Reference: Guideline for L&F/P&C

June 12, 2019

To: Federally Regulated Insurers (FRIs)

Subject: Draft Revised Guideline B-3: Sound Reinsurance Practices and Procedures

OSFI is issuing proposed revisions to Guideline B-3: *Sound Reinsurance Practices and Procedures* (the guideline).

In June 2018, OSFI issued a Discussion Paper on OSFI's Reinsurance Framework that included proposals to enhance and clarify OSFI's expectations for prudent reinsurance practices. The revisions to the guideline reflect these proposals, as well as comments received in response to the Discussion Paper. The Annex summarizes comments received regarding proposals to amend the guideline, along with OSFI's responses.

Key changes to the guideline encourage insurers to better identify and manage risks arising from the use of reinsurance, particularly counterparty risk. Revisions also clarify OSFI's expectation that reinsurance payments flow directly to a cedant insurer in Canada, and reaffirm OSFI's principles-based expectation that an insurer not cede substantially all of its risks. These changes are primarily clarifications, but may highlight the need for some insurers to adjust aspects of their reinsurance programs. OSFI intends to offer information sessions when it releases the final guideline in 2020.

Questions and comments concerning the draft guideline may be sent to Tara-Lea Herkert, Manager, Prudential Policy by email at tara-lea.herkert@osfi-bsif.gc.ca. When the final version of the guideline is issued, OSFI will post a non-attributed summary of comments received, along with OSFI's responses. Comments should be provided no later than August 16, 2019.

Yours truly,

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Assistant Superintendent
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Annex – Summary of Discussion Paper Comments and OSFI Responses

Industry Comments	OSFI Response
Clarify and enhance expectations for prudent reinsurance risk management, including that limits be set for overall exposure to any one reinsurance entity or group.	
There is general agreement with the need to enhance expectations for prudent reinsurance risk management, especially for large exposures and concentration risk. Some suggested that OSFI could enhance own risk and solvency assessment (ORSA) processes or Dynamic Capital Adequacy Test requirements to address specific concerns.	Revisions to Guideline B-3 are intended to encourage better identification and management of risks arising from the use of reinsurance, particularly counterparty risks. An insurer's Reinsurance Risk Management Policy should document the significant elements of an insurer's approach to managing risks through reinsurance, and managing risks arising from the use of reinsurance. While ORSA and DCAT are expected to address all risks, they do not set out OSFI's expectation on how risks should be managed. When OSFI has specific expectations regarding certain risks, it is appropriate that they be addressed in specific guidance.
When establishing concentration limits, an insurer should be permitted to have higher limits for an affiliated reinsurer than unaffiliated for reasons that include: 1) there is enhanced visibility on an affiliated reinsurer's business, financial strength and management, 2) there are fewer disputes with affiliated reinsurers, and 3) insurers may be able to secure more reasonable pricing from an affiliated reinsurer.	OSFI does not agree with the assertion that the risk of an affiliated reinsurer not honouring its obligations is less than that of a non-affiliated reinsurer, especially when considered in the context of a group-wide distress. Insurers should assess counterparty risks in both going-concern, and gone-concern, scenarios. The process for assessing counterparty risk should be consistent across all counterparties (affiliated and non-affiliated).
Many large international groups centralize their reinsurance placements with the external market. In such situations, a federally regulated insurer may have a concentrated exposure to reinsurers (including affiliates). However, the external reinsurance placed by the affiliate is typically diversified. A federally regulated insurer should be able to "look through" and consider its affiliate's retrocession the risks.	While there are advantages to group-wide programmes, and a "look-through" approach is encouraged by Guideline B-3, the retrocession may also introduce additional risks, such as maximum aggregate payments, shared reinstatements, and payments due in currencies and/or jurisdictions outside of Canada. Importantly, Guideline B-3 focuses on adequate reinsurance risk management and does not penalize affiliated reinsurance.
Worldwide treaties and flow of reinsurance payments directly to a cedant in Canada	
Several respondents agreed with OSFI's proposal to clarify the expectation that reinsurance payments flow directly to Canada. Some indicated that this requirement should only come into effect in an insolvency situation. Others expressed a view that it would be administratively burdensome for both cedants and reinsurers to comply with this requirement and that it is not required in other jurisdictions.	OSFI's expectation that reinsurance claims are to be paid to the federally regulated cedant in Canada is intended to address reinsurance payment concerns that may arise in circumstances of financial distress or in the case of an insolvency. If funds do not ordinarily flow directly to Canada, it is unlikely that such changes would be implemented in a distress scenario. This could result in a situation where a reinsurer has paid a claim for a risk insured in Canada, but the payment is not received in Canada, or not received in a timely manner.

