

OSFI releases revised Advisory on insurance in Canada of risks

Where we are, how we got here and where we're going

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Introduction – “Where we are”

On May 29, 2009, Canada's Office of the Superintendent of Financial Institutions (OSFI) released a revised Advisory (the Revised Advisory) updating its landmark October 2007 Advisory (the Original Advisory) on the insurance in Canada of risks under Part XIII of the Canadian *Insurance Companies Act* (ICA). The issuance of the Revised Advisory is the latest step in the long evolution of the Canadian regulatory regime for foreign insurance companies from a regime focused on risks located in Canada to one focused on insurance business in Canada. The Revised Advisory, which is the result of OSFI consultation with the industry and other stakeholders, significantly simplifies the Original Advisory and sets forth more concise, precise and objective criteria for determining whether a foreign insurer is insuring in Canada risks and, thus, subject to regulation under the ICA.

Under the ICA, all insurance companies incorporated outside Canada are required to be licensed by OSFI in order to “in Canada insure risks”. Whether the business is conducted “in Canada” has historically been a factual matter to be determined with regard to the circumstances of the placement and the extent to which the relevant activities were conducted in Canada as opposed to outside of Canada. Historically, where a foreign company with a licensed Canadian branch wrote coverage of risks located in Canada, OSFI required that the coverage of the Canadian risks be recorded on the books of the Canadian branch whether the policy was “written” (in the sense of being risk assessed, negotiated and serviced/administered) through the Canadian branch or through the foreign company's home office outside Canada. Consequently, the Canadian branch would be required to vest sufficient assets to support all of the foreign company's Canadian-related liabilities, whether or not “written” through the Canadian branch.

This newsletter was prepared by members of the Insurance Group at Stikeman Elliott.

In connection with changes to the ICA effective January 1, 2010, OSFI's administrative practice has shifted dramatically to focus on the location of the conduct of the insurance business rather than the location of the risk. As a result, under the Original Advisory and now the Revised Advisory, if the business relates to risks located in Canada but is nonetheless "written" outside of Canada, the business will no longer be required to be recorded on the books of the Canadian branch and the Canadian branch will, thus, no longer be required to vest assets in respect of that business. The Original Advisory and now the Revised Advisory provide detailed criteria for determining whether, in OSFI's view, the business is "written" in Canada as opposed to outside Canada. The thrust of OSFI's new approach was described well by Superintendent Dickson last year in a speech in which she noted:

Changes to Part XIII are about promises made and promises being kept. The policyholders that have transactions here in Canada, with a foreign insurer, expect that Canadian laws will protect them. They expect that, in a worst case scenario, there will be enough money to satisfy all eligible claimants in liquidation. This is a legitimate expectation. However, if we regulate on the basis of location of risks we lose the ability to keep that promise. So the promise being made is that if the transaction occurred in Canada, with some physical presence of the insurer, then the regime protects policyholders. In other words, if you "walked into the store" in Canada you are protected, but if you "walked into the store" abroad you are not protected in terms of solvency by OSFI (you are protected by a foreign regulator). Further to our announcement that the implementation date for Part XIII is being postponed until January 1, 2010, we have continued our work on guidelines and regulations that are relevant to the Part XIII regime. We also continue to work with the industry and the provinces on this initiative and remain ready to respond to any questions.

Chronology to May 2009 – "How we got here"

The new regime in Canada reflects both a change in interpretation by OSFI and changes to the ICA resulting from the proclamation into force on April 20, 2007 of *An Act to Amend the Law Governing Financial Institutions and to Provide for Related and Consequential Matters* (Canada) S.C. 2007, c.6. The changes to the ICA were originally intended to be effective as of January 1, 2009. On February 13, 2008, however, OSFI announced that the implementation would be postponed until January 1, 2010 in order to permit stakeholders more time to implement certain aspects of the new regime. The changes to the ICA and the related OSFI guidance, including that contained in the Original Advisory, reflected a long consultation with industry, leading advisors and other stakeholders. The Original Advisory, in particular, evolved through numerous drafts provided for comment to the industry, advisors and other stakeholders.

