

OSFI's reinsurance regulation Discussion Paper: Overview and international regulatory and economic perspectives in a changing world

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Introduction

Late last year, Canada's Office of the Superintendent of Financial Institutions (OSFI) released its long-awaited discussion paper on OSFI's regulatory and supervisory approach to reinsurance (the Discussion Paper). In the Discussion Paper, OSFI requested industry and other stakeholder feedback on a number of the elements of the current Canadian regulatory regime for reinsurance and feedback was due in March of this year. The release of the Discussion Paper coincided with what may well have been the peak of the recent global economic and financial institutions turmoil/crises which, by the spring of 2009, appear to be lessening somewhat. The passage of time since the release of the Discussion Paper and the continued unfolding of the crises in the subsequent months provides valuable perspectives on the Discussion Paper - perspectives which may not have been as readily apparent at the time of the release of the Discussion Paper or the deadline for industry and stakeholder feedback.

This Update provides an overview of the issues identified in the Discussion Paper, together with additional international and economic perspectives that have recently become more readily apparent as the economic and financial institutions crises have continued to unfold.

Overview of the Discussion Paper

At the outset of the Discussion Paper, OSFI identified the three main purposes of the Discussion Paper, which were:

- > to outline OSFI's current regulatory and supervisory approach to reinsurance in Canada;
- > to identify OSFI's initiatives already under way with respect to the regulation and supervision of reinsurance in Canada; and
- > to consult with the industry on the overall policy direction of reinsurance regulation and supervision in Canada.

At a more general level, as OSFI noted, the Discussion Paper constituted an effort to assess the issues at a broader level and consult more widely than previously undertaken by OSFI. Each of those very laudable general goals is consistent with OSFI's consultative approach, for which OSFI should be commended.

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

Upon considering the Discussion Paper as a whole, and the economic and regulatory environment in which it was released and subject to comment, it is apparent that four key themes run throughout the Discussion Paper:

- > Primacy of Solvency/Collateral Regulation – This is consistent with OSFI’s primary goal of protecting Canadian policyholders, and is, of course, acutely relevant in the current global economic environment;
- > International Contexts – Reinsurance is a highly globalized business, with the Canadian marketplace dominated by very large foreign groups, and accordingly, OSFI’s approach must be mindful of that international context and, at a global level, the regulation, or lack of regulation, of the reinsurance industry outside of Canada;
- > Efficiency/Streamlining – Commendably, the Discussion Paper is oriented toward promoting efficiency of regulation and elimination of regulatory requirements that are duplicative, outdated or otherwise of limited utility; and
- > Equity/“Levelling The Playing Field” – This applies in many respects, including in respect of licensed vs. unlicensed reinsurance, insurers vs. other types of financial institutions and regulation in Canada vs. regulation outside Canada.

Five Guiding Principles

In the Discussion Paper, OSFI enunciated five guiding principles that shape the current regime and against which any changes to the current regime would be required to be assessed. Those principles are:

- > protection of policyholders;
- > ensuring regulation and supervision are proportionate to risk (principles-based and risk-based, with specific rules where appropriate);
- > ensuring OSFI has the right supervisory tools;
- > ensuring a level playing field; and
- > co-ordinating effectively with international counterparts.

Issues Raised by OSFI in the Discussion Paper Regarding its Regulatory and Supervisory Approach

OSFI’s discussion of the current regulatory approach was centred on issues related to (i) unregistered reinsurance; (ii) registered reinsurance; and (iii) governance.

Unregistered Reinsurance

■ COLLATERAL REQUIREMENTS

OSFI’s regulatory approach for unregistered reinsurance in Canada (i.e. reinsurance with reinsurers not licensed to carry on business in Canada) is founded on collateral requirements that require an unregistered reinsurer to maintain enough collateral in Canada to cover 100% of the ceded liabilities and the associated capital requirement for the ceding company. The collateral requirement is, effectively, an alternative to OSFI’s capital or vested asset requirements for Canadian incorporated/licensed insurers. The collateral requirements are intended to ensure that, if the unregistered reinsurer fails to honour its obligations to the Canadian insurer, there are funds available in Canada to protect the registered Canadian insurer and its policyholders. As OSFI notes, the intent of the requirement is neither to promote nor discourage unregistered reinsurance, but rather to ensure that there is sufficient capital/collateral in the Canadian system to protect Canadian policyholders.

