Office of the Superintendent of Financial Institutions Canada | Bureau du surintendant des institutions financières Canada

Discussion Paper on OSFI's Reinsurance Framework

Office of the Superintendent of Financial Institutions
June 2018

Preface

The Office of the Superintendent of Financial Institutions (OSFI) has undertaken a broad review of the reinsurance framework applicable to federally regulated insurers (FRIs). The last comprehensive review of the framework occurred nearly a decade ago. Since that time, the insurance environment and reinsurance practices have changed significantly. This review was initiated to deepen our understanding of the broader reinsurance practices being used in both the Property and Casualty (P&C) and life insurance (life) sectors, and determine whether OSFI's current reinsurance framework remains appropriate and effective.

FRIs have increasingly adopted business models that rely heavily on reinsurance. Particularly in the P&C sector, there are concerns about the risks associated with writing large policies in Canada, and subsequently ceding a significant portion of these risks outside of Canada, with little capital or vested assets[1] maintained in Canada to support the increased risk exposure.

OSFI recognizes the importance of reinsurance as a risk management tool. Through the use of reinsurance, an insurer can reduce its insurance risks, stabilize its solvency, better withstand catastrophic events, and increase its underwriting capacity. Insurers can also benefit from reinsurers' knowledge and expertise when expanding into new lines of business. Moreover, reinsurance can indirectly benefit policyholders, by allowing direct insurance writers to offer coverage for a wider range of risks, and with higher policy limits.

Reinsurance, however, exposes insurers to increased operational, counterparty and legal risks. Prudently managing these risks, and balancing them against the benefits of reinsurance, is complex. At the same time, failure to do so can materially affect an insurer's financial soundness and reputation, and can ultimately contribute to its failure.

This paper describes OSFI's current reinsurance framework and discusses areas where changes are being considered. The scope of this review includes both the P&C and life sectors; however, the issues and considerations are most prominent in the P&C sector. More specifically, OSFI is considering making important changes to guidelines addressing prudential limits and restrictions and capital adequacy for P&C FRIs. The changes are aimed at addressing two key findings of the review, which are that:

1) Risks associated with large exposures and concentration of reinsurance counterparties must be better managed; and
2) Adjustments to the capital framework for reinsurance are warranted.

In addition to these two key areas, a number of clarifications will be made to the guideline addressing sound reinsurance practices and procedures. Changes to regulatory data forms and transaction instructions for legislative approvals related to reinsurance are also being considered.

By presenting the current framework, OSFI's concerns, and the various potential changes being considered, this paper aims to help the industry provide comprehensive feedback on the

[1] Unless otherwise specified, subsequent references to "capital" in this paper include the vested assets of foreign companies.

proposals contained herein. Comments received will be considered as OSFI finalizes certain proposals in the near term (i.e., this year through 2019). Industry's views will also help guide OSFI's analysis of the reinsurance framework in the longer term.

Process and Phases of Reinsurance Review

OSFI is seeking comments on this discussion paper by September 15, 2018.

Comments may be emailed to: Reinsurance-Reassurance@osfi-bsif.gc.ca

Alternatively, written comments may be addressed to:

OSFI Reinsurance Review Committee
255 Albert Street
Ottawa, Ontario K1A 0H2

A parallel consultation process is being undertaken for reinsurance related measures included in OSFI's draft *Minimum Capital Test* (MCT) Guideline for 2019. Comments specific to the MCT measures effective for 2019 and for 2020 should be provided according to the process and the timeline detailed with the release of the draft 2019 MCT Guideline. The consultations on, and finalization of, the MCT measures effective for 2019 and for 2020 represent Phase I of three phases of reinsurance framework changes being considered as a result of OSFI's reinsurance review.