Some noted that it should be acceptable to OSFI if reinsurance payments to a cedant flow through an agent or broker.	As part of OSFI's considerations for approving related-party reinsurance, foreign companies (i.e., branches) are expected to confirm that claims payments by a reinsurer are to be made to the foreign company's chief agent in Canada. Revisions to Guideline B-3 extend the expectation for reinsurance claims to be paid to the cedant in Canada to all federally regulated insurers and reinsurance arrangements. OSFI agrees that reinsurance payments made to an agent or broker in Canada that is expressly acting for, or on behalf of, a cedant would also be consistent with the policy intent. Guideline B-3 includes language in contemplation of these arrangements.
There is already an expectation for an appointed actuary to consider whether reinsurance arrangements require payments directly to Canada. It was also noted that there should not be regulatory concern if insurers do not take capital credit when reinsurance does not flow to Canada. It is better to have these coverages in place than not at all.	If reinsurance arrangements do not provide for payments that flow directly to Canada, a federally regulated insurer should not seek credit for the arrangement (e.g., in setting capital targets). OSFI does not intend to preclude a scenario where reinsurance payments are not directed to Canada and the federally regulated cedant is disregarding the reinsurance for capital purposes. The appointed actuary's obligation to identify reinsurance payments that do not flow directly to Canada was adopted as an interim measure to provide information to OSFI pending release of a revised Guideline B-3. If all payments considered for financial statements and stress testing are flowing to Canada as required by the proposed Guideline B-3, this request of the appointed actuary will no longer be required.
Quota-share treaties, "substantially all" and fronting	
The issues of concentration, quota share and fronting should not be assessed and managed independently of each other and should not be subject to a rules-based framework.	OSFI agrees, and is of the view that an insurer should take a comprehensive approach to managing risks arising from the use of reinsurance. The insurer should reflect this approach in its Reinsurance Risk Management Policy.
The concept of "substantially all" should be viewed at the insurer's consolidated level, rather than at an individual or product level. This permits insurers to issue policies based on customer needs, but to then have the capacity to cede a part of the risk to a reinsurer that falls outside of the insurer's risk appetite. Setting a global quota-share threshold does not align with a principle-based approach. OSFI should continue to permit fronting arrangements, as appropriate. OSFI should continue to allow quota-share treaties in significant portions for specific lines of business, including 50% or more. We would support efforts to	OSFI's approach to "substantially all" will remain principles-based and will be considered from the perspective of an insurer's entire business. As such, an insurer may be able to cede up to 100% of individual risks or blocks of business in appropriate circumstances.

restrict significant quota shares of an insurer's entire portfolio if defined properly. Consider establishing a threshold that would be clearly outside of the concept of "substantially all risks", for example, cessions that amount to 75% of total gross premiums or less would be permitted and cessions greater than 75% would be reviewed under a subjective analysis. Consider differences between life and P&C. Life insurers should be permitted to cede all or a majority on a "per course ongoing business model" basis. It should be acceptable to have a particular treaty ceding 90% of business or a specific inforce block fully (100%) reinsured.	
The Discussion Paper's risk mitigation strategy for captive/fronted business does not work for a number of reasons, most notably because there would not be transfer of risk from the policyholder to the insurer (and therefore the arrangement would be treated as a deposit under accounting rules, resulting in unfavourable tax treatment for the policyholder).	Revisions to Guideline B-3 do not specifically address fronting arrangements. An insurer should recognize that there is risk associated with fronting and captive arrangements and ensure that those risks are consistent with the risk limits established in the insurer's Reinsurance Risk Management Policy.
Ceding to home office	
There are valid business reasons for this practice. Furthermore, risks ceded require collateral, which mitigates the risks.	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 insurer. In particular, OSFI will generally not recognize or grant credit for a foreign insurer's reinsurance arrangement(s) where the risks it insures in Canada are ceded back to the home office through affiliated reinsurers.
Ceding to the home office is an integral component of a foreign life insurer's business model and does not pose policy issues for life reinsurance.	As noted above and reflected in the Discussion Paper, OSFI has concerns with this practice and is recommending a general approach. OSFI recognizes that there may be unique or exceptional circumstances that could be evaluated on a case-by-case basis. We would welcome additional representations in this regard.

Insurance linked securities (ILS)	
Appropriate due diligence should be conducted on any reinsurer, commensurate with the risk (and regardless of whether or not the reinsurer uses non-traditional funding). Guideline B-3 clearly articulates this point. Clarify what is meant by “an reinsurer that itself relies on non-traditional sources of funding” and consider that many traditional reinsurer use some form of ILS for retrocession alongside their own capacity. Consider distinguishing between a traditional reinsurer that uses ILS and a segregated accounts of special purpose reinsurer. To the extent that OSFI is concerned by non-traditional sources of funding, the revisions to Guideline B-3 should not refer to specific types of financial categories of financial instruments. This will minimize the need for future revisions as markets mature and certain risk transfer methods are no longer considered non-traditional. Insurers may not have information about retrocession arrangements.	No changes have been proposed. Insurers should thoroughly assess counterparty risk and conduct appropriate due diligence on their reinsurance counterparty (including, among many things, the reinsurer’s retrocession practices and arrangements).