

c.) Letters of Credit as Collateral

As discussed above, unregistered reinsurers that provide coverage to ceding insurers in Canada must provide collateral (in the form of a reinsurance trust/security agreement) to each ceding company that intends to claim a reinsurance credit. OSFI prescribes the types of assets that can be used for this purpose. Letters of credit ("LOCs") are currently permitted as acceptable collateral, but their use is limited to 15 per cent of the risks ceded to unregistered reinsurers.

The regulatory limit on the use of LOCs as collateral currently exists in order to mitigate the ceding company's reliance on a third party, other than the reinsurer, to provide funds to cover claims in the event of insolvency. Some reinsurers, however, claim that such a cap on the use of LOCs as collateral is unjustified, given that LOCs are generally safe. As well, they argue that increasing or abolishing the cap would grant more flexibility to ceding companies to conduct business with unregistered reinsurers.

OSFI will review its current policy on limiting the use of LOCs that are maintained as collateral for the benefit of a ceding insurer. Comments from the industry are welcome in this respect.

d.) Mutual Recognition for Reinsurance Supervision

Various commentators argue that collateral requirements can potentially restrict the effective use of capital thereby increasing the cost, and decreasing the availability, of reinsurance. They argue that collateral requirements and other prudential rules respecting risks ceded to unregistered reinsurers (e.g., 25 per cent limit on unregistered reinsurance cessions; 15 per cent cap on the use of LOCs as collateral) would not be necessary if there was an effective global regime of "mutual recognition" for reinsurance.

Mutual recognition is generally understood to mean that reinsurers registered in certain countries, and subject to the mutual recognition agreement, may write business in all other countries in the agreement without collateral or restrictions, subject to the following:

- An agreement by two or more regulators that their solvency requirements and regulations are mutually acceptable (but, not necessarily equivalent);
- Reliance on the home jurisdiction for the regulation and supervision of the foreign (or, in Canada, "unregistered") reinsurer; and
- Information sharing by the home country to the host country of all significant information regarding the relevant reinsurers.

In essence, mutual recognition entails a set of guiding principles to assist supervisors in working together to identify key areas on which they need to agree that equivalent outcomes must be achieved. The intention is for them to work out the details for themselves through formalized memoranda of understanding or similar agreements.

While the above description of mutual recognition is considered to be the "ideal", there are other forms of mutual recognition which can be effective or serve as intermediate steps to the ideal (including reduced/risk-based collateral requirements, as discussed later in this section).

As a member of the IAIS Reinsurance Subcommittee, as well as the Executive and Technical Committees, OSFI is working with its counterparts at the IAIS to study the issues associated with a possible international system of mutual recognition for reinsurance supervision in the long-run.

However, one should note that there are some significant challenges to the implementation of a global mutual recognition regime for reinsurance on a global, or even bilateral, basis. In contrast to banking regulation/supervision[7], there is a wide variation in the regulatory and capital requirements for reinsurance across several jurisdictions, including Canada, the US, EU, Switzerland, Japan and Bermuda, among others. Reinsurance supervision is also highly technical and complex, given its institutional nature and targeted risks.

OSFI's regulation of reinsurers is generally more extensive than that of most countries. OSFI would need to be satisfied that the regulatory and capital requirements for reinsurers operating in other countries provide sufficient protection for Canadian policyholders before eliminating the collateral requirement for unregistered reinsurers.

OSFI is closely monitoring the developments in the EU in regards to the creation of common capital rules for insurance companies (referred to as "Solvency II"), which could lay the groundwork for a mutual recognition regime in reinsurance within the EU. Such rules, however, are not expected to be implemented across the EU until 2012.

Factors for OSFI to Consider

OSFI would need to, at a minimum, take into account the following basic elements prior to entering into any potential mutual recognition agreement (even on a bilateral basis):

- The counterparty jurisdiction's supervisory practices and adherence to IAIS standards on supervision, and how they compare to Canadian requirements;
- An assessment of the counterparty supervisor's:
    - Legal protection and financial resources to exercise its functions and powers;
    - Operational independence;
    - Maintenance of sufficient staff; and
    - Appropriate treatment of confidential information;
- The legal framework in the counterparty jurisdiction, particularly as it relates to insolvencies and the rights of policyholders;
- The taxation framework in the counterparty jurisdiction, especially in regards to withholding taxes applied to policyholders; and
- The terms of any existing arrangements and/or memorandums of understanding with that jurisdiction.

[7] The Basel Committee for Banking Supervision has established common international standards regarding prudential banking regulation (Basel Principles and "Basel II" capital standards).