This paper seeks comments on proposals for amending guidelines addressing (1) prudential limits and restrictions (i.e., OSFI's Guideline B-2 *Investment Concentration Limits* for P&C Insurers) and (2) sound business and financial practices (i.e., OSFI's Guideline B-3). Many of these proposals are in the early stages of development. Accordingly, comments received in response to this paper will be taken into consideration as OSFI refines these proposals for further consultation, which will occur when the two draft revised guidelines are released in 2019. OSFI's objective is to finalize both guidelines prior to January 1, 2020. Revised transaction instructions in respect of approvals for unregistered related party reinsurance (i.e., *Reinsurance with a Related Party* known as Transaction Instruction DA 21) will also be released in 2019. These adjustments to the framework for reinsurance form part of Phase II of OSFI's reinsurance review.

Finally, this paper contemplates areas in which the MCT Guideline and *Life Insurance Capital Adequacy Test* (LICAT) may be revised for 2022 or later years, subject to further analysis. OSFI welcomes early views from the industry in these areas. Any resulting proposed revisions to the capital frameworks would be released in a draft MCT Guideline and/or LICAT to take effect in 2022 or later. Potential changes in these areas would be part of Phase III changes resulting from OSFI's reinsurance review.

Phases of OSFI's Reinsurance Review

2018	2019	Beyond 2020
PHASE I	**PHASE II**	**PHASE III**
Consultation on, and finalization of, reinsurance related measures effective for 2019 and 2020 to be included in the capital guideline: • 2019 MCT	Consultation on, and finalization of, measures to be included in: • Guideline B-2 for P&C • Guideline B-3 Issuance of: • Revised DA 21 Transaction Instructions	Possible additional changes to capital guidelines (MCT and/or LICAT) for 2022 or later years

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Introduction

OSFI's mandate is to protect depositors, policyholders and other creditors by: developing guidance on risk management and mitigation, assessing the safety and soundness of financial institutions, and intervening promptly when corrective actions need to be taken. OSFI recognizes the importance of allowing financial institutions to compete and take reasonable risks, and it holds boards and senior management ultimately responsible for the viability of their institutions. OSFI's approach to the supervision and regulation of risks specific to reinsurance aligns with this mandate.

At the time of its last comprehensive review[2] OSFI recognized that the shift from a rules-based to a principles-based framework could result in significant changes to insurers' business models and their use of reinsurance, particularly in the P&C sector.[3] The current review is motivated by precisely that observation; reinsurance practices have evolved for a number of reasons, and it is important that the regulatory framework keep pace.

The guiding principles underlying OSFI's reinsurance framework have remained consistent over time. They include:

1) **Policyholders of FRIs must be adequately protected –** This is a core element of OSFI's mandate and of its approach to regulating a FRI's use of reinsurance. Recognizing that FRIs and entities to which they cede risks can fail, OSFI administers a framework designed to require that adequate financial resources be maintained in Canada to absorb unexpected losses (to a prescribed confidence level) and to satisfy obligations to policyholders and creditors in the event of a failure.

2) **Regulation and supervision must be balanced and risk-based –** Regulatory requirements and expectations aimed at protecting policyholders must be balanced with the need to allow FRIs to compete and take reasonable risks. Recognizing this, OSFI takes a risk-based approach that emphasizes the need for FRIs to implement prudent reinsurance risk management practices and procedures. OSFI provides principles-based guidance in this regard, supplemented with specific rules, where appropriate.

3) **OSFI must have the ability to effectively assess risks –** In order to fulfil its mandate, OSFI must have the right supervisory information at its disposal. OSFI's approach depends on complete, accurate, and timely reporting by FRIs.

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[2] *Discussion Paper on OSFI's Regulatory and Supervisory Approach to Reinsurance* (2008), *Response Paper: Reforming OSFI's Regulatory and Supervisory Regime for Reinsurance* (2010).

[3] A key outcome of the last reinsurance review was the introduction of OSFI's principles-based Guideline B-3: *Sound Reinsurance Practices and Procedures* (Guideline B-3) in 2010, and the subsequent repeal, in 2011, of regulations that prescribed limits on a P&C FRI's use of reinsurance. Pursuant to the now repealed *Reinsurance (Canadian Companies) Regulations* and *Reinsurance (Foreign Companies) Regulations*, Canadian (i.e. domestic) and foreign companies (i.e., branches), respectively, were subject to the following limits on reinsurance risks ceded: (i) 75 per cent of gross premiums and (ii) 25 per cent of gross premiums to unregistered reinsurers. These limits were premium-based and did not apply to reinsurers.

