The Pendulum Swings Back? Thinking about the OSFI Reinsurance Framework Discussion Paper

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- Canada's federal insurance sector prudential regulator, the Office of the Superintendent of Financial Institutions ("**OSFI**") recently released a landmark Discussion Paper that will shape the regulation of reinsurance in Canada for years to come.
- The long-awaited *Discussion Paper on OSFI's Reinsurance Framework* (the "**Paper**") is the product of a wide-ranging review of the Canadian reinsurance sector that OSFI has undertaken over the past few years.
- The Paper focuses primarily on the perceived risks in the business model of certain property and casualty ("**P&C**") federally-regulated insurers ("**FRIs**"). These insurers, which include Canadian companies as well as branches of foreign insurers, are increasingly reliant on reinsurance provided by reinsurers outside Canada, with little capital or vested assets held in Canada to support the increased exposure. OSFI has significant concerns about this type of arrangement, which it calls the "**leveraged business model**".
- In the Paper, OSFI indicates that its continuing review and refashioning of the reinsurance framework will be completed in three phases over approximately five years. Although certain of the proposals would apply equally to life and P&C reinsurance, most of the Paper is focused on the P&C sector.
- OSFI welcomes comments on the Paper by September 15, 2018.

Context: The OSFI Reinsurance Framework

By way of background, OSFI's reinsurance framework is currently comprised of 4 components:

- **Principles-based guidance** - Including Guideline B-3 (Sound Reinsurance Practices and Procedures), which sets out OSFI's expectations regarding reinsurance risk management by FRIs;
- **Capital Framework** – Regulatory capital Guidelines (the Minimum Capital Test, or "**MCT**", for P&C insurers and the Life Insurance Capital Adequacy Test, or "**LICAT**", for life insurers). These Guidelines allow an FRI to reduce its required capital for insurance risk ceded, with the reduction varying if the risks are ceded to another FRI or, alternatively, to an unregistered reinsurer. In the latter case, the FRI is permitted to take capital credit only when the unregistered reinsurer has provided collateral in Canada in compliance with OSFI requirements;
- **Risk-Based Supervision** – OSFI takes a risk-based approach to the supervision of reinsurance activity, using a variety of regulatory tools; and

- **Approvals for Reinsurance with Unregistered Affiliates** – Under the applicable Canadian federal legislation, the *Insurance Companies Act* (the "**ICA**"), OSFI approval is required for reinsurance by an FRI with an unregistered affiliated reinsurer.

Commentary: How OSFI's Approach Is Changing

The Paper centres on two important developments in OSFI's approach to reinsurance: a seeming lessening of enthusiasm for the principles-based approach that OSFI had previously championed and a reduced comfort with reliance by FRIs on the worldwide assets of the global reinsurance industry to respond to Canadian claims.

Reversing course on the principles-based approach?

OSFI's proposed refashioning of the reinsurance regulatory regime arguably represents a pendulum swing back from the **principles-based approach** that OSFI has increasingly embraced over the last 10 years. Indeed, since the late 2000s, OSFI has consciously pushed down to FRIs a number of important regulatory and governance controls and permitted them to implement their own risk management practices. Developments that exemplify that trend include:

- The 2011 repeal of the previous reinsurance regulations under the ICA, which contained hard caps on premiums cedable to registered and unregistered reinsurers;
- The adoption of Guideline B-3;
- The repeal of the reinsurance trust collateral mechanism and replacement of it with reinsurance security accounts supported by legal opinions;
- The adoption of Guideline E-17 on background checks of directors and senior officers;
- OSFI's guidance on longevity risk transfers; and
- OSFI's guidance on corporate governance best practices.

As a consequence of these developments and others like them, FRIs have become accustomed to being given some latitude for developing risk management practices that are efficient and responsive to their particular situations.

It appears from the Paper that, having observed the increased use of the leverage business model since the repeal of the hard caps under the former reinsurance regulations, OSFI is now pushing back, with the intention of employing a strict, empirical formula to limit the ability of certain insurers to front large risks in Canada and otherwise govern their own reinsurance risk management.

Ring-fencing sufficient assets in Canada

The Paper also reflects an increased emphasis by OSFI on ring-fencing sufficient assets in Canada, rather than relying on the global reinsurance industry to respond to claims, including potentially catastrophe claims, in Canada. It is taking this approach notwithstanding the global nature of the reinsurance industry, the vast capital available in the industry (including sufficient capital to meet a number of simultaneous large U.S. catastrophes), and that the reinsurance industry has, in general terms, honourably and fully responded to claims throughout its long history. OSFI's approach is also consistent with its approach to assets in Canada in connection with the recent insolvency of Maple Bank GmbH, a German bank which had a licensed Canadian branch.

Framework: The Guiding Principles

In the Paper, OSFI indicates that all potential changes to its reinsurance framework will be measured against four guiding principles:

1. Policyholders of FRIs must be adequately protected;
2. OSFI regulation and supervision must be balanced and risk-based;
3. OSFI must have the ability to effectively assess risk; and
4. A level playing field among financial sector participants should be maintained where appropriate.