■ 25% LIMIT

Under regulations (the Reinsurance Regs) to the *Insurance Companies Act* (Canada) (ICA), property and casualty insurers (but not life insurers) are limited to reinsuring 25% of their risks on an annual basis with unlicensed reinsurers. It has long been argued that this limit is inconsistent with the international nature of the reinsurance business, resulting in hindered access to very strong and well-capitalized reinsurers not licensed in Canada. In the Discussion Paper, OSFI reviewed the historical rationale for the 25% limit and noted several possible alternatives, including a more generally-worded guideline requiring insurers to adopt adequate reinsurance practices and procedures. Such a guideline could also be bolstered with additional guidance on

clearer wording in reinsurance contracts and inclusion of specific clauses in reinsurance contracts. OSFI welcomed the industry's and other stakeholders' views on the 25% limit.

There is clearly no magic to a 25% cap, as opposed to, say, a 15%, 20%, 30% or 35% cap. The rationale for establishing a cap was to protect cedants that experienced higher than expected loss ratios, and their policyholders, from situations where the cedant's solvency could be jeopardized if unregistered reinsurers refused to pay claims or deposit additional collateral. However, as long as sufficient and appropriate collateral is held by the cedant, and the cedant conducts business with reinsurers with strong financial ratings, then it might be questioned whether a cap should still be required. The issue of appropriateness of collateral also raises another issue, which OSFI has been considering for some time, as to the efficacy of the current standard reinsurance trust agreement and whether it would in fact, under provincial personal property security legislation, protect the interests of cedants in the event of the insolvency of the unregistered reinsurer. Accordingly, OSFI has taken some steps toward addressing the possible issue by way of potential migration to a template reinsurance security agreement that would more effectively create an enforceable security interest under provincial personal property security legislation.

■ LETTERS OF CREDIT AS COLLATERAL

Currently, OSFI practice permits letters of credit as acceptable collateral, but only as to 15% of risks ceded to unregistered reinsurers. Further, such letters of credit must be issued by Canadian financial institutions and be evergreen and in a standard form acceptable to OSFI. It has been argued that the 15% cap is unjustified, given the safety and soundness of the Canadian financial institutions issuing the letters of credit. It has further been suggested that allowing wider use of Canadian-issued letters of credit would provide more flexibility to cedants and reinsurers. OSFI indicated that it will be reviewing the 15% cap, and welcomed industry comments.

Given that OSFI regulates the issuers of the letters of credit, it is difficult to see how the Canadian financial system and the interests of Canadian policyholders would be adversely affected significantly by allowing increased utilization of letters of credit. Increased use, however, would presumably be subject to similar concentration risk limits as already apply under the ICA in respect of permitted investments by Canadian insurance companies.

■ MUTUAL RECOGNITION FOR REINSURANCE SUPERVISION

Many commentators have long called for, and promoted the purported benefits of, an effective global regime of "mutual recognition" for reinsurance supervisory purposes. OSFI noted in the Discussion Paper that any potential migration to such a system would raise a number of challenges, including the wide variety of regulatory regimes applicable in different jurisdictions and the complexity of the product itself. The Discussion Paper listed a number of the factors that OSFI would need to consider prior to entering into any potential mutual recognition arrangements, even on a bilateral basis. In addition, as OSFI noted, depending on the jurisdiction and regulatory regime of the reinsurer, the result could potentially be more onerous than the current regime.

One alternative considered by OSFI in the Discussion Paper is a risk-based approach to collateral requirements. As OSFI noted, a wide variety of arrangements exist internationally.

US Approach – Regulatory Modernization

Like the system currently in place in Canada, U.S. states require non-licensed reinsurers to post collateral in order for the ceding insurer to obtain relief from its capital requirements. However, the National Association of Insurance Commissioners (NAIC) in the U.S. recently published draft legislation which, if enacted, will harmonize the regulation of reinsurance across the states and allow U.S. cedants to obtain capital relief when ceding to qualifying non-licensed reinsurers. The proposed legislation, to be titled the *Reinsurance Regulatory Modernization Act of 2009* (the Proposed Act), is based on a framework adopted by the NAIC in December 2008, following several years of effort.