4) **A level playing field among financial sector players should be maintained where appropriate –** It is important to maintain a relative consistency in the development and application of regulatory guidance, standards and rules between lines of business, sectors, and for domestic and foreign players.

Any changes to the reinsurance framework being contemplated must be assessed against these guiding principles.

OSFI's Current Reinsurance Framework

OSFI has implemented an approach for reinsurance risks that combines: 1) principles-based guidance, 2) capital frameworks and 3) risk-based supervisory oversight. There is also a statutory approvals regime for FRIs that enter into reinsurance arrangements with unregistered (i.e., non-OSFI supervised) related-party reinsurers. Each of these is discussed below.

Principles-Based Guidance

The principles contained in Guideline B-3, which are applicable to both the life and P&C sectors, are intended to guide FRIs in developing prudent approaches to managing their reinsurance risks by expressing OSFI's expectations in this regard. For example, Guideline B-3 sets out the expectation that a FRI develop and implement its own sound and comprehensive reinsurance risk management policy (RRMP). It states that the RRMP should have regard for the FRI's risk appetite and risk tolerance and should include, among other things, risk concentration limits and ceding limits. Guideline B-3 also sets out OSFI's expectation that a ceding FRI conduct ongoing due diligence on its reinsurance counterparties and assess and manage its counterparty credit risk. This includes an expectation that FRIs conduct a higher level of due diligence when its reinsurance counterparty is not also a FRI (i.e., unregistered). Finally, Guideline B-3 sets out OSFI's expectation that reinsurance contracts contain clear terms and conditions, including offset and insolvency clauses intended to ensure appropriate outcomes in the event of the cedant's or reinsurer's insolvency.

Capital Frameworks

The LICAT and the MCT Guideline recognize the benefits and risks of reinsurance. Under these guidelines, a FRI may reduce its required capital for insurance risk ceded. The reduction in required capital depends on whether the risks are ceded to another FRI (a registered reinsurer) or an unregistered reinsurer. In the former case, the ceding FRI no longer holds capital for the insurance risk as the liabilities have been reinsured by the FRI reinsurer, which must maintain capital, in Canada, to support the assumed insurance risk. In the latter case, a FRI is permitted to take capital credit for reinsurance when the unregistered reinsurer has posted acceptable collateral in Canada to support the ceded liabilities and capital requirements. The requirement that adequate collateral be maintained in Canada to obtain a capital credit is an important aspect of Canada's regulatory approach to the use of unregistered reinsurance; it protects a FRI and its policyholders against the risk that an unregistered reinsurer fails to honour its obligations. The rules for what constitutes acceptable collateral, and the determination of an appropriate amount of collateral, are set out in the capital guidelines. Additional guidance on the collateral arrangements known as "reinsurance security agreements", is set out in OSFI's Guideline on Reinsurance Security Agreements.

Risk-Based Supervision

OSFI applies a risk-based approach to the supervision of reinsurance. Supervisory intensity of any particular FRI's reinsurance program increases proportionally with that FRI's reliance on reinsurance. Supervisors use regulatory returns, financial reports and "stress tests" of capital adequacy to determine the importance of a reinsurance program to a particular FRI, and to gain insights into the associated risks. Additional information about a FRI's reinsurance arrangements and the oversight of its reinsurance risks may be sought as part of OSFI's periodic examinations of the FRI. A FRI that is not sufficiently managing its reinsurance risks may be denied capital credit for a reinsurance arrangement as part of OSFI's discretionary authority. OSFI may also use its discretionary authority to adjust the FRI's capital requirements or internal target ratio to compensate for reinsurance that may not be wholly effective or reliable.

