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OSFI Releases Draft Guideline B-3: *Sound Reinsurance Practices and Procedures*

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On June 12, 2019, the Office of the Superintendent of Financial Institutions Canada (OSFI) issued its proposed revisions to Guideline B-3: *Sound Reinsurance Practices and Procedures* (Guideline B-3). The release of Draft Guideline B-3 (the Draft Guideline) is part of Phase II of OSFI's ongoing review of the Canadian reinsurance framework for federally regulated insurers (FRIs) which commenced nearly one year ago with the publication of OSFI's Discussion Paper on the Reinsurance Framework (the Discussion Paper). A copy of our e-LERT regarding the Discussion Paper can be accessed here.

In addition to the Draft Guideline, OSFI published its responses to a summary of industry comments relating to the Discussion Paper (the Summary).

We have summarized certain proposed changes to Guideline B-3 and OSFI's comments in the Summary below:

1. Foreign FRIs Ceding Risks Back to the Home Office

In the Discussion Paper, OSFI expressed concern with arrangements whereby foreign FRIs cede risks insured in Canada to an unregistered affiliated reinsurer which are then retroceded back to the FRI's home office.

The Draft Guideline provides that: "Reinsurance may be used for purposes not directly linked to the mitigation of a FRI's insurance risks. Under such circumstances, OSFI will evaluate the reinsurance arrangements, including the appropriateness of capital credit for such arrangements, based on the risk impact to the FRI. *In particular, OSFI will generally not recognize or grant credit for a foreign FRI's reinsurance arrangement(s) when risks insured in Canada are ceded back to the foreign FRI's home office through affiliated reinsurers.*" (emphasis added)

With respect to the arrangements, the Summary provides that "OSFI recognizes that there may be unique or exceptional circumstances that could be evaluated on a case-by-case basis". As arrangements of this nature are a common practice among foreign FRIs, we encourage FRIs to consider submitting additional representations to OSFI on this issue.

2. Due Diligence on Counterparties and Concentration Llimits

The Draft Guideline provides that the due diligence process for assessing counterparty risk should be "consistent across all counterparties (i.e., affiliates and non-affiliates)." In response to industry feedback on OSFI's proposal to establish concentration limits on reinsurance arrangements, OSFI states that Guideline B-3 does not "penalize affiliated reinsurance." While this may be accurate, it is important to note that the concentration "charge," if applied, would appear in a revised Minimum Capital Test Guideline.

3. Reinsurance Payments in Canada

The Discussion Paper indicated that revisions to Guideline B-3 would include additional guidance regarding global treaties and OSFI's expectation that reinsurance payments flow directly to the FRI in Canada. The Draft Guideline provides that "OSFI expects reinsurance receivables to be paid directly to a FRI-cedant in Canada, or to a person acting for, or on behalf of, the FRI-cedant in Canada." OSFI has reiterated its concerns with funds flowing to Canada in the event of financial distress or insolvency. In our view, this does not represent a significant deviation from Guideline B-3.

4. Reinsurance Reporting and Monitoring

The Draft Guideline indicates that the results of stress testing performed on the reinsurance program should be maintained and provided to OSFI upon request. We expect that the stress testing scenarios detailed in Annex 1 of the Discussion Paper will be addressed in OSFI's revisions to Guideline B-2: Investment Concentration Limit for Property and Casualty Insurance Companies, which we anticipate will be published this year.

5. Significant Quota Share Treaties

In the Discussion Paper, OSFI wrote: "In particular, OSFI is seeking views on the concept of "substantially all of [an insurer's] risks" and how this concept could be expressed in a more objective manner." Although industry response was mixed on this point, some FRIs felt that an objective threshold would be useful. However, the Summary provides that the concept of determining the threshold for "substantially all" of a risk will remain principles-based. It is our view that this approach is probably preferable for many insurers.

6. Insurance-Linked Securities

In the Discussion Paper, OSFI indicated that it may consider new requirements pertaining to insurance-linked securities (ILS). OSFI does not currently permit FRIs to take credit for reinsurance for ILS. The Draft Guideline does not address ILS and the Summary provides that no changes have been proposed to OSFI's treatment of ILS. This is unfortunate given the growing demand for reinsurance coverage and the fact that the use of ILS is internationally accepted.

7. Fronting Arrangements

OSFI raised concern with certain fronting arrangements in the Discussion Paper. The Draft Guideline does not contain any new requirements. However, OSFI stated that it expects FRIs to take a “comprehensive approach to managing risks arising from the use of reinsurance,” with respect to fronting arrangements.

Conclusion

Despite a strong and often negative reaction from the Canadian insurance industry to various proposals in the Discussion Paper, OSFI’s initial views have not changed in any material respect. None of OSFI’s proposed revisions to Guideline B-3 are particularly surprising. FRIs should begin reviewing their reinsurance programs considering the Draft Guideline as well as OSFI’s comments in the Summary.

One of the most controversial parts of the Discussion Paper is the new stress test for large limit policies. If the proposed stress test was implemented, it would lead to a requirement for many commercial insurers to maintain significantly larger amounts of capital in Canada. OSFI’s position on it will likely be released as part of a revised Minimum Capital Test Guideline later this year.

OSFI has invited comments to be submitted on the proposed revisions to Guideline B-3 by August 16, 2019. We would encourage insurers to provide submissions to OSFI about how the revised Guideline B-3 will affect their business in Canada. We would be pleased to assist with any submissions on your behalf to OSFI.

For more information regarding the Draft Guideline, the Discussion Paper or for assistance with preparing a submission, please contact any member of the Cassels Insurance & Reinsurance Group.

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