As well, in order to eliminate or reduce collateral requirements for unregistered reinsurance through a mutual recognition regime, risk-based capital requirements for ceding federally-regulated insurers would need to be developed in order to reflect the additional risk of conducting business directly with a company that is based in a specific jurisdiction. These capital requirements for ceding insurers could potentially be higher than the collateral requirements now imposed for unregistered reinsurance in order to reflect both jurisdictional and counterparty risk.

Further, given provincial jurisdiction over market conduct regulation, and in some cases solvency regulation for insurance, effective coordination with provincial regulators through the Canadian Council of Insurance Regulators would be required in order to put into effect a workable mutual recognition agreement with a foreign jurisdiction. It would be impossible to move ahead with such an agreement without carefully considering the impact on provincial regulatory regimes.

Given the factors noted above, moving to a system of mutual recognition would be very complex and there are significant challenges. The IAIS process will take time, and OSFI will need to conduct its own work in this area. Although the IAIS initiative is still in the very early stages, representatives from OSFI will be present and active in these discussions.

<u>Risk-Based Collateral Requirements: An Alternative Approach</u>

Though there has been an increase of those championing a global system of mutual recognition for reinsurance supervision, it appears that some form of collateral requirements is being maintained in the US and being introduced in Australia. There is broad consensus among regulators that, in the absence of an effective system of mutual recognition that protects domestic policyholders, some form of collateral requirements is unavoidable.

Both the US and Australia are currently proposing a more graduated approach in the application of collateral requirements. In the current US and Australian proposals, for example, reinsurers in the home country that meet certain requirements would qualify for reduced (or no) collateral.[8] In a variation to this model, reinsurers would post collateral – again, based on the assessed risk of that reinsurer – on a consolidated basis, rather than on an individual contractual basis.

Such approaches could be contemplated for Canada. Although they are consistent with OSFI's risk-based regulatory approach, there are a number of factors to consider, including:

[8] The riskiest rated reinsurers would still be required to post collateral that covers 100 per cent of the ceding company's liabilities.

- The reduced collateral requirement would need to be developed and appropriately calibrated to maintain adequate protection for policyholders. This would depend largely on the regulatory, legal and insolvency frameworks of other jurisdictions, and the degree of certainty provided to policyholders about the availability of collateral to satisfy claims in the event of insolvency;
- Reduced collateral requirements would need to be balanced with potentially *enhanced* regulatory and supervisory controls. Examples of possible controls include: adjusted capital requirements for insurers ceding risks to unregistered reinsurers; increased supervisory oversight of reinsurance practices; and higher accountability standards for management;
- A competitive and level playing field would need to be maintained between registered and unregistered reinsurers, i.e., the intent would be to avoid creating a competitive *advantage* for unregistered reinsurers;
- It may require expanded information-sharing arrangements with regulators in other jurisdictions; and
- Enhanced coordination with the provinces would be required.

OSFI welcomes comments and insights from the industry on Canada's current capital/collateral regime for unregistered reinsurance activities. In the meantime, OSFI will continue to closely monitor developments in other countries.

e.) Approvals for Unregistered Reinsurance with Related Parties

Insurance companies often enter into reinsurance arrangements with an unregistered reinsurer that is a related party. Such transactions, which require the Superintendent's approval under the ICA, can be part of a large insurance conglomerate's strategy to pool similar risks from across its corporate structure.

In 2007, these approvals represented more than half of all reinsurance-related approvals administered by OSFI. Yet, the transactions falling under this approval requirement are often insignificant relative to the overall risk profile of the applicant insurer, and are subject to other OSFI controls, including collateral requirements and governance guidelines for ceding companies (discussed in later sections).

OSFI welcomes the industry's views on what changes could be made (e.g., development of materiality criteria) to streamline approval requirements without putting policyholders at risk.

2. Registered Reinsurance

Mirroring OSFI's approach to unregistered reinsurance business, the regulatory framework for registered reinsurance is based on capital/asset requirements for insurers, prudential limits on risks ceded and regulatory approvals.

a.) Capital Requirements

Similar to other FRFIs, insurers and reinsurers are subject to various regulatory capital requirements.[9] However, OSFI alters its approach to reflect the varying size and nature of the risks undertaken between the P&C and Life sectors. P&C companies do not engage in financial intermediation and underwrite insurance contracts that are generally short- and fixed-term, and entirely dependent on the occurrence of a specified event of loss.