Timeline: A Phased Approach

As noted above, OSFI intends to divide its process into three phases, as follows:

1. Phase I includes a parallel consultation on reinsurance-related measures included in the Draft 2019 MCT Guideline, which was released on June 21, 2018 and comments on which are due by August 21, 2018; [*Update: See here for more information about the finalized 2019 MCT Guideline.*]
2. Phase II will entail amendments to various Guidelines pertaining to prudential limits and restrictions and sound business and financial practices. Revised drafts of the applicable Guidelines will be released in 2019 and OSFI expects to finalize them by January 1, 2020. In addition, revised Transaction Instructions for related party unregistered reinsurance approvals will be released during 2019; and
3. Phase III will entail revisions to the MCT and LICAT Guidelines for the 2022 or later years.

OSFI's Proposals: Key Highlights

The principal OSFI concerns and proposals are grouped into three categories, as follows.

1. Large Exposure and Counterparty Concentration Risks

As discussed above, OSFI is increasingly concerned about the so-called leveraged business model and the possibility that its use may contribute to overly concentrated credit risk and potential solvency issues. To address those concerns, OSFI proposes to:

- Revise Guideline B-3 to enhance and clarify expectations related to the prudent management of reinsurance risks. This revision, which will occur in Phase II, will include an expectation that FRIs establish reasonable limits on their overall reinsurance exposure to any one reinsurance entity or group, particularly where the FRI relies on its reinsurers to write high-limit policies.
- Introduce a hard rule respecting the issuance of high-limit policies by P&C FRIs. The maximum policy limit would depend on the FRI's capital level and excess collateral and the diversity of its reinsurance counterparties. The calculation of the cap is set out in Annex I to the Paper, and includes detailed actuarial/algebraic formulae. This would be implemented in Phase II, in the form of revisions to OSFI Guideline B-2 (Investment Concentration Limit for Property and Casualty Insurance Companies). Although this would only apply to P&C direct writer FRIs, OSFI is also considering a similar rule for FRI P&C reinsurers. That would be part of Phase III.

2. Capital Framework for Reinsurance

- **Counterparty Credit Risk** – the MCT currently applies a charge to P&C FRIs that reinsure with unassociated FRIs, but not to those that cede to associated FRIs. However, OSFI is of the view that the risks with respect to an associated FRI are the same as those with respect to an unassociated FRI. Consequently, OSFI proposes to change the MCT Guideline to conform the counterparty credit risk factors for both associated and unassociated FRIs.

Importantly, the counterparty credit risk charges would not apply to reinsurance under an OSFI-approved intercompany pooling arrangement. This change would be made in Phase I, as part of the 2019 MCT Guideline.

- **Unregistered Associated Reinsurance Funds WithheldArrangements** – the MCT Guideline prescribes the forms of acceptable collateral from unregistered reinsurers, but domestic and foreign P&C FRIs are subject to different restrictions on funds withheld arrangements with associated reinsurers. As part of the proposed Phase I changes, OSFI will remove the funds withheld restriction from domestic P&C FRIs and recognize, for capital purposes, the amount of funds held to secure payment from associated and non-qualifying subsidiary reinsurers. In addition, as part of the proposed changes to the 2019 MCT and LICAT Guidelines, OSFI will prescribe conditions permitting the recognition of funds withheld payables for cessions to both registered and unregistered associated and non-associated insurers. The proposed MCT condition reads as follows*:*

"In order for a ceding insurer to obtain credit for funds held under a funds withheld reinsurance arrangement, 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). Furthermore, the ceding insurer may not provide non-contractual or implicit support, or otherwise create or sustain an expectation that funds withheld could be paid to the reinsurer before all subject policies have expired and all claims settled."

- **MCT Guideline Margin Requirements for Unregistered Reinsurance** – Currently, for a P&C FRI to obtain full MCT credit for risks ceded to an unregistered reinsurer, the reinsurer must post collateral equal to 115% of the ceded unpaid claim reserves and unearned premium. As part of the Phase I changes for the 2019 MCT Guideline, OSFI proposes to increase the margin from 15% to 20% in order for the P&C FRI to obtain full credit. This will be consistent with a similar change made to the LICAT in 2018. This could require cedents to obtain significantly more collateral for their current books of ceded business, and may be problematic if historical treaty wordings are tied to the 115% level rather than a more generic level sufficient to result in complete MCT credit for the cedent.
- **Financial Resources Supporting Earthquake Risk Reserves** – Currently, domestic and foreign FRIs may include 10% of their consolidated/world-wide capital and surplus as an eligible financial resource to reduce the required earthquake risk reserve. OSFI is concerned regarding potential double counting of this capital, given that it is also included as part of a FRI's capital available. As part of Phase III, OSFI is seeking feedback on removal of the 10% amount as an eligible financial resource.
- **Reinsurance Concentration Risk** – OSFI has noted that certain FRIs have material reinsurance arrangements with a single or only a few insurers, or a few groups of related reinsurers. This raises counterparty credit risk and, as part of Phase III, OSFI is considering introducing a concentration risk charge/limit on reinsurance assets and is seeking feedback on the considerations relevant to such a potential change.

