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OSFI Releases Draft Guideline B-2 and Revises Rule for Large Insurance Exposures

Gordon Goodman

12/01/2020

On November 26, 2020, the Office of the Superintendent of Financial Institutions Canada (OSFI) issued its draft Guideline B-2: *Property and Casualty Large Insurance Exposures and Investment Concentration* (Guideline B-2). In OSFI's Reinsurance Discussion Paper released in June 2018 (the Discussion Paper), OSFI advised that it would introduce a rule in Guideline B-2 to limit the size of policies provided by Property and Casualty (P&C) Federally Regulated Insurers (FRIs) in certain circumstances (the Rule). The Rule would restrict the maximum policy limit that a P&C FRI could issue, depending upon its capital level and excess collateral, as well as the diversity of its reinsurance counterparties and would cause the FRI to meet certain stress testing scenarios. OSFI advised that the proposed Rule would apply to P&C FRIs that provide coverage directly to policyholders and to P&C FRI reinsurers in respect of direct business assumed by registered affiliates.

The draft Guideline B-2 proposes an amended rule, which requires a P&C FRI to be able to cover the maximum loss related to a Single Insurance Exposure (as opposed to three of its largest policy limit losses) on any policy it issues, assuming the default of its largest unregistered reinsurer on that exposure (the Amended Rule). The Amended Rule is expressed as a percentage of Total Capital Available (or Net Assets available for foreign branches). OSFI advised that it has developed the Amended Rule with the aim of meeting OSFI's mandate of protecting policyholders.

While we welcome OSFI's approach regarding the draft Guideline B-2, we expected more detail regarding OSFI's expectations as to how the implementation of Guideline B-2 will work to ensure consistency among P&C FRIs. We have summarized below the areas that could be expanded upon with greater detail in the final version of Guideline B-2:

1. **Single Insurance Exposure**

The draft Guideline B-2 provides that P&C FRIs should have a comprehensive Gross Underwriting Limit Policy (GUWP) that is consistent with the P&C FRI's Risk Appetite Framework. The draft Guideline B-2 provides that the GUWP should define what constitutes a Single Insurance Exposure by class of insurance, as appropriate, as well as establish limits by class of insurance regarding the level of gross insurance risk that the P&C FRI is willing to accept in respect of a maximum loss related to a Single Insurance Exposure. While we generally agree with OSFI's approach in allowing a P&C FRI to define what constitutes a Single Insurance Exposure by class of insurance, it would be helpful for OSFI to provide examples as to how a

P&C FRI should define a Single Insurance Exposure to ensure consistency amongst participants in the insurance industry.

2. **Insurance Exposure Limit**

The draft Guideline B-2 provides that at no time should any P&C FRI's net retention, plus its largest net counterparty unregistered reinsurance exposure, due to the occurrence of a maximum loss on a Single Insurance Exposure, exceed (i), in the case of an insurance company, 25% of Total Capital Available; (ii), in the case of a foreign branch, 100% of the Net Assets Available (provided that criteria set out in Annex 2 to the draft Guideline B-2 are satisfied, failing which, the limit is 25% of Net Assets Available); or (iii), in the case of a subsidiary in Canada, 100% of Total Capital Available (provided that criteria set out in Annex 2 to the draft Guideline B-2 are satisfied, failing which, the limit is 25% of Total Capital Available). It is unclear whether such limits provide a level playing field among insurance companies, foreign branches and P&C FRI subsidiaries in Canada. In addition, the draft Guideline B-2 does not delineate the difference between an insurance company and a P&C FRI subsidiary in Canada. Further clarity is required from OSFI with respect to the above-noted items.

3. **Annex 2 – Criteria**

The draft Guideline B-2 sets out the criteria to assess whether the Insurance Exposure Limit is: (i) 100% or 25% of Net Assets Available for a foreign Branch; or (ii) 100% or 25% of Total Capital Available for a P&C FRI subsidiary in Canada. The criteria provided in Annex 2, however, is overly broad. It would be helpful for OSFI to provide more detail regarding the criteria, making it easier for foreign branches and P&C FRI subsidiaries to determine the Insurance Exposure Limit.

Conclusion

While OSFI's draft Guideline B-2 is shorter than expected, it is an improvement over OSFI's proposed Rule set out in its Discussion Paper. The draft Guideline B-2, however, still leaves several unanswered questions. We expect that FRIs will require more detail regarding OSFI's expectations set out in the draft Guideline B-2, including the following: (i) how to define the maximum loss of a Single Insurance Exposure; (ii) how the maximum loss on a Single Insurance Exposure limit will affect insurance companies, foreign branches and P&C FRI subsidiaries in Canada; and (iii) the application of the criteria set out in Annex 2 for foreign branches and P&C subsidiaries. We look forward to receiving clarification from OSFI as to how the implementation of Guideline B-2 will work to ensure consistency and a level playing field among FRIs in Canada.

OSFI has invited comments to be submitted on the proposed draft Guideline B-2 by email at **B.2@osfi-bsif.gc.ca** by March 18, 2021. OSFI notes that the consultation period will run for an extended period of 16

weeks in order to encourage thoughtful discussion and assessment of the issues while P&C FRIs manage the operational constraints posed by the COVID-19 pandemic. We encourage FRIs to provide submissions to OSFI about how the revised Guideline B-2 will affect their respective operations. We would be pleased to assist with any submissions on your behalf to OSFI. OSFI expects to issue the final Guideline B-2 and Guideline B-3: *Sound Reinsurance Practices and Procedures* (Guideline B-3) in tandem in mid-2021, along with a non-attributed summary of comments received and OSFI's response. OSFI has advised that it will provide an adequate transition period so that FRIs will have time to adjust their respective business models in connection with the implementation of Guideline B-2 and Guideline B-3.

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