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Regulating Reinsurance: OSFI Releases its Discussion Paper

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On June 8, 2018, the Office of the Superintendent of Financial Institutions Canada (OSFI) released a Discussion Paper on OSFI's Reinsurance Framework (the Discussion Paper). OSFI has undertaken a broad review of the reinsurance framework applicable to federally regulated insurers (FRIs). The Discussion Paper is important and provides a roadmap for the future direction of the regulation of reinsurance in Canada. OSFI has been concerned for several years about the business model of certain FRIs that rely heavily on reinsurance by ceding a significant portion of risks outside of Canada, with little capital or vested assets maintained in Canada to support the increased risk exposure. OSFI refers to this type of structure as the "leveraged business model."

In its Discussion Paper, OSFI identifies two key findings of its review of the reinsurance framework:

1) Risks associated with large exposures and concentration of reinsurance counterparties must be better managed; and

2) Adjustments to the capital framework for reinsurance are warranted.

The Discussion Paper also addresses a number of proposed clarifications to OSFI Guideline B-3 – *Sound Reinsurance Practices and Procedures* (Guideline B-3) and changes to regulatory data forms and transaction instructions for legislative approvals related to reinsurance.

OSFI has indicated that its review of the reinsurance framework will be completed in three distinct phases: Phase I (in 2018) will include consultation and finalizing the 2019 Minimum Capital Test (MCT) Guideline; and Phase II (in 2019) will involve consultation and finalizing and revisions to Guideline B-2 and Guideline B-3, as well as revised Transaction Instructions for Related Party Reinsurance (DA-21) and Phase III (in 2020) will consider changes to capital guideline tests (MCT and LICAT) for 2022 onward.

Guiding Principles

OSFI highlights four guiding principles in its Discussion Paper, indicating that any proposed changes to the reinsurance framework should be assessed against each principle:

- Policyholders of FRIs must be adequately protected;
- Regulation and supervision must be balanced and risk-based;
- OSFI must have the ability to effectively assess risks; and

- A level playing field among financial sector players should be maintained where appropriate.

OSFI's Two Key Findings

1) Reinsurance Risk Management – Large Exposure and Concentrated Counterparty Risks

OSFI is concerned with the "leveraged business model." Under this Model, a FRI issues high-limit policies in Canada and then commonly reinsures these risks with an unregistered related party. Consequently, a "leveraged business model" may result in significant and highly concentrated counterparty risk and a potential solvency issue, if a loss occurs and the counterparty is unable to satisfy its reinsurance obligations.

To address this concern, OSFI proposes to revise Guideline B-3 by clarifying and enhancing the expectations related to the prudent management of reinsurance risks, including an expectation that a FRI establish reasonable limits on its overall reinsurance exposure to any one reinsurance entity or group, particularly where the cedant FRI relies on its reinsurance programs to underwrite high-limit policies.

Additionally, OSFI intends to introduce a rule to limit the size of policies provided by P&C FRIs in certain circumstances in OSFI Guideline B-2 – *Large Exposure Limits* (Guideline B-2). 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. 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.

2) The Capital Frameworks for Reinsurance

OSFI has identified a number of potential changes to the capital frameworks in respect of reinsurance.

Proposed Changes Effective January 1, 2019

Changes that will be consulted upon this year for inclusion in the 2019 MCT Guideline with an effective date of January 1, 2019, are as follows:

- introduce a counterparty credit risk charge to P&C FRIs on cessions to registered associated reinsurers; however, OSFI does confirm in the Discussion Paper that there is no intention at this time to apply counterparty credit risk charges to cessions within an OSFI approved intercompany pooling arrangement.
- Remove the current restriction in the MCT Guideline regarding funds withheld from reinsurers that are associates and non-qualifying subsidiaries and recognize the amount of funds held to secure payment from assuming unregistered associated reinsurers as acceptable collateral for Canadian insurers, subject to certain conditions:

(1) the arrangement must not contain any contractual provision that would require payment of funds withheld to the reinsurer before all subject policies have expired and all claims settled (e.g., an acceleration clause); and

(2) the ceding insurer may not provide non-contractual or implicit support, or otherwise create or sustain an expectation that any funds withheld could be paid to the reinsurer before all subject policies have expired and all claims settled.