The previous regime resulted in a number of statutory and practical anomalies in the Canadian regulatory regime, which the new regime intends to address, including the following:

1. The old regime required foreign companies with Canadian branches, and which covered Canadian risks as part of multinational programs, to identify the portions of those programs that related to Canadian risks. Foreign companies had to ensure that the Canadian portions of their programs were recorded in the books of the Canadian branch and, thus, assets maintained in Canada to support the related liabilities. Compliance with this identification, allocation and reporting obligation proved onerous for certain international groups, whether through inadvertence or sloppiness, and compliance proved particularly problematic in the circumstance of a voluntary windup of a Canadian branch, where it sometimes proved difficult to determine with certainty that the books of the Canadian branch reflected all Canadian-related risks whether written through the Canadian branch or via the home office.

2. There was inconsistency between the wording of the ICA and the provisions under the *Winding-Up and Restructuring Act* (Canada) that would apply in the event of the liquidation of a branch, which presented the possibility in such a circumstance that there would be insufficient assets in the Canadian branch to provide for all Canadian policyholders. Specifically, there was a concern that a policyholder in respect of a non-Canadian risk written through the Canadian branch would have a claim against the branch assets. This was the principal rationale advanced by OSFI for the evolution of the regime.
3. If a foreign company, which was not licensed in Canada, but which had written Canadian-located risks entirely outside of Canada, subsequently decided to establish a Canadian branch, all of the historic Canadian risks would be required to immediately be recorded on the books of the Canadian branch, with assets vested to support them. This could result in a requirement for double capital: capital in Canada and the original capital in the home jurisdiction. Similarly, if such an unlicensed foreign company that had written Canadian-located risks entirely outside of Canada later merged in its home jurisdiction with another entity that maintained a Canadian branch (this second company would have recorded its Canadian-related risks in the books of its Canadian branch), the Canadian-related risks of the unlicensed company would be required to be immediately reported in the Canadian branch of the merged entity. In neither case was any "grandfathering" possible of the Canadian-located risks originally written entirely outside of Canada.
4. The old regime was inconsistent with the Canadian tax regime, which required filing based on the worldwide business of a Canadian branch and not merely in respect of the risks located in Canada. Many companies, unaware of the distinction, simply based their tax returns on their OSFI filings, which would only have captured the Canadian-located risks and not the worldwide business of the Canadian branch.

Under the new regime, effective January 1, 2010 all risks on the books of a Canadian branch will be presumed by OSFI to have been insured in Canada. Business written outside Canada will no longer be required to be recorded on the books of the branch and branches will be able to apply for a release of assets backing business written outside Canada. No grandfathering will be available in either circumstance. OSFI expects foreign companies, within a reasonable time after January 1, 2010, to exercise due diligence to identify all risks located outside Canada that were written in Canada prior to January 1, 2010 and to comply with Part XIII going forward in respect of those risks. In all cases, this process is to be completed by December 31, 2010.

In late 2008, OSFI released its latest package of administrative guidance to the industry in connection with the new regime. That package was comprised of an explanatory Cover Letter, Implementation Instructions, a Note to Cedants and a list of Questions and Answers. Pursuant to the Implementation Instructions, all foreign companies with Canadian branches will be required to submit to OSFI four quarterly progress reports in 2009/2010 relating to the branches' identification of risks located outside of Canada that were insured in Canada (and which will accordingly be required to be reported in the branch going forward). The first of the reports was due on May 31, 2009. As described in the Implementation Instructions, the progress reports must describe the structure of the internal project, related governance and timelines and key personnel involved, including accountabilities and an assessment of whether sufficient resources exist to meet the requirements. The reports must also describe the controls that the foreign company will have implemented to identify policies that have been insured in Canada prior to January 2010 and a description of any significant impact on the branch's vested assets as a result of the new regime. The reports must also include the planned schedule for the project and a description of the company's compliance with the schedule. In the Cover Letter, OSFI indicated its expectation that a foreign company will communicate with

its auditors and actuaries with respect to the review and involve a senior officer from the company's home office. If the implementation will significantly impact the vested assets, OSFI expects the foreign company's board, or a committee thereof, to be involved in the project.

