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# Guideline

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**Subject: Sound Reinsurance Practices and Procedures**

**No: B-3**

**Date: December 2010**

Reinsurance is an important risk management tool available to an insurer. It can be used to reduce insurance risks and the volatility of financial results, stabilize solvency, make more efficient use of capital, better withstand catastrophic events, increase underwriting capacity, and to draw on reinsurers' expertise. However, reinsurance exposes an insurer to other risks, including operational, legal, counterparty, and liquidity risks. The combination of these risks can make reinsurance complex and challenging to implement effectively. Inadequate reinsurance risk management practices and procedures can materially affect an insurer's financial soundness and reputation, and can ultimately contribute to its failure.

This Guideline sets out OSFI's expectations for effective reinsurance practices and procedures. These practices and procedures should form an important part of an insurer's overall reinsurance risk management policy. It applies to all federally regulated insurers, including life insurers and property and casualty insurers, domestic insurance companies and foreign insurance companies in respect of their insurance business in Canada, registered reinsurers<sup>1</sup>, and fraternal benefit societies (collectively referred to as FRIs), that are party to reinsurance cessions, retrocessions, and, where applicable, to assumption reinsurance transactions<sup>2</sup>.

FRIs are reminded that OSFI's *Guideline on Corporate Governance* extends to the business of reinsurance with respect to ensuring effective oversight and risk management policies and procedures.

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<sup>1</sup> See, as applicable, [Guideline A - Life Insurance Capital Adequacy Test](#) and the [P&C-1 Annual Return Instructions](#) for property and casualty insurance companies for complete definitions of "registered reinsurer". Note that these definitions include federally approved provincial / territorial reinsurers.

<sup>2</sup> Please refer to the *Other OSFI Guidance* section of this Guideline for guidance on the statutory approval requirements for assumption reinsurance transactions.



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## Table of Contents

	<b>Page</b>
Key Principles .....	3
Guideline Administration.....	7
Supervisory Information .....	7
Capital / Asset Requirements.....	8
Reinsurance Reporting.....	8
Other OSFI Guidance .....	8

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## Key Principles

The following reinsurance principles are intended to assist FRIs in developing prudent approaches to managing their reinsurance risks. OSFI will assess a FRI's reinsurance risk management policy against these principles and, where considered necessary, will require remedial action consistent with its early intervention mandate.

**1. A FRI should have a sound and comprehensive reinsurance risk management policy that is overseen by senior management.**

### *Reinsurance Risk Management Policy (RRMP)*

OSFI expects that a FRI's RRMP will form an integral component of its overall enterprise-wide risk management plan.

The RRMP should reflect the scale, nature and complexity of a FRI's business, and have regard for its risk appetite<sup>3</sup> and risk tolerance<sup>4</sup>. OSFI expects the RRMP to document the significant elements of the FRI's approach to managing risks through reinsurance, including the purpose and objectives for seeking reinsurance, risk diversification objectives, risk concentration limits<sup>5</sup>, ceding limits<sup>6</sup>, and the practices and procedures for managing and controlling its reinsurance risks.

The RRMP should detail:

- the roles and responsibilities for those positions charged with implementing the RRMP;
- the process for ensuring that the RRMP is updated to reflect changing market conditions; and,
- the FRI's policy on the use of registered and unregistered reinsurance.

Additionally, a FRI must assess the adequacy and effectiveness of the reinsurance arrangements to ensure that exposures to large and catastrophic losses are adequately addressed. This may require stress testing of exceptional but plausible scenarios to determine if the reinsurance

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<sup>3</sup> In this Guideline "risk appetite," often a qualitative assessment, refers to the total level and type of risk exposure that a FRI is willing to undertake to achieve its objectives.

<sup>4</sup> In this Guideline, "risk tolerance" refers to specific parameters and / or limits on the level and amount of risk a FRI is willing to accept / retain, such as maximum net retentions.

<sup>5</sup> Appropriate concentration limits should be based on premiums, expected claims, amount of risk, and possible future exposures (at time of inception or renewal of policy), on a consolidated basis, to individual counterparties, groups of individual counterparties or related entities and counterparties in a specific geography.

<sup>6</sup> A FRI generally should not, in the normal course of its business, cede 100 per cent, or substantially all, of its risks in the main areas in which it conducts business. Absent extenuating circumstances (e.g., a troubled FRI), such an arrangement could weaken the underwriting standards and discipline at the ceding FRI. A FRI may, however, occasionally cede a portion, or even 100 per cent, of a specific line of business or a particular type of risk that is ancillary to its core business to, for example, underwrite the business for purely marketing or relationship purposes. Cessions of existing lines of business at 100 per cent may, depending on the circumstances, also be acceptable to OSFI.