3. Clarifications to OSFI Guideline B-3 and other Potential Reinsurance Framework Adjustments

As part of Phase II, OSFI is considering clarifications to Guideline B-3 and a number of other potential reinsurance framework adjustments, and is seeking feedback on certain of the proposed adjustments, as follows:

- **Worldwide Treaties and Flow of Reinsurance Funds** – OSFI is inviting views on its plan to amend Guideline B-3 to provide additional guidance regarding worldwide treaties and to reflect OSFI's expectation that reinsurance payments will flow directly to an FRI in Canada.

OSFI may also amend its regulatory data forms to require more information about the utilization of worldwide treaties.

- **Significant Quota Share Treaties** – As noted above, OSFI is particularly concerned about reinsurance concentrated with one reinsurer or reinsurance group, particularly large quota share arrangements:

> "Over reliance by FRIs on quota share reinsurance is a concern for OSFI. The risks associated with extensive reliance on reinsurance are augmented when that reinsurance is concentrated with one reinsurer or reinsurance group. Particularly in the P&C sector, where reinsurance treaties are typically short term, it is possible that reinsurance cover may not be available from one year to the next. Heavy reliance on reinsurance could weaken the underwriting standards and discipline at the ceding FRI. Poor underwriting could, in turn, ultimately impair a FRI's ability to renew or replace its reinsurance. Reinsurance could also suddenly disappear due to reinsurer distress. Whatever the origin, a FRI that is over reliant on a reinsurance arrangement could find itself in difficulty if its reinsurance arrangement cannot be renewed or its cost increases significantly. A FRI could, for example, be forced to quickly raise capital to replace the disappearing reinsurance cover. If it cannot raise that capital, it may fail."

OSFI invites views on its intention to strengthen Guideline B-3 with respect to risk management related to such significant quota share treaties and with respect to the expectation that FRIs not cede substantially all of their risks. OSFI is particularly seeking views on the notion of "substantially all risks" and how the notion can be framed in a more objective fashion.

Fronting Arrangements – OSFI plans to clarify its expectations in Guideline B-3 relating to fronting arrangements and is likely to include an expectation that FRIs take reasonable measures to satisfy themselves that legal risks related to contract wording are appropriately managed in relation to reinsurance with captive unregistered unrelated foreign insurers ("**UUFIs**"). OSFI also expects to apply to fronting arrangements certain other measures described in the Paper. OSFI noted that while certain types of traditional fronting arrangements may be acceptable:

> "More recently, however, OSFI has become aware of other types of fronting arrangements that raise prudential concerns. For one, some FRIs have proposed to enter into fronting arrangements:
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> - 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 the UUFI, including underwriting.
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> With little or no involvement in the origination and underwriting of the risks, the FRI would likely have inadequate knowledge of the risks it has insured and for which it is liable in the first instance. Even in cases where a FRI is involved in the underwriting to some extent, underwriting discipline may be compromised where all of the risks are reinsured. The prudential risks related to such fronting arrangements are correlated to the materiality of the fronting arrangements with respect to the FRI's overall business.
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> A fronting arrangement involving an insured's captive-UUFI could also raise prudential concerns to the extent that the arrangement represents a large exposure relative to the FRI's capital or assets in Canada (i.e., raising similar concerns as those identified in the reinsurance concentration section of this paper). Such concerns may, however, be mitigated. For example, to the extent that the contractual terms of a reinsurance arrangement do not obligate a FRI to pay out a claim to the insured when the insured's captive has not first met its obligation under the reinsurance treaty with the FRI.

OSFI expects FRIs have sufficient knowledge and expertise when entering into fronting arrangements that expose the FRI to material risks, or that represent a material portion of the FRI's insurance business in Canada."

Foreign FRIs Ceding Risks to their Home Office – OSFI indicates that it has observed situations in which licensed branches cede Canadian risks to an unregistered affiliated reinsurer, which then further reinsures the risks back to the branch's home office. OSFI notes that the cession by the branch is generally recognized for the purposes of determining required assets in Canada, even though the risk is ultimately economically retained within the FRI. OSFI is inviting comments on this practice, including with respect to its prevalence.

Affiliated Reinsurance Approvals – OSFI plans to revise its Transaction Instructions for such approvals to capture additional information and also to expand the scope of information to be reported annually to OSFI in respect of such arrangements.

Insurance Linked-Securities (ILS) – OSFI intends to revise Guideline B-3 to include its expectations for FRIs that cede risks to reinsurers that rely upon ILS. OSFI expects an FRI to conduct an appropriately greater level of due diligence in respect of such a reinsurer, and in such circumstances to carefully consider the risks associated with relying on a reinsurer that is dependent on non-traditional funding sources.