As noted in the Cover Letter, once the amendments to the ICA become effective in January 2010, the existing exemption, which excludes the application of Part XIII of the ICA to marine insurance, will be removed. Consequently, foreign companies already having a licensed branch will be required to request to amend their existing licensing to include marine insurance as a class of insurance, and foreign companies without a licensed branch will be required to establish a branch in order to insure in Canadian marine business.

The Implementation Instructions also provided guidance on, and examples of, the types of notifications that foreign companies with licensed branches will be required to set out in all premium notices, applications for policies and policies, in order to indicate whether the applicable document was issued or made in the course of the foreign company's insurance business in Canada. The Implementation Instructions also provided detailed guidance on the procedures with which compliance will be required by a foreign company desiring the removal of some or all of the liabilities in respect of risks reported on the books of the Canadian branch where, under the new regime, the risks were not insured or reinsured in Canada.

The Revised Advisory

As noted above, the Revised Advisory sets forth much more concise, precise, certain and objective criteria for determining whether insurance business is carried on in Canada, and simplifies the detailed and granular analysis contained in the Original Advisory. Unlike the Original Advisory, the Revised Advisory focuses on Canada as a specific jurisdiction, rather than on more general generic locations and there is no longer a focus on the wording of the policy itself or the connection of the policy to a particular jurisdiction or having regard to interpretation relating to the proper law of contracts. The new test is much more objective and no longer includes subjective criteria related to representations made by the parties or the location where the parties considered the risk to have been insured. The Revised Advisory also clarifies that the indicia listed in it are only the "key" indicia, with the inference that other indicia not listed in the Revised Advisory may also be relevant in any particular circumstance.

The core elements of the Revised Advisory are contained in Sections 2, 4 and 5 of the Revised Advisory, which provide as follows:

2. To determine whether a foreign insurer is insuring in Canada a risk, consideration should be given to whether any person acting for, or on behalf of, the foreign insurer:
 - a) promotes the foreign insurer or the foreign insurer's insurance products through a medium of communication that is primarily circulated, transmitted, broadcasted or otherwise accessible in Canada (other than in the course of the activity referred to in subparagraph 2(b) below);
 - b) directly incites a person located in Canada to request insurance coverage (where that person is specifically identified and targeted), and that person is provided with the opportunity and/or means with which to make a request for insurance coverage in the course of that activity (e.g., telemarketing, door-to-door solicitation, direct/targeted mail);
 - c) receives in Canada a request for insurance coverage from a policyholder;
 - d) negotiates from Canada the terms and conditions of insurance coverage;
 - e) decides in Canada to bind the foreign insurer to insurance coverage;

- f) communicates from Canada an offer to provide insurance coverage, or the acceptance of a request for insurance coverage, to a policyholder;
 - g) receives in Canada an acceptance of the foreign insurer's offer to provide insurance coverage from a policyholder;
 - h) receives in Canada payment for insurance coverage from a policyholder; and
 - i) interacts in Canada with the policyholder in the provision of services related to the insurance coverage (e.g., providing information about the coverage and receiving claims).
4. OSFI considers that a foreign insurer is insuring in Canada a risk where its business model encompasses:

Scenario 1: Two or more of the activities referred to in any of subparagraphs 2(b) to (h).

Scenario 2: Any one of the activities referred to in any of subparagraphs 2(b) to (h) and both of the activities referred to in subparagraphs 2(a) and (i).

Scenario 3: Reaching an agreement, actual or in principle, on most or all of the material terms and conditions of the insurance coverage in the course of its negotiations in Canada (i.e., this Scenario contemplates that, in addition to 2(d), at least one additional activity referred to in 2(e) through (g) would apply).