- A corresponding revision would be made to the LICAT in respect of Life FRIs, permitting a ceding insurer to obtain credit for funds held under a funds withheld reinsurance arrangement provided that:

(1) the arrangement does not contain any contractual provision that would require payment of funds withheld to the reinsurer before the end of the reinsurance term (e.g. an acceleration clause); and

(2) the ceding insurer does not provide non-contractual or implicit support, or otherwise create or sustain an expectation that any funds withheld could be paid to the reinsurer before the end of the reinsurance term.

Proposed Changes Effective January 1, 2020

The following change will be consulted upon this year for inclusion in the 2019 MCT Guideline with an effective date of January 1, 2020:

- For P&C FRIs, increase the margin required for reinsurance ceded to unregistered reinsurers from 15% to 20% in order for a FRI to obtain full capital/asset credit for such reinsurance.

Financial Resources Supporting Earthquake Risk Exposures

FRIs are currently required to establish an earthquake reserve. FRIs may reduce their earthquake reserve using eligible financial resources. OSFI is concerned that such reduction may cause the FRI to count the same resource twice, which inappropriately reduces the FRI's overall level of capitalization.

Accordingly, OSFI is considering the removal of the 10% of consolidated/world-wide capital and surplus as an eligible financial resource for all FRIs in the calculation of the earthquake reserve. This is an important proposal that needs to be considered by all FRIs with large cat exposures.

Reinsurance Concentration Risk

The Discussion Paper indicates that the use of reinsurance by FRIs (both P&C and life) has created a concentration of credit risk through FRIs implementing reinsurance programs with a single or a few reinsurers or a few groups of related reinsurers.

OSFI is considering introducing a concentration risk charge/limit on reinsurance assets in a future update of the capital guidelines.

Guideline B-3 Clarifications and Regulatory Data Form Changes

Global Treaties and Flow of Reinsurance Funds

Large, international insurance groups commonly use global treaties which provide coverage in respect of multiple insurance operations in different countries. OSFI is concerned that, given the multiple risks and locations covered by global treaties, it is possible that a treaty's coverage limit could be exhausted following an event in another jurisdiction, such that subsequent events affecting Canadian policyholders are not covered. OSFI's additional concern is that, during a stress event, the proceeds of a reinsurance treaty flow to the entity arranging the coverage, in the foreign jurisdiction, rather than directly to the FRI in Canada.

OSFI indicated that its revisions to Guideline B-3 would include additional guidance regarding global treaties and its expectation that reinsurance payments flow directly to the FRI in Canada.

Significant Quota Share Treaties

According to the Discussion Paper, over-reliance on quota share reinsurance in the P&C sector has increased overall risk with the arrangement; particularly where concentrated with a single reinsurer or reinsurance group. OSFI argues that this results in, among other things, a weakening of underwriting standards and discipline at the ceding FRI, which could impair the FRI's ability to renew or replace its reinsurance.

Guideline B-3 provides that a FRI should not cede “substantially all of its risks” in the normal course of business. OSFI has indicated that as part of its consultation, it is seeking to express this restriction in a more “objective” way. The practical meaning of this phrase has generally depended on the particular facts and the nature of the reinsurance arrangement(s), making it difficult to establish a standard rule that is reasonable for all FRIs.

The amount of permitted reinsurance was previously regulated by OSFI. The Reinsurance Regulations provided that an FRI could cede up to 75% of its premiums to registered reinsurers and 25% to unregistered reinsurers. Although these limits were arbitrary, they provided the insurance industry with clear direction regarding how much reinsurance would be permitted. OSFI repealed the Reinsurance Regulations in 2011 on the basis that it was a principles-based rather than rules-based regulator. It is possible that the new “substantially all” test may be at least a partial return to a rules-based approach. OSFI has used 75% as its test for “substantially all” in assumption reinsurance transactions. Additional guidance on what amount of reinsurance is acceptable to OSFI would be of great assistance to many reinsurers.