Although the P&C and Life sectors undertake different business risks, they face similar counterparty and operational risks as they relate to reinsurance. Therefore, it is the view of OSFI that there currently exist a few disparities in the capital requirements between the P&C and Life sectors that are applied for risks ceded to registered reinsurers.

Counterparty Credit Risk Capital Charge

OSFI imposes a fixed capital/asset charge on P&C insurers ceding risks to registered reinsurers in order to protect policyholders and to ensure the safety and soundness of those ceding companies. The capital charge covers the risk that the registered reinsurer will not honour its obligations in the event of failure (i.e., counterparty risk) and the risk that ceded liabilities are improperly estimated.

This charge, which is in place in all other major jurisdictions, is essentially the domestic alternative to collateral requirements. Such a charge, therefore, is not applied to insurers that cede risks to unregistered reinsurers (the collateral posted is deemed adequate to cover the risks).

However, unlike the P&C sector, this fixed capital/asset charge currently does not apply to Canadian life insurers which cede their risks to registered reinsurers. OSFI will implement a capital charge on the Life sector in the next round of major changes to the credit risk component in the Minimum Continuing Capital and Surplus Ratio (MCCSR) to account for counterparty credit risk.

[9] The overall capital framework for federally regulated insurers and reinsurers - the main capital tests being the Minimum Capital Test (MCT) and Minimum Continuing Capital and Surplus Ratio (MCCSR) for P&C and Life insurers/reinsurers respectively - is extensive and complex, and is, therefore, not the subject of this paper.

Operational Risk Minimum Requirement

Aside from counterparty credit risk, when insurers cede a significant portion of their insurance risks to a reinsurer, they are also exposed to operational risk; that is, the risk that losses could materialize as a result of deficiencies in information systems or internal controls. At this time, life insurers have a 20 per cent flat capital charge on business embedded in their 120 per cent MCCSR to account for this risk.

However, as the Life sector is not subject to any ceding limit, it is possible that the 20 per cent flat charge could be inappropriately reduced to zero when an insurer cedes all of its business. To overcome such a scenario, OSFI will implement a minimum capital charge of 25 per cent of MCCSR gross capital requirements for life insurers to account for operational risk. This approach will be temporary until an explicit capital charge for operational risk is developed.

b.) 75 Per cent Fronting Limit

Coupled with capital requirements for insurers ceding risks to domestic reinsurers, a P&C insurer cannot cede more than 75 per cent of its gross premiums, and cannot cede more than 25 per cent of its gross premiums to unregistered reinsurers (as discussed in a previous section).

The 75 per cent “fronting” limit was implemented on the basis that where a direct writer’s capital is not exposed to loss, it has little incentive to carefully underwrite business. This risk can be amplified as insurers receive commissions on business reinsured. Some insurers have in the past been inclined to write large volumes of business and to charge lower premiums to attract more business. Due to poor underwriting, some reinsurers have not honoured their obligations. In certain cases, they have claimed fraud or misrepresentation by the insurer.

However, this prudential limit, which is essentially intended to mitigate moral hazard, may not be effective, as certain lines of business may be fully fronted if they represent less than 75 per cent of total premiums. Some insurers may front lines for unregistered reinsurers for cost-efficiency purposes, as the latter do not have to set up a subsidiary or branch in Canada. While the fronting limit applicable to the company as a whole may be met, poor underwriting could nevertheless occur for fronted lines.

As well, there are currently other OSFI tools and mitigating factors that encourage prudent underwriting and sound risk control standards. For example, under OSFI’s risk-based framework, reinsurance risks are examined thoroughly. OSFI expects insurance and reinsurance companies to have policies and procedures in place to properly underwrite and assume risk respectively (see section on Governance below). Also, since 1992, actuaries have opined on the adequacy of actuarial reserves of P&C insurers and, more recently, these reports have been subject to peer reviews. Consistent with this diligence and scrutiny, insurers are now required to consider reinsurance risks as part of their Dynamic Capital Adequacy Testing (DCAT).

As a result of the relative ineffectiveness of the fronting limit in addressing prudent underwriting standards and because of existing risk controls in the current regulatory and oversight framework, it has been suggested that this limit be replaced with an explicit operational risk capital charge on P&C insurers (similar to what is proposed for the Life sector in a previous section). In addition, general principles could be formulated in a guideline (See Guideline B-3 in the section on Governance) requiring companies to carry out adequate due diligence regarding their reinsurance risks. Such a guideline would apply to both the P&C and Life sectors.

