Office of the Superintendent of Financial Institutions Canada   Bureau du surintendant des institutions financières Canada

Response Paper: Reforming OSFI's Regulatory and Supervisory Regime for Reinsurance

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A. INTRODUCTION

In December 2008, the Office of the Superintendent of Financial Institutions (OSFI) issued a discussion paper on its regulatory and supervisory approach to reinsurance (Discussion Paper).[1] The purpose of the paper was to outline OSFI's current regulatory regime for reinsurance; to identify, and provide an update on, a number of OSFI initiatives in this area; and, more importantly, to consult with the industry on Canada's overall policy direction in reinsurance regulation and supervision.

OSFI received a total of 28 submissions from a wide range of industry stakeholders, including property and casualty insurers ("P&C"), life insurers ("Life"), and other domestic and international stakeholders.

Following several months of internal analysis and a comprehensive assessment of the industry's input (which included follow-up consultations with the industry), OSFI has now finalized its policy approach to reinsurance regulation and supervision. Our analysis included a review of developments in other jurisdictions such as Australia and the United States.

This response paper outlines OSFI's policy decisions and impending reforms to its reinsurance regulatory and supervisory framework, articulates its rationale for these decisions, and sets out a timetable for implementing reforms in the following areas:

- The 25 percent unregistered reinsurance limit;
- The 75 percent fronting limit;
- Reinsurance governance, specifically sound reinsurance practices and procedures;
- Collateral requirements and mutual recognition for reinsurance supervision;
- A capital charge for the Life sector in respect of reserves ceded to registered reinsurers; and
- Regulatory approval requirements.

OSFI hopes to be in a position to implement many of the proposed changes to its reinsurance regulatory and supervisory framework applicable to federally regulated insurance companies (companies) **by the end of 2010**. Until implementation of such changes, existing OSFI guidance remains in effect; however, during the transition period, we expect companies to take into account the changes outlined in this paper in their planning and business activities and to thereby prepare for such changes.

[1] The Discussion Paper can be found on OSFI's Web site at:
http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/notices/osfi/dscp_reins_e.pdf

B. BACKGROUND

International regulatory and supervisory approaches to reinsurance vary widely. In some countries, for example, reinsurance is not regulated at all. However, the degree to which reinsurance is regulated and supervised in any given country is generally premised on some mix of the following two perspectives[2]:

- The policyholders of reinsurance contracts (i.e., the ceding companies) are "sophisticated" purchasers of an insurance risk management product and, hence, do not require intrusive oversight (View 1); and
- While reinsurance can mitigate the insurance risk exposure for a regulated ceding company, it can also constitute a significant counterparty risk if the reinsurer is not able to meet its claim obligations (View 2).

Traditionally, depending on whether the regulatory authorities of a jurisdiction subscribed to View 1 and/or View 2, they may have opted for little, if any, regulation and supervision of reinsurance, or may have implemented relatively comprehensive prudential rules and requirements to mitigate the potential for policyholder losses. However, recent international efforts have focused on striking a more consistent balance between regulating and supervising reinsurance operations in a prudent manner while also allowing insurers and reinsurers to compete effectively at the domestic and global levels.

Regulatory authorities in various jurisdictions have recently undertaken lengthy policy reviews in an attempt to revamp and update their reinsurance frameworks (e.g., Australia, United States). Also, the International Association of Insurance Supervisors (IAIS) has in the past five years strived to develop international standards in insurance and, to a lesser extent, reinsurance, with the hope that mutual recognition arrangements could be facilitated among countries.

The Canadian federal regulatory and supervisory regime for reinsurance is extensive, as Canada has subscribed to View 2. Some stakeholders noted that OSFI's relatively strict approach has been beneficial during the current global financial crisis, while others noted that, with various reforms occurring in other jurisdictions, certain aspects of the Canadian reinsurance framework are diverging from international regulatory and supervisory best practices.