Fronting Arrangements

OSFI has become increasingly concerned with fronting arrangements:

- that are not reasonably ancillary to the FRI's existing business;
- for which the FRI has little or no in-house underwriting experience; and
- for which all (or nearly all) of the insurance-related activities related to the fronted business are carried out by an unregistered unrelated foreign insurer (UUFI), including underwriting.

OSFI's overall concern is that such FRIs will have inadequate knowledge of the risks it has insured and for which it is liable in the first instance. OSFI states that a fronting arrangement involving an insured's captive UUFI could raise prudential concerns to the extent that the arrangement represents a large exposure relative to the FRI's capital or assets in Canada.

OSFI indicates that FRIs will be expected to "take reasonable measures" to satisfy themselves that legal risks related to contracts in respect of reinsurance arrangements with captive UUFIs are managed. In our view, such measures will likely depend on the nature and amount of risk which is subject to the fronting arrangement.

We expect, subject to the results of consultation, that Guideline B-3 will contain greater detail regarding fronting arrangements and large exposures.

Foreign FRIs Ceding Risks back to the Home Office

The Discussion Paper reviews arrangements whereby foreign FRIs cede risks insured in Canada to an unregistered affiliated reinsurer, which then retrocedes the risks back to the FRI's home office. These foreign FRIs then generally recognize this reinsurance arrangement for the purposes of determining their required vested assets. When a loss occurs in Canada, reinsurance proceeds flow from the FRI's foreign accounts, to the FRI's affiliated reinsurer in the first instance, before flowing to the FRI's branch in Canada.

OSFI is concerned that such arrangements may reduce the total available assets in Canada to satisfy the FRI's financial obligations related to its insurance business in Canada.

The Discussion paper indicates that one proposed solution is to deny credit to a foreign FRI for the risks that are ultimately retroceded back to the home office and exclusively through entities within the FRI's group. Alternatively, OSFI may require additional collateral to be maintained in Canada to mitigate its concerns related to the availability of assets in Canada.

Legislative Approvals for Reinsurance with Related Parties

OSFI has indicated that it intends to request additional information for Related Party Reinsurance Applications and to expand the scope of the annual information submissions in respect of such reinsurance relationships for all related party reinsurance arrangements.

Insurance Linked Securities

OSFI has highlighted that a reinsurer that transfers the risks it assumes to investors via insurance-linked securities (ILS), may have a very different risk profile relative to a traditional reinsurer.

At this time, OSFI has not provided details concerning how it intends to revise Guideline B-3 to include its expectations for FRIs that cede risks to reinsurers that rely on ILS. OSFI does not currently permit an FRI to take credit for reinsurance for an ILS. OSFI has indicated that ILS may be permitted in certain cases but has not provided any detailed information. This is an important development since Canada is one of the few jurisdictions in the world that does not allow credit for reinsurance for ILS as an alternative to traditional reinsurance. OSFI has likely recognized the growling depth and maturity of the ILS market and its importance as an alternative source of capacity.

Conclusion

It will be interesting to see the reaction from the Canadian insurance industry to the Discussion Paper since it will have a significant impact on the operations of many FRIs. Increased scrutiny can clearly be expected with respect to “leveraged business model”, fronting arrangements, and capital and collateral requirements for reinsurance structures pertaining to Canadian risks. There will likely be greater information requirements to demonstrate that FRIs have proper internal procedures and underwriting expertise with respect to the risks they are proposing to write or reinsure.

It is clear that OSFI intends to maintain its regime of requiring significant amounts of “ring-fenced” assets to be maintained in Canada. OSFI has rejected some of the important international insurance regulatory trends such as Mutual Recognition and Equivalency. It will be important for OSFI to strike the right balance in the changes that are finally implemented between protecting Canadian policyholders and ensuring that Canada remains a competitive insurance market with adequate capacity available. It is possible that some FRIs will exit the Canadian market if OSFI’s rules and capital requirements become too extreme.

OSFI indicated in its press release that the revised MCT Guideline would be released in draft format in the next few weeks.

OSFI has invited comments to be submitted on the Discussion Paper by September 15, 2018. We would encourage all FRIs to review the Discussion Paper in detail and make an assessment of the effect of the proposals on their operations. We would be pleased to assist with any submissions on your behalf to OSFI.

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