Legislative Approval Requirements for Reinsurance with Unregistered Related Parties

Legislative provisions require a FRI to obtain the Superintendent's approval to reinsure any of its risks with an unregistered related party reinsurer. OSFI has developed an approvals framework to administer these provisions, which is reflected in Transaction Instruction DA 21. To obtain the Superintendent's approval in this regard, OSFI must be satisfied that, among other things, the reinsurance arrangement is on terms at least as favourable to the FRI as market terms and conditions. As part of the approval process, OSFI also evaluates the proposed reinsurance arrangement against the standards and expectations set out in the other guidance related to reinsurance (e.g., Guideline B-3). Where an approval is granted, the FRI is required to provide OSFI, on an annual basis, with information that allows OSFI to assess the FRI's reinsurance relationship with the related party.

Maintaining the Effectiveness of OSFI's Reinsurance Framework

Reinsurance has become more important to FRIs, and more complex, since the last review and update of OSFI's supervisory and regulatory framework for reinsurance. In this context, a couple of key findings have emerged over the course of this review. In particular, for the P&C sector:

1) Risks associated with large exposures and concentration of reinsurance counterparties must be better managed, and

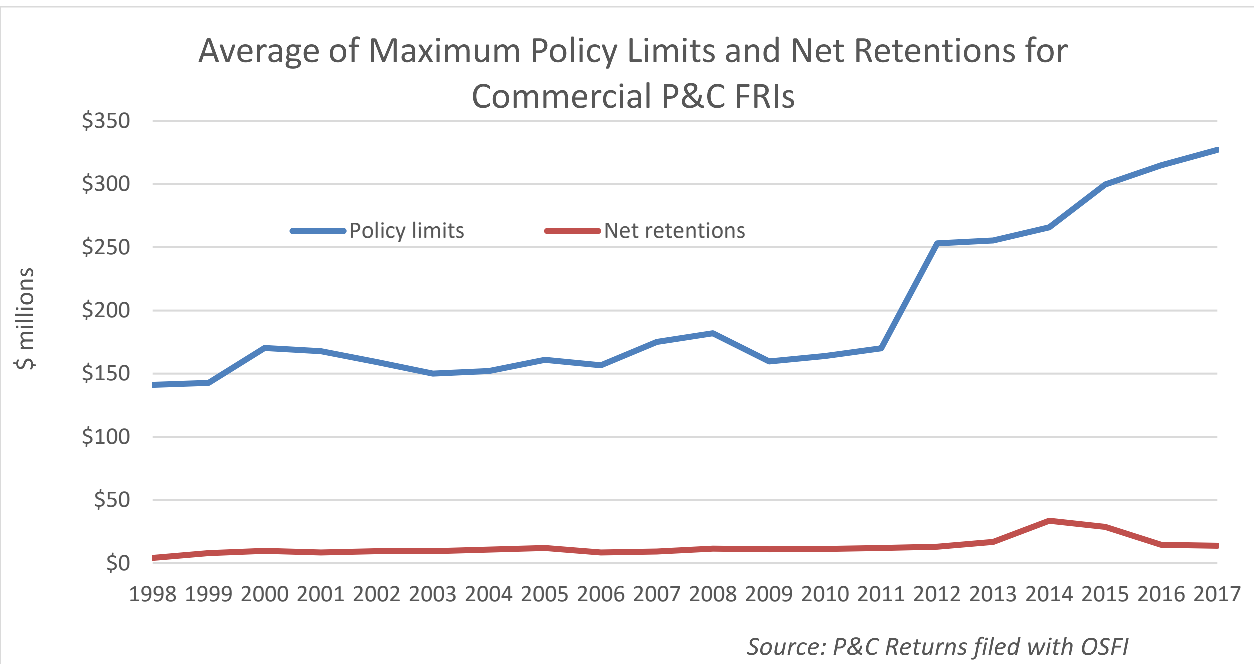
2) Adjustments to the capital framework for reinsurance are warranted.

In addition to these two key areas, a number of clarifications and other more minor adjustments to the framework (e.g., to Guideline B-3) are under consideration. Changes to OSFI's regulatory data forms and Transaction Instruction DA 21 are also being considered, as discussed below.