There is some credence to the above arguments, as many of the core elements of OSFI's regulatory and supervisory framework for reinsurance (e.g., collateral requirements, the 25 percent limit on unregistered reinsurance, the 75 percent fronting limit, etc.) have existed for several decades, without any substantive reforms. Further,

[2] These principles apply mainly to indemnity reinsurance.

much of OSFI's reinsurance framework is not applied to the Life sector for reasons that may no longer be appropriate given the current environment.[3]

The nature of insurance and reinsurance operations, for both the P&C and Life sectors, has evolved rapidly in the past decade – it is more technologically advanced, increasingly segmented/niche and much more globally-diversified – and, in response, insurance and reinsurance companies have since developed more sophisticated risk management programs.

Various regulatory principles for OSFI's approach to regulating and supervising reinsurance were articulated in the OSFI Discussion Paper. Given these principles (which are widely supported by the industry) and the above context, the policy decisions that follow have been developed with a few overarching regulatory and supervisory objectives in mind:

- Developing a more risk-based reinsurance regulatory and supervisory framework, which would be consistent with OSFI's overall approach to financial institution regulation and supervision, as well as with international trends;
- Ensuring regulatory "neutrality" between registered and unregistered reinsurance, recognizing that reinsurance is a diversified international business and that most reinsurers operating in Canada are foreign-based;
- Creating greater equity and consistency with respect to the regulatory (and more specifically, capital) treatment applicable to similar risks underwritten by the P&C and Life sectors;
- Bolstering OSFI guidance on reinsurance governance, with a focus on sound reinsurance practices and procedures (as part of enterprise-wide risk management), including the enforceability of reinsurance contracts; and
- Strengthening OSFI's supervisory tools to allow its staff to fully appreciate and scrutinize the risks that companies are undertaking via their reinsurance programs, and to undertake appropriate actions in the event of imprudent reinsurance practices.

C. POLICY DECISIONS AND REFORMS

1) The 25 Percent Limit on Unregistered Reinsurance

Under the *Reinsurance (Canadian Companies) Regulations* and the *Reinsurance (Foreign Companies) Regulations* (Regulations), a federally regulated P&C insurance

[3] In the 1980s and earlier, with the exception of excess share and certain quota share transactions, the Life sector undertook less reinsurance than is current practice, due to the longer-term nature of its business and the interest in ceding companies to hold the risk, as well as the existence of several mutual life companies at the time. Hence, many of OSFI's prudential rules were not applied to the Life sector. However, the Life sector is now heavily reinsuring its business for risk and capital management purposes, as many of the larger companies are now owned by shareholders.

company cannot cause itself in any year to be reinsured by unregistered reinsurers against more than 25 percent of its risks insured (“25 percent limit”).

Assessment

Aside from the issue of collateral requirements (discussed later), which garners more attention internationally, the 25 percent limit is one of the more debated elements of the Canadian reinsurance regulatory framework.

The 25 percent limit can be a source of concern for some Canadian ceding companies with multi-national clients and/or global reinsurance programs, as well as for foreign reinsurance companies preferring to underwrite Canadian risks directly from abroad on an unregistered basis. Commentators pointed out in their consultation submissions, as well as in their discussions with OSFI, that the limit seems to be inconsistent with OSFI’s general policy of treating registered and unregistered reinsurance in a “neutral” manner.[4]

Although the 25 percent limit has appeal from a prudential perspective, it does not provide the incentive for ceding companies to scrutinize their risks with respect to the financial condition/capacity of an unregistered reinsurer or other relevant factors (e.g., legal and insolvency framework of the jurisdiction in which the reinsurer is operating).

Further, because reinsurers themselves are not subject to the 25 percent limit, it does not necessarily act as an absolute bar to companies gaining exposure to additional unregistered reinsurance. For example, an insurance company that wishes to exceed the limit can do so by reinsuring a portion of its risks above the 25 percent limit with a registered reinsurer on the understanding that the reinsurer will retrocede the risk to an unregistered reinsurer selected by the direct insurer (often an off-shore captive). Such arrangements between direct insurers and reinsurers are common practice.