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arrangements entered into are adequate at mitigating losses to acceptable levels in accordance with the FRI's risk appetite and risk tolerance.

### *Senior Management Oversight*

OSFI expects senior management<sup>7</sup> to oversee the development and implementation of the RRMP. At a minimum, senior management should review the RRMP annually.

Senior management has the responsibility of ensuring that the RRMP is operationalized through the dedication of adequate resources and is implemented by the risk management and business line officers and managers charged with the day-to-day responsibility for the RRMP.

It is the responsibility of senior management to ensure that appropriate policies, procedures, and internal controls exist to monitor the effectiveness of, and operational compliance with, the RRMP on an on-going basis.

Please refer to OSFI's *Corporate Governance Guideline* for OSFI's expectations of FRI Boards of Directors in regards to operational, business, risk and crisis management policies.

**2. A FRI should perform a sufficient level of due diligence on its reinsurance counterparties on an on-going basis to ensure that the FRI is aware of its counterparty risk and is able to assess and manage such risk.**

A FRI should evaluate the ability of all current and prospective reinsurance counterparties to meet their liabilities under exceptional but plausible adverse events on an on-going basis. The level of a FRI's due diligence on any reinsurance counterparty should be commensurate with its level of exposure to that counterparty.<sup>8</sup>

In the evaluation of its current and prospective reinsurance counterparties, however, a FRI should generally not rely solely on third parties, including rating agency assessments<sup>9</sup> or broker analysis and recommendations.<sup>10</sup> Prudent practice dictates that the FRI should, to an extent proportional to the importance of such counterparty, conduct its own due diligence on the financial strength and capabilities of all reinsurance counterparties.

When performing its due diligence, a FRI should give consideration to, among other things, the reinsurance counterparty's:

- claims payment record;
- expected future claims obligations;
- balance sheet strength;

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<sup>7</sup> For foreign company branches, OSFI looks to branch management to oversee operations in Canada.

<sup>8</sup> The level of due diligence should not be any less thorough if the counterparty is a related party of the FRI.

<sup>9</sup> By analogy, see the Financial Stability Board's report on Principles for Reducing Reliance on CRA Ratings: [https://www.fsb.org/2010/10/r\\_101027/](https://www.fsb.org/2010/10/r_101027/).

<sup>10</sup> Any significant outsourcing of this due diligence function to a third party must be in accordance with OSFI's Guideline B-10: [\*Outsourcing of Business Activities, Functions and Processes\*](#).

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- funding sources, including its level of and access to capital, and form, amount and sources of liquidity;
  - management, including the quality of its governance practices and procedures; and,
  - retrocession arrangements and the direct or indirect impact they may have on the FRI's own arrangements with the reinsurer.<sup>11</sup>

Similarly, a FRI that is a reinsurer should, commensurate with its level of exposure to the cedant, conduct its own due diligence on the risk management and risk assessment criteria of the cedant.

The evaluation of each of a FRI's reinsurance counterparties should be updated throughout the life of the reinsurance contract. In cases where there may be material exposures to incurred but not reported losses, management should ensure that the evaluation continues beyond the expiration date of the contract to ensure that the FRI assesses potential reinsurance recoverables from expected future claims.

OSFI expects a higher level of due diligence by a FRI in respect of any current or prospective reinsurance arrangement with an unregistered reinsurer<sup>12</sup> or with a cedant that is not regulated by OSFI. This assessment of counterparty risk should consider the regulatory and supervisory regime, and the legal and insolvency frameworks of the unregistered party's home jurisdiction.<sup>13</sup>

### **3. The terms and conditions of the reinsurance contract should provide clarity and certainty on reinsurance coverage.**

A FRI should have processes and procedures in place to ensure that a comprehensive, written, and binding<sup>14</sup> reinsurance contract is executed prior to the effective date of reinsurance coverage. To achieve clarity and certainty on reinsurance coverage, a reinsurance contract should be unambiguous, and there should be complete and final agreement of all material terms and conditions of the contract, documented in writing, by all parties prior to the contract's effective date.

OSFI recognizes that there may be situations where a comprehensive reinsurance contract is only duly executed by all parties after the effective date. In such circumstances, historical practice has been that the reinsurance coverage during this interim period is usually set out in a less formal document (e.g., slip, cover note, letter of proposal, binding letter of intent, hereinafter referred to as the "summary document"). If an event were to occur within this interim period, lack of certainty relating to the terms and conditions of the reinsurance coverage in the summary

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<sup>11</sup> If a cedant FRI is aware that a reinsurance counterparty relies significantly on retrocessions, the cedant should seek greater visibility of the identities and financial standing of the retrocessionaires.