5. OSFI considers that a foreign insurer is not insuring in Canada a risk where its business model encompasses no more than one of the activities referred to in paragraph 2.

As indicated in the Revised Advisory, Canadian risks can now clearly be insured partly via insurance business in Canada and partly via insurance business outside Canada.

T-minus six months to implementation – “Where we’re going”

Foreign companies writing Canadian risks, licensed in Canada or unlicensed, have a number of actions to undertake prior to the implementation of the changes to the ICA on January 1, 2010. These include:

1. Reviewing the Revised Advisory against their current and any proposed business models to determine the extent to which current or proposed business will be in Canada as opposed to outside Canada under the Revised Advisory and the possible ramifications for current or proposed business models. Considerations should include whether or not to seek licensing in Canada (if currently unlicensed), or to seek to withdraw from Canada (if currently licensed).
2. If currently licensed, completing the required due diligence on their Canadian-related books, and completing and filing quarterly progress reviews. In this connection, involving auditors early to ensure adequate controls are in place to satisfactorily complete this action.
3. If a marine insurer, amending or seeking licensing in Canada.
4. If currently licensed, preparing to comply with the requirements for disclosure in policies and other related documents regarding whether the business was written in Canada.
5. If currently licensed but seeking to remove business from the books of the Canadian branch and eventually withdraw the related assets, complying with the applicable requirements enunciated by OSFI in the Implementation Instructions for insurers or reinsurers, as applicable.

6. If currently licensed, reviewing historical cessions with foreign companies to determine whether the risks were reinsured inside Canada or outside Canada, as per the Revised Advisory, in order to determine the extent to which the cedant may take capital/asset credit (no credit if reinsured outside Canada unless the reinsurer has provided sufficient security). This also applies to Canadian-incorporated insurers and not merely foreign companies.
7. If currently licensed, watching for the release by OSFI of drafts of revisions, necessitated by the changes to ICA, to the Reinsurance (Foreign Companies) Regulations, Reinsurance (Canadian Companies) Regulations and the Assets (Foreign Companies) Regulations, in each case under the ICA.
8. In general, updating corporate recordkeeping, accounting, IT and other related systems and procedures to ensure compliance with the new regime.

As has been widely noted, the new regime leaves open certain residual issues, including the interplay between the definition of insurance in Canada under the new regime as opposed to the provincial definitions of “carrying on insurance business” under the various provincial insurance statutes. As OSFI noted in the Revised Advisory, it is possible that a particular business model of a foreign company could require licensing under one of the provincial regimes, but not technically under the new federal regime. As has been widely suggested, it would be preferable if OSFI and the various provincial regulators could continue their efforts towards potential harmonization of the differing definitions, either by statute or in practice. There is also the challenge that under provincial premium tax legislation, the tax remains payable based on the location of the risk, rather than the location of the related insurance business. In addition, federal excise tax continues to apply on unregistered insurance.

It remains to be seen whether the migration to the new regime will, as has been widely speculated, result in an acceleration of withdrawals of existing branches in circumstances where the business model could be more conveniently carried on a basis that would not constitute insurance in Canada of risks under the new regime.

For further information, please contact your Stikeman Elliott representative, or the author, Stuart Carruthers (scarruthers@stikeman.com).

Stikeman Elliott has a leading Canadian practice advising insurance sector clients on mergers and acquisitions, demutualization and outsourcing transactions, the development of innovative financial products, and a wide range of regulatory, tax, class action defense, commercial risks, energy, marine/aviation, insolvency and technology matters. Our clients include major Canadian and international insurers and reinsurers, Lloyd's of London, insurance brokers and agents and investment banks. We have also advised governments and their regulatory agencies on legislative and regulatory issues affecting the insurance sector. Members of our group were recently recognized in the Euromoney 2008 Guide to the World's Leading Insurance and Reinsurance Lawyers, as well as The Best of the Best Expert Guide for insurance. A member of our group is also the founder and editor-in-chief of Butterworth's quarterly legal journal Canadian Insurance Regulation Reporter, the leading Canadian publication in the field.

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