Although OSFI does intervene through the supervisory process in cases where a company has surpassed its 25 percent limit, the usual timing of negotiation and signing of reinsurance agreements between companies, which often occurs at the end of a calendar year, allows OSFI very little scope to take pre-emptive action.

OSFI Decision

OSFI will recommend changes to the Regulations to repeal the 25 percent limit once the following regulatory and supervisory safeguards are in place:

- Guideline B-3 (to be renamed *Guideline on Sound Reinsurance Practices and Procedures*) is bolstered and reinstituted – discussed in a later section – so that, among other things, insurance companies are explicitly required to consider the

[4] Although OSFI’s capital rules account for the additional counterparty risk associated with unregistered reinsurance (relative to registered reinsurance), OSFI does not encourage or discourage the use of unregistered reinsurance by companies.

likelihood of recoverability of reinsurance claims, from registered and unregistered cessions, as part of the institution's overall risk management program;

- Insurance companies are required to report to OSFI, if requested, a description of all their reinsurance arrangements, including the levels of reinsurance and the proportion of registered and unregistered cessions.[5]

OSFI is aware that the removal of the 25 percent limit may result in the additional use of non-registered reinsurance and, therefore, could entail the undertaking of more complex counterparty risks by regulated financial institutions. For some institutions, the removal of the 25 percent limit may cause significant changes to their business models and their use of reinsurance, in general. OSFI will closely monitor the effects of such changes on the overall risk profiles of the financial institutions, and, where appropriate, take any steps necessary to address situations deemed prudentially unsound.

Timing

OSFI will target to revise and reinstitute Guideline B-3 accordingly, and adopt a new reporting regime for reinsurance, by the end of 2010. Once this is accomplished, OSFI will recommend repealing the 25 percent limit from the regulations at the first available opportunity.

2) The 75 Percent Fronting Limit

In addition to the 25 percent limit on unregistered reinsurance, the Regulations stipulate that a P&C insurer cannot cede more than 75 percent of all its risks insured in any given year (75 percent fronting limit).

Assessment

Although the term "fronting" is often used to describe this limit, in fact, it is a *ceding* limit. In P&C insurance, "fronting" can involve writing a risk for another insurance company that is not licensed in Canada. It often involves captive insurance companies that are located in off-shore domiciles (Scenario 1). The 75 percent fronting limit was intended to capture Scenario 1.

In other cases, however, insurance companies will cede a portion (or even 100 percent) of the risk to a reinsurer because that risk does not fit the direct insurer's underwriting profile or the insurer does not have the requisite expertise (e.g., boiler and machinery insurance; catastrophic risk element – damage from a tornado, flooding, etc. – for general property insurance), but it seeks to underwrite the business for purely

[5] Currently, insurance companies are not required to provide this information to OSFI relationship managers (and often do not). In the U.S., all reinsurance arrangements are reported in the insurance company's schedule "S" regulatory filing.

marketing/relationship purposes. In this case, the reinsurer has the expertise to complete the full actuarial/insurance risk assessment (Scenario 2). This practice of ceding business, which is quite common in the industry and acceptable from a prudential supervisory perspective, is also captured by the 75 percent fronting limit.

In Scenario 2, as long as the insurance company is diligent in respect of underwriting an insurance policy through prudent practices and procedures, is cognizant of the associated risks involved with its business, and is maintaining sufficient regulatory capital to account for those risks, then the *amount* of the business that is ceded, in effect, becomes a less important metric from a prudential perspective.

It is not surprising, therefore, that the P&C industry has expressed indifference in regards to maintaining the 75 percent fronting limit because, as stated in various industry submissions to OSFI, pure "fronting", as described in Scenario 1, is simply <u>not</u> a natural aspect of the general insurance business – underwriting risks is.