<sup>12</sup> Generally, an "unregistered reinsurer" is a reinsurer that is not reinsuring in Canada risks in accordance with OSFI [Advisory 2007-01-RI: Insurance in Canada of Risks](#), and, as such, is not regulated and supervised by OSFI. For complete definitions of "unregistered reinsurer", see [Guideline A - Life Insurance Capital Adequacy Test](#) and the [P&C-1 Annual Return Instructions](#) for property and casualty insurance companies.

<sup>13</sup> For example, the review should include an assessment of the quality of the regulatory and supervisory regime, compliance with international standards and best practices, and the adequacy of the insolvency laws governing proceedings in the reinsurer's home jurisdictions.

<sup>14</sup> "Binding" means that the parties are bound to the terms and conditions of the contract.

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document could result in actual operational and reputational risks for both the cedant and the reinsurer. In an effort to mitigate these risks, OSFI expects FRIs to:

- (a) obtain contractually binding summary documents prior to the effective date of the reinsurance coverage, including, but not limited to electronic copies, or original hard copies, of signed documents that set out:
  - the premium / consideration paid by the cedant;
  - the percentage of risk assumed by each reinsurer;
  - the risk(s) reinsured;
  - the duration of the coverage;
  - where applicable, any exclusions to terms of coverage; and,
  - any standard clauses that are to be relied upon or incorporated by reference into the reinsurance contract;
- (b) address, within the summary document, any material issues most likely to arise, including all variable or unique agreement terms; and,
- (c) ensure that all final comprehensive reinsurance contracts, including any amendments thereto, bear the duly authorized signature of both the ceding company and the reinsurer(s)<sup>15</sup> within a relatively short timeframe having regard for the nature, complexity and materiality of the agreement (e.g., within 120 days of execution).

Generally, a reinsurance contract should stand on its own, providing the necessary clarity and legal certainty on reinsurance coverage. OSFI acknowledges, however, that there may be situations where it is necessary and appropriate for a FRI to enter into a supplemental or subordinated reinsurance contract, a side letter, or other types of arrangements that are ancillary to, and form part of, the main reinsurance contract. In addition to ensuring that these arrangements meet the requirements of this Guideline, the FRI should be transparent with stakeholders about these arrangements, ensure that such amendments are appropriately reflected in its financial statements, and ensure that they do not adversely change the terms or conditions of the original contract to the detriment of policyholders.

**4. A ceding FRI should not be adversely affected by the terms and conditions of a reinsurance contract.**

The terms and conditions of a binding reinsurance agreement should provide that funds will be available to cover policyholder<sup>16</sup> claims in the event of either the cedant's or reinsurer's insolvency. To this end, reinsurance contracts should include an "insolvency clause", and particular attention should be paid to the appropriate use<sup>17</sup> of "off-set" or "cut-through" clauses,

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<sup>15</sup> OSFI would generally not consider an agreement bearing the signature of the reinsurance intermediary as acceptable unless the intermediary can support a finding that it has the authority to act for, or on behalf of, the cedant or reinsurer, as the case may be.

<sup>16</sup> No policyholder in the (re)insurance chain should be adversely affected, including the cedant and its policyholders.

<sup>17</sup> OSFI recognizes that there may be situations where the interests of a cedant FRI and its policyholders may be better served by the use of off-set and cut-through clauses. OSFI does not intend to restrict the use of such terms

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the structure of “funds withheld” arrangements<sup>18</sup>, and other such types of terms or conditions that may frustrate the scheme of priorities under the *Winding-Up and Restructuring Act* (WURA).

Ceding FRIs should ensure that all reinsurance contracts contain an insolvency clause clarifying that the reinsurer must continue to make full payments to an insolvent cedant without any reduction resulting solely from the cedant’s insolvency. Such a clause provides greater certainty that reinsurance receivables remain within the overall general estate of the insolvent ceding company, or as part of the assets in Canada of a foreign insurance company as defined under the WURA and the *Insurance Companies Act* (ICA), rather than being allocated toward the payment of specific claims of creditors or policyholders.

Reinsurance contracts should not contain other types of terms or conditions that may *limit* a troubled or insolvent cedant’s ability to enforce the contractual obligations of a reinsurer, or that may adversely affect the treatment of any claims in respect of the cedant’s policyholders. Off-set and cut-through clauses may allow certain creditors or policyholders to have preferential treatment over other claims, contrary to the scheme of distribution in the WURA. In the case of off-set clauses, for example, where the ceding company is a foreign insurance company authorized to insure in Canada risks, the reinsurer should not have any right of off-set against the obligations of the ceding company other than those related to the ceding company’s insurance business in Canada.