The Proposed Act would create an oversight body called the National Association of Insurance Commissioners Reinsurance Review Board (the Board) and would allow qualifying states (i.e. states that the Board determined had sufficient supervisory regimes in place) to act as "Home State Supervisors" or "Port of Entry Supervisors". States that wished to act as a Home State or Port of Entry Supervisor would need to adopt legislation that contemplates acting as such under the Proposed Act.

The Proposed Act would also create two classes of reinsurers: National Reinsurers and Port of Entry Reinsurers. Each class of reinsurer would have a single state regulator – either in their Home State (in the case of U.S.-domiciled reinsurers) or in the Port of Entry State (in the case of foreign reinsurers). The responsible state regulator would have exclusive jurisdiction over its reinsurers’ reinsurance business. To qualify as a National Reinsurer or a Port of Entry Reinsurer, a company would need to have minimum capital and surplus of US\$250 million. The minimum capital requirement could also be satisfied by a group of underwriters having minimum capital and surplus equivalents of at least US\$250 million and a central fund containing a balance of at least US\$250million.

In addition to reviewing the reinsurance supervision regimes of states, the Board would also examine the supervisory regimes of foreign jurisdictions to determine whether they were deemed appropriate to be “Qualified Non-U.S. Jurisdictions”. The Board would also develop reciprocal recognition and information sharing agreements to be entered into with regulators in Qualified Non-U.S. Jurisdictions.

The Port of Entry or Home State Supervisor would then be responsible for assigning one of five security ratings to National and Port of Entry Reinsurers. The ratings would be based on a number of factors, including, among others, financial strength ratings received from recognized ratings agencies, the business practices of the reinsurer in dealing with its ceding insurers and past regulatory actions against the reinsurer. The five rating categories and their corresponding collateral requirements are as follows:

RATING	COLLATERAL REQUIRED
Secure – 1	0%
Secure – 2	10%
Secure – 3	20%
Secure – 4	75%
Vulnerable – 5	100%

In order for a U.S. ceding insurer to obtain full capital credit for reinsurance ceded to a Port of Entry Reinsurer, the reinsurer would be required to post the percentage of collateral indicated above based on its rating. National Reinsurers rated as Secure – 3 or above would not be required to post any collateral for reinsurance assumed, while those rated Secure – 4 or Vulnerable – 5 would be required to post the percentage of collateral indicated in the table above.

The graduated approach to collateral requirements set out in the Proposed Act has received mixed reactions from industry participants. The proposed change has been welcomed by many non-U.S. reinsurers, who feel that this will level the playing field for foreign reinsurers and result in an increase in available reinsurance for the U.S. market. However, many U.S.-based insurers and reinsurers are opposed to the changes, claiming that the new rules will result in reduced financial security for U.S. cedants and will lead to fewer non-U.S. licensed reinsurers applying to become licensed in the U.S. NAIC requested comments on the Proposed Act from interested stakeholders by April 23, 2009.

European Union – Reinsurance Directive

In 2005, the European Council and Parliament approved a directive (the Directive) intended to harmonize the regulation of reinsurance across all member states of the European Union (Member States). Member States were required to incorporate the Reinsurance Directive in their domestic legislation by December 2007. Under the Directive, once a reinsurer is authorized to conduct business in one Member State, it is permitted to do business in all other Member States. The reinsurer is subject to financial regulation only in its home state. The Directive also stipulates that Member States are prohibited from imposing collateral requirements on reinsurers from other Member States. The Directive does not restrict Member States from imposing collateral requirements on reinsurers that are not authorized by a Member State. Most Member States, however, are understood not to follow this practice.

Other Countries

Most other countries, including Japan and Bermuda, are understood not to have any collateral requirements and indeed, the vast majority of the international insurance industry is understood to operate without collateral requirements.

The Discussion Paper then listed a number of factors which OSFI would need to consider in connection with any risk-based approach.

Notwithstanding the conceptually receptive tone of the Discussion Paper to progress toward some form of mutual recognition regime and OSFI's significant participation in a number of the relevant international organizations, given the continuing global economic crises and given the weaknesses in the U.S., U.K. and other international regimes exposed by those continuing crises and the ongoing efforts to fix those weaknesses, realistically it would seem unlikely that any significant progress toward mutual recognition will be achieved any time soon. As Superintendent Dickson noted in a speech in April to the American Bar Association in respect of global financial regulatory responses to the current crises:

However, even as these initiatives are discussed and rolled out, it is still important for regulators to worry about their own backyards.