OSFI welcomes the views of the industry on the future of the 75 per cent fronting limit. Following the consultation process, OSFI intends to finalize its position on this issue.

c.) Approvals for Registered Reinsurance Transactions

A prudentially effective, balanced and responsive approvals process is critical. OSFI values the strong relationship it has with institutions, and strives to continuously assess and improve the approvals process. It is also conscious of not placing unnecessary or duplicative regulatory burden on its regulated institutions.

The approvals regime for reinsurance transactions was significantly changed during the last legislative review period. The new reinsurance approval framework for Canadian companies was brought into force on April 20, 2007, and similar changes for foreign companies are expected to be brought into force on January 1, 2010.

Under the ICA, Canadian insurers are required to seek the Minister's approval when they cede, on an assumption basis, all or substantially all of their insurance risks. Canadian insurers are also required to seek the Superintendent's approval when they cede, on an assumption basis, less than substantially all of their insurance risks. On January 1, 2010, foreign companies will require the approval of the Superintendent (rather than the Minister, as is currently the case) when they cede on an assumption basis any risks tied to their insurance business in Canada.

As well, approval requirements related to indemnity reinsurance and transfers of policies were eliminated. From OSFI's perspective, these changes were justified given supervisory innovations in the areas of risk-based capital rules and other prudential tools.

The reinsurance approval regime will continue to be a key element of OSFI's overall regulatory and supervisory approach to reinsurance. Nevertheless, any changes to the broader regulatory and supervisory framework (e.g., capital requirements, monitoring, etc.), as discussed in earlier sections, can have implications for OSFI's approval and administrative requirements. OSFI would appreciate any views on the reinsurance approval regime that stakeholders may have in light of the issues raised elsewhere in this paper.

3. Governance

Regulation and supervision are not substitutes for sound business practice and controls. Responsibility for managing reinsurance risks lies with those operating/managing the FRFI. As such, effective senior management and boards are an essential element in the safe and sound functioning of financial institutions. It is not the practice of OSFI to manage the business affairs of financial institutions. However, OSFI fulfils its prudential mandate by promoting the adoption by management and boards of directors of policies and procedures designed to control and manage risk.

a.) Guideline on Corporate Governance

OSFI's *Guideline on Corporate Governance* provides information to boards and management of financial institutions about the expectations of OSFI on corporate governance. Although good governance is fundamental for any corporation, the guideline draws attention to certain areas that are especially important for financial institutions, owing to the nature and circumstances of business conducted and risks assumed.

The Guideline points to a need for an independent, responsive and effective board of directors, the development of sound risk management practices and adequate internal controls. As well, it stresses strong independent oversight by internal audit and compliance officers, as well as appointed actuaries and external auditors.

Ultimately, Canadian financial institutions, including insurers and reinsurers, will succeed (or fail) on the merits of their business and their ability to control and manage their own risks. OSFI's *Guideline on Corporate Governance* serves as a starting point, and applies to all FRFI's, including insurance and reinsurance companies.[10]

[10] Branches do not have boards of directors. As such, OSFI looks to the Chief Agent of a branch to oversee the management of the branch and to be aware of OSFI's *Guideline on Corporate Governance* (See Guideline E-4A on the *Role of the Chief Agent and Record Keeping Requirements*).

b.) Guideline on Sound Reinsurance Practices and Procedures (B-3)

With respect to reinsurance activities specifically, it is especially important that directors and management enter into contracts with reinsurers that are financially sound and able to meet any future claims obligations. An OSFI guideline on sound reinsurance practices and procedures in this regard (*Guideline B-3*) is currently being updated and will apply to all reinsurance cessions by federally-regulated insurers.[11]

The guideline will underscore OSFI's expectation that insurers establish and implement sound reinsurance cession practices and procedures as part of their enterprise-wide risk management programs. It is proposed that these practices and procedures will encompass the following fundamental elements:

- A reinsurance management strategy (e.g., circumstances for which reinsurance is required);
- Criteria for assessing the suitability of a reinsurer;
- Appropriate risk concentration limits;
- Parameters for delegation of certain responsibilities (e.g., officer limits on executing reinsurance cession arrangements);
- Adequate internal systems for monitoring reinsurance transactions; and
- Sound risk management and compliance mechanisms.

While OSFI strives to provide guidance to FRFIs on its expectations regarding sound reinsurance practices and procedures through general principles, history has shown that certain rules have been needed to address specific risks (e.g., the 25 per cent limit on unregistered reinsurance and the 75 per cent fronting limit). OSFI welcomes the views of the industry on whether the above principles, along with other current OSFI regulatory and supervisory tools, are adequate to effectively control reinsurance risks and whether such rules can be replaced.