If a reinsurance contract provides for a funds withheld arrangement, the contract must clearly provide that, in the event of the cedant’s or reinsurer’s insolvency, the funds withheld, less any surplus due back to the reinsurer, must form part of the property of the cedant’s general estate, or part of the assets in Canada of a foreign insurance company as defined under the WURA and the ICA.

OSFI expects all contracts related to reinsurance coverage to stipulate a choice of forum, a choice of law, and the appointment of agents for service of legal processes that are necessary to ensure the reinsurance contract and any disputes arising from such contract are subject to the laws and courts of a Canadian province or another legal jurisdiction of, in the reasonable opinion of the FRI, equivalent or greater reliability and certainty which has a natural connection to the transaction.

## **Guideline Administration**

### *Supervisory Information*

Enhanced transparency will allow OSFI to better understand the economic impacts and risks associated with a FRI’s reinsurance arrangements. A FRI is required to maintain and provide to OSFI, upon request, its RRMP and a complete description of all its reinsurance arrangements,

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or conditions where they do not give preferential treatment over other claims under the scheme of distribution in the *Winding-Up and Restructuring Act*.

<sup>18</sup> Under funds withheld arrangements, assets (generally the premium) that would normally be paid over to a reinsurer as consideration under the reinsurance agreement are withheld and retained by the ceding company as a form of security enabling a capital credit for unregistered reinsurance.

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including levels of reinsurance, the due diligence performed on reinsurance counterparties, and the proportion of registered and unregistered cessions.

A FRI should promptly inform OSFI if it becomes aware of any reinsurance issues that could materially impact its financial condition.

### *Capital / Asset Requirements*

Reinsurance may be a major part of a FRI's overall risk management program. Non-adherence to the principles in this Guideline could result in a reinsurance program or reinsurance contract that does not provide the intended protection to the ceding company. It may also compromise the availability of balances that may have been otherwise recoverable. If a FRI fails to meet the principles set out in this Guideline, on a case-by-case basis, OSFI may not grant a capital / asset credit for the reinsurance arrangement, or may, commensurate with risk, use its discretionary authority under the ICA, to adjust the FRI's capital / asset requirements or target solvency ratios to compensate for reinsurance that is not, or may not, be wholly effective or reliable.

Federally approved provincial/territorial reinsurers may lose their status if they fail to meet the expectations set out in this Guideline.

### *Reinsurance Reporting*

The FRI's RRMP should be made available to OSFI on request.

There should be regular reporting to senior management to confirm that the FRI's reinsurance risk management practices and procedures meet, except as otherwise disclosed, the standards set in this Guideline. The reporting should include assurances that the FRI's reinsurance arrangements effect a risk transfer and that they are accounted for in the appropriate manner.

When a deviation from this Guideline has taken place over such year, the nature and extent of the deviation, and the measures taken or proposed to correct or otherwise mitigate the risk associated with such deviation, should be documented and disclosed to senior management and to OSFI in full.

## **Other OSFI Guidance**

This Guideline is complementary to, and should be read in conjunction with, other OSFI guidance that implicitly or explicitly addresses various elements of reinsurance or governance, including:

- [\*Guidance for Reinsurance Security Agreements\*](#), which sets out OSFI's minimum standards for reinsurance security agreements;
- [\*Guideline B-10 – Outsourcing of Business Activities, Functions and Processes\*](#), if a FRI uses the services of a reinsurance intermediary to facilitate its reinsurance RRMP;



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- [Guideline A - Life Insurance Capital Adequacy Test](#) for federally regulated life insurers and societies, which includes the Test of Adequacy of Assets and Margin Requirements for foreign life insurance companies; [Minimum Capital Test](#) for federally regulated domestic property and casualty insurers; and the *Branch Adequacy of Assets Test* for foreign property and casualty companies;
  - [Corporate Governance Guideline](#), which provides information to Boards and management of FRIs about OSFI's expectations on corporate governance; and,
  - [Guideline E-17: Background Checks on Directors and Senior Management of Federally Regulated Entities \(FRE\)](#), which outlines principles to assess the suitability and integrity of directors and senior management by FREs.

A FRI should consider that, before reinsuring with an unregistered related party, an approval may be required under subsection 523(2) or 597(1) of the ICA. A ceding FRI must seek the requisite approval under subsection 254(2), 254(2.01) or 587.1(2) of the ICA prior to causing itself to be reinsured on an assumption basis.

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