As in the case of the 25 percent limit, the 75 percent fronting limit was only applied to the P&C sector. Although it prevents P&C insurance companies from operating solely as fronting entities, it may not provide the incentive for ceding companies to scrutinize the risks associated with underwriting business. Further, the limit can be bypassed entirely using other risk transfer methods (e.g., securitization, hedges such as catastrophe bonds, etc.).

It is anticipated that by eliminating the 75 percent limit, insurance companies would potentially abandon complicated (and costly) reinsurance arrangements between affiliated financial institutions, and would be encouraged to pursue simplified pooling arrangements that, in fact, may *reduce* the risk to individual financial institutions – a positive result from a supervisory perspective.

OSFI Decision

OSFI will recommend repealing the 75 percent fronting limit once the following regulatory and supervisory safeguards are in place:

- Guideline B-3 is bolstered and reinstituted so that, among other things, OSFI's expectations with respect to any insurance fronting/ceding arrangements and underlying underwriting standards of federally-regulated ceding companies are explicitly outlined;
- Insurance companies are required to disclose <u>all</u> fronting/ceding arrangements to OSFI, if requested; and
- A minimum operational risk capital requirement is imposed on the P&C sector in the Minimum Capital Test (MCT) that is parallel to the one being imposed on the Life sector through the Minimum Continuing Capital and Surplus Requirements (MCCSR).

Timing

OSFI will reinstitute and revise Guideline B-3 accordingly and adopt new disclosure requirements for fronting arrangements by the end of 2010. Once this is accomplished, OSFI will recommend repealing the 75 percent fronting limit from the regulations at the first available opportunity.

As well, OSFI will implement a gross minimum capital requirement in the next round of general amendments to the MCT (scheduled for 2012).

3) MCCSR Capital Charge for Reserves Ceded to Registered Reinsurers

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

Assessment

Companies should hold capital for recoverables and other amounts due from reinsurers, as these assets are subject to the same credit risk as bonds, loans, or (in the context of other types of risk transfer) obligations of a derivatives counterparty. Very often, the credit risk associated with the failure of a reinsurer to make good on its obligations is exacerbated because the exposure to the reinsurer may be quite large. This credit risk as it relates to life reinsurance has not been adequately taken into account up to now, partly due to the fact that exposures of life companies to reinsurers have been netted against actuarial liabilities on the balance sheet under GAAP. The MCCSR is currently one of the few insurance solvency tests internationally that does not impose a capital charge for counterparty exposures to reinsurers.

OSFI Decision and Timing

A counterparty risk capital charge will be developed (in consultation with the industry) and applied to the Life sector in the MCCSR – through the next round of amendments scheduled for 2012 – which is analogous to the approach currently being imposed on the P&C sector through the MCT.

4) Reinsurance Governance

OSFI's governance framework for reinsurance is comprised of the following three guidelines (one of which was recently revoked and another remains in draft):

- *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), which only applied to unregistered life reinsurance cessions and focused on the cedant's assessment of the financial viability of the reinsurer and its ability to meet claims obligations (revoked effective January 1, 2010); 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 full contract.

Assessment

Following a thorough assessment of OSFI's existing governance standards in regards to reinsurance and a review of the industry's input in response to the Discussion Paper, OSFI is of the view that enhanced guidance is required to ensure an effective regulatory and supervisory regime for reinsurance.

Guideline B-3, which touched upon certain elements of reinsurance governance, was inadequate because it only applied to the Life sector and unregistered reinsurance. Further, it did not address critical elements (negotiation, approval, timing, contractual clauses, etc.) of reinsurance arrangements, which are often driven by common industry practices that are not necessarily consistent with regulatory prudence.[6]

Guideline B-3 did not require companies to integrate their reinsurance program into their broader enterprise-wide risk management practices and procedures. For example, it did not provide *specific* guidance on the role of the Board of Directors in respect of a company's reinsurance strategy, processes and practices.[7] There is ample evidence suggesting that the Board of Directors of some Canadian insurance companies is often not involved in the establishment of a company-wide reinsurance program. In some cases, the Boards of these companies do not review material reinsurance agreements, which are often negotiated and implemented at the operational level.[8]