An updated *Guideline B-3* will be released to the industry for consultation in the coming months.

c.) Guideline on Reinsurance Agreements (B-13)

As a complement to *Guideline B-3*, which is general in nature, more specific guidance will be forthcoming in areas such as the implementation of reinsurance agreements.

There is often a time lag between the initiation of a reinsurance arrangement, the execution of a summary document, and the execution by the parties of the full

[11] The current Guideline B-3 only applies to unregistered life reinsurance.

agreement. If an event were to occur during these gaps, there could potentially be uncertainty relating to coverage. Experience, both in Canada and abroad, suggests that disputes regarding reinsurance coverage can be central to instances of insurer insolvency.

OSFI is currently analyzing the business practices of the industry with regards to the use of cover notes and formal treaties, and will incorporate this analysis into guidance to the industry.

OSFI's *Guideline B-13* will set out prudential considerations relating to time lags in reinsurance arrangements. It will also address issues relating to wording within a reinsurance agreement. OSFI has completed preliminary consultations with the industry and will finalize *Guideline B-13* in the coming months.

d.) Insolvency and Other Contract Clauses

Explicit in *Guideline B-13* will be the notion that a ceding company and a reinsurer enter into a written contract. However, even written contracts can contain poor language and lack appropriate protection clauses for ceding companies.

For example, an "insolvency clause" in a reinsurance contract clarifies that a reinsurer must continue to make full payments to an insolvent insurer without reduction resulting from the ceding company's insolvency. Under such a clause, reinsurance receivables remain within the overall general estate rather than being allocated toward the payment of specific policyholder claims.

As a result of past failures of insurers and associated litigation stemming from disputes concerning coverage, the inclusion of insolvency clauses in reinsurance agreements have become common practice in the US, United Kingdom and Australia. Many state insurance statutes in the US, in particular, require an insolvency clause in the reinsurance contract if the ceding company intends to recognize reinsurance receivables as an asset on its balance sheet (and take advantage of the corresponding regulatory capital relief).

In Canada, while most reinsurance contracts have contained an insolvency clause since the adoption of recommended wording by the Reinsurance Research Council of Canada in 1991, it is not a requirement for the reinsurance receivables to be recognized as an asset for regulatory capital purposes.

In contrast to insolvency clauses, other types of reinsurance clauses can *limit*, rather than enhance, a failed insurer's ability to enforce the claims obligations of a reinsurer and to cover the claims of its own policyholders. "Offset" and "cut-through" clauses, for example, may effectively place any reinsurer claims (i.e., mutual debts and credits), or the claims of a specific creditor/policyholder of the cedant, ahead of the statutory claims against the estate under the *Winding-Up* *and Restructuring Act*. In essence, such clauses may allow certain creditors/policyholders to have preferential treatment over other creditors/policyholders of the ceding company in the event of insolvency.

OSFI proposes to issue guidance, or to amend existing guidelines[12], on its expectations regarding good business practice associated with reinsurance contracts, including its expectations regarding insolvency and other clauses contained in such contracts.

D. MOVING FORWARD

Financial institutions are facing rapid change, and the regulatory environment is evolving accordingly throughout the world. OSFI attempts to maintain a relevant regulatory and supervisory framework of guidance and rules for reinsurance that is adaptable to the changing landscape and that meets or exceeds international standards. Given recent international developments, an assessment of this framework is timely and appropriate.

Further, as a member of the IAIS, which is currently examining the issues associated with mutual recognition in reinsurance supervision, OSFI will need to be in a position to bring the right issues and concerns to the table in future discussions and negotiations at the international level. This discussion paper, therefore, along with critical input from the Canadian industry, will serve to equip OSFI to fully engage in this process.

This paper outlines, in general terms, OSFI's regulatory and supervisory approach to reinsurance, as well as provides a summary of various OSFI initiatives currently underway. It also serves to continue (and for some issues, initiate) discussion with the industry on a number of specified areas and on the overall policy direction of OSFI's approach.

A position will be finalized in the coming months on areas where OSFI is already consulting, or has consulted, the industry (e.g., capital requirements for the Life sector). OSFI recognizes that such a discussion paper cannot possibly address all of the technical complexities and nuances of the reinsurance business. However, the views of all stakeholders on these issues and others related to reinsurance, whether addressed or not addressed in this paper, would be appreciated.

[12] Consideration will be given to amending existing capital guidelines regarding contract clause requirements if a ceding company intends to seek regulatory capital relief as a result of the reinsurance arrangement.

OSFI looks forward to receiving comments of interested stakeholders on this discussion paper. Written comments should be forwarded to:

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