Reinsurance Risk Management – Large Exposure and Concentrated Counterparty Risks

In 2015, OSFI first shared its concerns about the emergence of a "leveraged business model".[4] This business model involves a FRI issuing high-limit policies in Canada and subsequently reinsuring a very significant portion of these risks, typically with an unregistered reinsurer. This practice has long been used to transfer large catastrophic risks when there is limited reinsurance capacity in Canada; OSFI recognizes and acknowledges the validity of this reinsurance practice for risk management purposes.

Beyond the management of catastrophic risks, the leveraged business model has different motivations and inherent risks. Since the 2011 repeal of the *Reinsurance (Canadian Companies) Regulations* and the *Reinsurance (Foreign Companies) Regulations*, OSFI has observed this model being used by commercial P&C FRIs to increase policy limits and sizes without commensurately increasing net risk retention. The chart below illustrates a two-decade trend in commercial policy limits and net retentions in Canada. In 2011, on average, the maximum policy limit issued by P&C FRIs in Canada that insure commercial risks was just under $170 million. This grew to more than $327 million in 2017, an increase of more than $157 million. The average net retention for the same group of P&C FRIs has not risen correspondingly; it was $12 million in 2011 and less than $14 million in 2017.



[4] Remarks by Superintendent Jeremy Rudin to the 2015 Property and Casualty Insurance Industry Forum, Cambridge, Ontario, June 4, 2015. Subsequent remarks by Superintendent Jeremy Rudin to the 2016 National Insurance Conference of Canada (NICC), Vancouver, British Columbia, September 29, 2016 also communicated OSFI's concerns about the business model.

Due to the nature of P&C business, where reinsurance is often used to mitigate the risks associated with low frequency and high severity exposures, little collateral is required to be held in Canada until the occurrence of a loss. In the event of a loss, a reinsurance recoverable is created, which introduces credit risk. As a result, the leveraged business model can result in significant and highly concentrated counterparty credit risk, and a potential solvency issue, should the loss occur and the counterparty fails to promptly satisfy its reinsurance obligations to the cedant FRI.

OSFI expects all FRIs to prudently manage their reinsurance arrangements with due regard for exposure risks, and Guideline B-3 will be expanded and clarified accordingly. To supplement and reinforce these expectations, OSFI also intends to introduce a rule to establish a link between financial resources and policy sizes written by P&C insurers who provide coverage directly to policyholders (i.e., direct writers).

OSFI intends to revise Guideline B-3 to clarify and enhance expectations related to the prudent management of reinsurance risks. This will include an expectation that a FRI establish reasonable limits on its overall reinsurance exposure to any one reinsurance entity or group, particularly where the cedant FRI relies on its reinsurance programs to underwrite high-limit policies. Guideline B-3 applies to all FRIs.

In addition, OSFI intends to introduce a rule related to the issuance of high-limit policies by P&C FRIs. Under the proposed rule, the maximum policy limit that a P&C FRI could issue would depend upon its level of capital and excess collateral, as well as the diversity of its reinsurance counterparties. Annex I contains details about the proposed rule. The rule would be included in a revised Guideline B-2 for P&C. It would only apply to P&C FRIs that provide coverage directly to policyholders and to P&C FRI reinsurers in respect of direct business assumed by registered affiliates.

OSFI invites comments on its intention to revise Guideline B-3 and on the technical aspects of the rule to be included in Guideline B-2. These proposals form part of Phase II of OSFI's reinsurance review.

OSFI is also considering the merits of developing a rule to address similar concerns with P&C FRI reinsurers, and welcomes industry's views in that regard. The potential development of a rule specific to FRI reinsurers would form part of Phase III.

The Capital Frameworks for Reinsurance

OSFI has identified a number of potential changes to the capital frameworks in respect of reinsurance. These potential changes are to ensure continued policyholder protection by addressing the concerns raised in this paper, while maintaining a balanced and risk-based framework. The purpose of this section is to:

1) Highlight proposed changes that will be consulted upon this year for inclusion in the 2019 MCT Guideline with an effective date of January 1, 2019:

- introduce a counterparty credit risk charge on cessions to registered associated reinsurers; and
- recognize the amount of funds held to secure payment from assuming unregistered associated reinsurers as acceptable collateral for Canadian insurers (i.e., the current restriction in the MCT Guideline will be removed).