Moreover, Guideline B-3 did not offer any explicit guidance to insurance companies with respect to developing reinsurance risk management programs that take into account the legal and counterparty risks involved with cessions to unregistered reinsurance companies. In particular, there is no obligation for a ceding company to conduct some level of due diligence on the ability of the unregistered reinsurer to meet its claims obligations.[9]

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[6] Key provisions of the guideline were included in revised capital guidance for life insurance companies issued in 2006, while other provisions were included in the revised 2009 capital guideline.

[7] Guideline B-3 suggested that the Board should be active in the development of sound reinsurance practices, but did <u>not</u> cover specifics, and was focused more on capital/margin requirements and acceptable security for unregistered cessions.

[8] In many respects, this is contrary to the spirit of the *Guideline on Corporate Governance*, which sets out OSFI's general expectations on the role of the Board of Directors in respect of risk management.

[9] There is evidence that suggests that ceding company due diligence on both registered and unregistered reinsurers with respect to their ability to meet claims obligations (financially and in regards to internal controls) is often weak.

Guideline B-13, which is more specific in nature, attempts to address a long-standing issue in the industry that relates to the timing lag between the initial agreement of a reinsurance arrangement and the finalization of the reinsurance contract itself. Disputes relating to coverage have arisen in the past when a claim has been made prior to the finalization of the legal contract.

Throughout the drafting process of Guideline B-13, which was put on hold during this policy review, OSFI and the industry debated the application of a period of three months or longer as an acceptable time lag for the execution of summary documents and six months thereafter for reinsurance arrangements, often neglecting the basic legal and operational principle of contract *certainty* and the enforceability of such contracts.

OSFI does not currently provide any guidance with respect to contract language and clauses increasingly common to reinsurance agreements that can also lead to coverage uncertainty, as well as adversely affect policyholders in the event of insurer insolvency. For example, according to various legal and liquidation experts, "offset" and "cut-through" clauses in reinsurance agreements can effectively place reinsurers' claims (i.e., mutual debts and credits), or the claims of specific creditor/policyholder of the cedant, ahead of the statutory claims against the estate under the *Winding-Up and Restructuring Act*.

Also, it is currently not a regulatory requirement in Canada for reinsurance agreements to contain a variety of important elements, such as an "insolvency clause" (although it is becoming more common), which stipulates that a reinsurer must continue to make full payments to an insolvent insurer without reduction resulting from the cedant's insolvency. This issue has been highlighted by the Property and Casualty Insurance Compensation Corporation (PACICC) in a recently released research paper.[10]

OSFI currently provides a credit to ceding companies for regulatory capital purposes in good faith, without having a broad set of standards to provide assurance that companies are appropriately managing all of their reinsurance risks. This is contrary to regulatory practice in other jurisdictions such as the U.S., U.K. and Australia, where the existence of an acceptable insolvency clause in a reinsurance agreement, among other critical elements, is mandatory before a capital credit is provided by the regulatory authority to the ceding company.

OSFI Decision

OSFI will expand and reinstitute Guideline B-3 (as noted earlier, to be renamed *Guideline on Sound Reinsurance Practices and Procedures*) to explicitly state its expectations in this regard related to <u>all</u> reinsurance arrangements by companies[11]; more specifically:

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[10] *(Re)Assurance of Solvency: Reinsurance Assets in Insurance Company Liquidations* (PACICC, November 2008).

[11] Prior to the release of the Discussion Paper, OSFI had embarked on a process to revise Guideline B-3, and had circulated a draft to select companies for pre-consultation. However, that process was put on hold pending the results of this reinsurance policy review. Although that pre-consultation draft contained certain elements (not all)

1.) The *Guideline on Corporate Governance* applies to all insurance companies with respect to effective risk management practices and procedures (including underwriting).