The pace of international rule making has been slow historically, and while there has been a great improvement in the speed of decision making due to the global turmoil, and due to the new role played by organizations such as the Financial Stability Board, agreement on all issues is not easy (the same can be said of many global issues outside the financial services sector) ... If agreement cannot be reached within reasonable time frames, each national regulator has to worry about their own accountabilities, and act within time frames that they think are prudent. We cannot delegate all decisions to an international committee.

In addition, the recent crises have presumably dampened enthusiasm regarding migration to increased principles-based regulation and, conversely, fortified support in some quarters for more "rules", even if the rules are ultimately quite ineffective (see, for example, the Madoff scandal). Consequently, momentum toward more principles-based regulation may also be on the wane.

■ APPROVALS FOR REINSURANCE WITH UNREGISTERED RELATED PARTIES

Under the self-dealing provisions of the ICA, Canadian-incorporated or Canadian-licensed cedants require Superintendent approval to reinsure with affiliated unregistered reinsurers. In the 1980s, the refusal by affiliated reinsurers to pay claims made by their Canadian-licensed cedants contributed to the failure of some of these cedants. However, this was partly due to deficiencies in the wording of reinsurance agreements or a complete lack of written contracts.

OSFI noted that this approval requirement has historically resulted in a significant volume of applications and, correctly, identified that requiring this approval may be of little prudential value given that the transaction may be of little materiality, or present little exposure, to the cedant. OSFI welcomed the industry view on the continued requirement for this type of approval. As a number of commentators have noted, it would arguably be preferable to retain the requirement but tie it to a specific materiality threshold applicable to each cedant, based on a number of factors such as composite risk rating and/or group credit ratings. Current rules relating to written reinsurance agreements and related party transactions should help to ensure that the problem that contributed to the failure of cedants in the 1980s is not repeated.

Registered Reinsurance

OSFI also canvassed in the Discussion Paper certain issues related to capital requirements, fronting limits and transactional approvals for reinsurance with reinsurers incorporated or licensed under the ICA. With respect to capital requirements, OSFI announced that there would be a new counterparty credit charge under the Minimum Continuing Capital and Surplus Requirements for life insurance companies (MCCSR) under the ICA, together with a new, temporary operational risk charge under the MCCSR.

Under the Reinsurance Regs, property and casualty insurers (but, again, not life insurers) are subject to a 75% annual reinsurance limit. OSFI noted that it welcomed industry and shareholder views on that cap and would finalize its position following the consultation process. It would arguably be preferable to retain that limit on the

basis that if a cedant is proposing to continually front more than 75% of its business, query what it is doing in Canada on a licensed basis in the first place. Additionally, an insurer that cedes more than 75% of its risks retains little financial risk in the profitability of the business, which may lead to poor underwriting practices and decisions, especially if the insurer is subsidizing its underwriting results with reinsurance commissions or overrides.

■ REGISTERED REINSURANCE APPROVALS

OSFI also welcomed the industry's and other stakeholders' views on certain reinsurance transactional approvals required under the ICA. However, in some respects, this is somewhat of a red herring in relation to reinsurance regulation in Canada in the ordinary course, as those approvals relate to assumption reinsurance (formerly typically called "transfer and assumption") transactions, rather than ordinary course reinsurance which forms the balance of the subject of the Discussion Paper.

Governance

OSFI also identified, in summary, the benefits of its Guideline on Corporate Governance, and noted that an updated draft Guideline B-3 (Sound Reinsurance Practices and Procedures) will be forthcoming, that draft Guideline B-13 (Reinsurance Agreements) would be finalized shortly and that OSFI is proposing to eventually issue guidance on insolvency clauses and other significant customary reinsurance agreement clauses.

As noted, industry and other stakeholder feedback was due earlier this year and responses were received from the key industry associations and a number of individual registrants, as well as other relevant stakeholders such as the Property and Casualty Insurance Compensation Corporation. Each of the responses are understood to have represented the particular perspectives and, in some cases, the particular "axe to grind", of the applicable commenters, some of which took positions on some of the issues but not on others. OSFI's ultimate approach will undoubtedly be impacted by the ultimate extent and duration of the global economic crises.

For further information, please contact your Stikeman Elliott representative, the author, Stuart Carruthers (scarruthers@stikeman.com) or any member of our Insurance Group listed at www.stikeman.com

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