- Adequate internal controls should be in place when originating and ceding insurance business (e.g., pure fronting is not acceptable).

2.) Ceding companies should have a sound and comprehensive reinsurance risk management strategy and processes.

- The reinsurance risk management plan should be integrated with the company's (and group's) overall and on-going risk management strategy and processes;
- The company's overall reinsurance strategy (e.g., counterparties, concentration, alternative risk management arrangements), processes (e.g., oversight, approvals), and material reinsurance contracts (e.g., coverage, acceptable contract terms, etc.) should be reviewed and approved by the Board of Directors;[12] and
- Particular attention should be paid to the management of potentially large risk exposures under catastrophe reinsurance arrangements, which often involve a relatively small proportion of an insurer's total premiums, yet could represent a relatively large exposure.

3.) Ceding companies should perform an adequate level of due diligence on their reinsurance partner(s).

- A ceding company should thoroughly evaluate the financial ability of its reinsurance partner to meet its claims obligations (and not rely solely on rating agency assessments);
- In tandem with the above, a ceding insurer should consider, to the extent possible, the retrocession arrangements of its reinsurance partner and the extent to which those arrangements can indirectly affect its own agreement with the reinsurer; and
- If entering into a reinsurance arrangement with an unregistered reinsurer, a ceding insurer should examine its counterparty risk carefully, including a review of the legal and insolvency framework of the counterparty home jurisdiction.

of what are being presented in this paper, that draft is no longer deemed to be relevant. Guideline B-3 will be expanded substantially.

[12] This is consistent with a 2005 OSFI letter to the industry, which requested that the Board of Directors of each company approve the company's reinsurance risk management policies and practices. The proposed guideline would stipulate that this would be OSFI's expectation on an on-going basis. This could include a requirement that the Board of Directors sign off on the company's enterprise risk management (ERM) framework and annual changes to reinsurance risk parameters.

4.) There should be clarity and certainty in insurance coverage under the terms of the reinsurance agreement.

- A reinsurance agreement should be in writing; and
- A reinsurance contract between the ceding company and reinsurer should be *legally-binding*, with evidence in writing, and without any material ambiguity as to the terms and conditions of coverage (Guideline B-13 will be amalgamated into Guideline B-3).[13]

5.) Policyholders (i.e., federally regulated insurance companies) should not be adversely affected by the terms of a reinsurance contract.

- A reinsurance agreement should contain an insolvency clause that meets OSFI's expectations.[14] Further, although guidance may be provided by OSFI on whether a reinsurance agreement should contain "offset", "cut-through" or other legal clauses/arrangements that could effectively allow certain creditors to have preferential treatment over the policyholders of the ceding company, it remains the responsibility of the ceding company to ensure that such clauses are understood and prudent;
- Arrangements made under the reinsurance agreement should not raise legal questions as to the availability of funds to cover policyholder claims (e.g., "funds withheld" arrangements[15]) in the event of a reinsurer insolvency; and
- Reinsurance contracts should be subject to Canadian laws and any disputes between the insurer and reinsurer should be heard in a Canadian court.[16]

The new guidance will be linked to OSFI's provision of a capital credit to ceding companies for reinsurance, such capital credit being OSFI's key regulatory and supervisory "tool" with respect to reinsurance. A capital credit will not be provided by OSFI to the federally regulated ceding company unless it meets the expectations set out in the new Guideline B-3 – i.e., the terms of the reinsurance agreement entered into are clear (and legally binding) and the agreement does not in any way adversely affect the policyholder (e.g., the existence of an insolvency clause in the contract).

[13] A reinsurance arrangement can be legally binding (with the necessary evidential documentation) without an actual signed contract in place. From a regulatory perspective, and for the purposes of a capital credit, the existence of a legally binding contract is what is critical. As such, OSFI will move away from the approach of other jurisdictions, which focuses on the timing of the finalized and signed contract.

[14] OSFI does not intend to provide the industry with acceptable language in this regard. Rather, it will work with the industry, which has either developed, or is in the midst of crafting, standard language with respect to insolvency clauses.

[15] Under certain arrangements, assets that would normally be paid over to a reinsurer are often withheld by the ceding company to permit a capital credit for unregistered reinsurance or to retain control over investments. "Funds withheld" arrangements, which are increasingly common, have raised questions as to whether the ceding company can legally maintain/access those funds in the event of a reinsurer insolvency.

[16] The Australian Prudential Regulation Authority (APRA) requires ceding companies to ensure that disputes involving reinsurance contracts will be governed by Australian laws and heard by Australian courts (Prudential Standard GPS 230 – *Reinsurance Management*).

Companies entering into reinsurance arrangements may be asked to provide an attestation to OSFI (prior to receiving a capital credit) that the arrangements meet the criteria outlined in Guideline B-3. While OSFI's supervisors may still conduct some level of analysis of the risks being undertaken by the financial institution, an attestation would serve to provide OSFI with a minimum level of comfort and would sensitize the financial institutions as to the potential consequences of not adhering to the new Guideline B-3.

The general approach articulated above – including the link to a capital credit – is generally consistent with international regulatory and supervisory practices with respect to reinsurance governance.

Timing

As noted earlier, OSFI will work with the industry in the coming months with the goal of issuing a new and more comprehensive Guideline B-3 by the end of 2010.

5) Collateral Requirements and Mutual Recognition

If a company 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 percent 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 the business it underwrites.

Assessment

The issue of collateral requirements for unregistered reinsurers has been the subject of much debate worldwide, with many commentators and multinational reinsurance companies supporting a global system of mutual recognition in reinsurance regulation and supervision.

Following the implementation of the European Union Directive in 2005, which essentially did away with collateral requirements throughout most of the European Union, Australia has moved, and the U.S. has proposed to move, towards a collateral regime that is graduated and risk-based.

OSFI currently has a relatively straightforward risk-based capital/collateral framework with respect to unregistered reinsurers. It relies on that collateral to offset the reinsurer's counterparty risk. This, however, does not capture the risks associated with the collateral arrangement itself, nor does it explicitly recognize that a reinsurance arrangement with a relatively strong unregistered reinsurer may mitigate a ceding company's overall risks.

Based on responses to OSFI's discussion paper, there is broad support from the industry for a move towards a more sophisticated system of risk-based collateral

requirements, and not towards a system of *full* mutual recognition (i.e., no Canadian collateral requirements at all), which appears to be a longer-term project at the international level.

Most stakeholders acknowledge that some form of collateral is necessary in order to protect policyholders, who may have limited access to assets abroad in the event of insolvency. Recent developments have served to underscore this point. The global financial crisis has reminded regulators worldwide of the importance of collateral as a critical prudential safeguard for protecting their respective financial systems.

OSFI Decision

It is the view of OSFI that it would be imprudent to discontinue or weaken its collateral regime for unregistered reinsurance cessions at this time in light of the recent financial market developments, which have stressed the necessity of collateral requirements.

At this time, it is premature for OSFI to consider the adoption of a "mutual recognition" framework, which would effectively relinquish all regulatory and supervisory functions to the home jurisdiction of the unregistered reinsurance company (i.e., no Canadian capital or collateral requirements).

OSFI will, however, undertake developmental policy work to identify the issues and parameters associated with establishing a more sophisticated, graduated, risk-based capital/collateral framework for unregistered reinsurance. Consistent with the overall risk-based regulatory philosophy of OSFI, such an approach could focus on both the *strength* of the reinsurer and the protection provided by collateral, and could allow 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.

In tandem with this policy work, OSFI will fully assess the overall *quality* of the collateral that is being posted by unregistered reinsurance companies. For example, while OSFI is of the view that reinsurance trust agreements generally provide adequate protection to ceding companies, there is currently discussion among the legal community as to whether the enforceability of such agreements could be challenged. As well, OSFI will also fully assess its policy on the use of letters of credit as collateral by unregistered reinsurance companies.[17]

Finally, given the pivotal role of collateral in protecting policyholders when unregistered reinsurance is obtained (e.g., the collateral posted by such a reinsurer effectively substitutes for assets being held by the ceding insurer), OSFI will continue to review its capital rules to ensure that adequate capital is maintained by the ceding insurer in respect of the risk posed by such collateral arrangements.

[17] The use of letters of credit as collateral was limited to 15 percent of the risks ceded to unregistered reinsurers. Following a preliminary assessment of the issue, this limit was recently increased to 30 percent in the MCCSR and MCT.

For example, the MCCSR currently provides for collateral “haircuts” (reductions in the credited value) for different types of collateral. However, in 2011, the MCCSR will require life insurers to capitalize for credit and market risks related to collateral (rather than requiring a haircut).[18] Another risk that will need to be considered is the operational risk arising from collateral requirements, including the risks arising from different forms of legal arrangements used to provide capital.

6) Regulatory Approvals

The current reinsurance approval framework was amended significantly during the last legislative review and came into force in 2007 (with some elements coming into force in 2010).

Under the *Insurance Companies Act*, Canadian insurers are now only required to seek the Minister's approval when they cede, on an assumption basis, all or substantially all of their insurance risks (if less than all, then it is a Superintendent approval). This also became the case for foreign companies effective January 1, 2010. Insurers are also required to seek the Superintendent's approval when they reinsure business with an unregistered related party.

Assessment

Given that the new reinsurance approval framework for Canadian companies was brought into force on April 20, 2007, it is too early to assess its effectiveness. As such, the industry did not provide much comment in this regard in its submissions to OSFI.

However, the Discussion Paper did note that insurance companies often enter into reinsurance arrangements with an unregistered reinsurer that is a related party as part of a global strategy to pool similar risks from across its corporate structure.

Many of these transactions are relatively immaterial in that they represent a very small percentage of a company's/branch's gross premiums. In addition, the approval requirement is often misunderstood by the industry and leads to instances of non-compliance. The level of OSFI resources devoted to administering these types of approvals seems disproportionate to regulatory value, which becomes particularly relevant given OSFI is moving forward with an enhanced guideline on reinsurance practices.

However, intra-group reinsurance programs can be significant and some of these transactions can still be material from an *exposure* perspective, especially for

[18] There are no capital requirements for unregistered reinsurer default risk in the MCT. However, effective January 1, 2011, a 0.5 percent capital charge will be in place for letters of credit used to obtain a capital credit for unregistered reinsurance. OSFI is currently reviewing its capital requirements for P&C ceding insurers for other types of collateral held.

catastrophe programs covering earthquake risks where the premium amounts for such coverage could be relatively small, but the potential claims can be quite large.

OSFI Decision and Timing

OSFI does not plan to propose amendments to the regulatory approvals regime at this time. With respect to the approval requirement for unregistered related party reinsurance transactions, OSFI will re-examine this once a revised Guideline B-3 is in force.

D) CONCLUSION

In summary, the policy decisions and reforms outlined above represent a regulatory shift from strict reliance on prudential limits (the 25 percent unregistered reinsurance limit and 75 percent fronting limit) to guidance on sound reinsurance practices and procedures (new Guideline B-3), enhanced and more equitable capital requirements for federally-regulated ceding companies, greater disclosure requirements, and increased supervisory and actuarial scrutiny of reinsurance arrangements/contracts.

Along with this regulatory and supervisory shift, OSFI will undertake developmental policy work to assess the issues associated with establishing a more sophisticated risk-based system for unregistered reinsurers and corresponding risk-based capital requirements for ceding companies (which considers the strength of the reinsurer and the posted collateral).

OSFI aims to implement the main changes to its reinsurance regulatory and supervisory framework by the end of 2010. The industry will be consulted as the new Guideline B-3 is developed in accordance with OSFI's usual practices for issuing new guidelines.

Any questions can be addressed by:

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