2) Highlight a proposed change that will be consulted upon this year for inclusion in the 2019 MCT Guideline with an effective date of January 1, 2020:
   - increase the margin required for reinsurance ceded to unregistered reinsurers.
3) Describe and seek feedback on two other items under review relating to reinsurance:
   - Financial resources supporting earthquake risk exposures; and
   - Reinsurance concentration risk.

Counterparty Credit Risk

In the MCT Guideline, a capital charge is applied to P&C FRIs that cede risks to unassociated FRIs. This capital charge is intended to address the risk that the assuming FRI will not honour its obligations.

This capital charge does not, however, apply to P&C FRIs that cede risks to an associated FRI. OSFI is of the view that the risk that an associated FRI will not honour its obligations is the same as with an unassociated FRI. Therefore, OSFI plans to implement a capital charge on P&C FRIs that cede risks to associated FRIs to account for counterparty credit risk.

For life FRIs, the 2018 LICAT implemented counterparty credit risk factors for risks ceded to associated FRIs.

In the 2019 MCT Guideline, OSFI intends to introduce counterparty credit risk factors for receivables and recoverables from associated FRIs. The proposed credit risk factors are equal to those applied to unassociated FRIs, as follows:

Balance Sheet Asset	Risk Factor
Insurance receivables	0.7%
Unearned premium recoverables	2.5%
Unpaid claim recoverables	2.5%

There is no intention at this time to apply counterparty credit risk charges to cessions within an OSFI approved intercompany pooling arrangement.

These changes are part of Phase I of OSFI's reinsurance review.

Unregistered Associated Reinsurance Funds Withheld

The MCT Guideline prescribes the forms of collateral that can be used to reduce the margin required for unregistered reinsurance. One form of collateral is the amount of funds withheld by the cedant FRI to secure payment from the assuming reinsurer. For domestic P&C FRIs, OSFI imposes a restriction on funds withheld from reinsurers that are associates, and non-qualifying subsidiaries, by not recognizing the funds withheld payable as acceptable collateral. Foreign P&C FRIs are not subject to this same restriction, nor are life FRIs.

Further to this reinsurance review, OSFI does not believe the differing treatment between domestic and foreign P&C FRIs is justified. The review, however, highlighted the need for a condition to be added to both the MCT Guideline and LICAT in order for all FRIs to recognize all funds withheld arrangements for credit.

As part of Phase I of its reinsurance review, OSFI intends to remove the funds withheld restriction for domestic P&C FRIs and recognize the amount of funds held to secure payment from reinsurers that are associates and non-qualifying subsidiaries. Therefore, OSFI plans to allow a credit in the calculation of the margin required for risks ceded to unregistered associated reinsurers. However, conditions will be added to the MCT Guideline (and also to LICAT) in order to recognize funds withheld payables for cessions to both registered and unregistered associated and non-associated insurers. The proposed conditions, which would apply to all FRIs effective January 1, 2019, are:

For the MCT Guideline:

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 any funds withheld could be paid to the reinsurer before all subject policies have expired and all claims settled.

For LICAT:

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 the end of the reinsurance term (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 any funds withheld could be paid to the reinsurer before the end of the reinsurance term.

MCT Guideline Margin Requirements for Unregistered Reinsurance

As noted earlier, a FRI that reinsures its risks may obtain capital relief because it has reduced its overall insurance risk.

If a FRI cedes risks to another FRI, the latter must increase its capital (or vested assets) held in Canada because it is exposed to more insurance risks, and has increased its potential insurance liability. The net result of this is a "balancing out", between the two insurers, of the insurance risk and the capital in Canada to support it.

While cessions to unregistered reinsurers are treated differently, the same fundamental principle applies. Since unregistered reinsurers are not regulated in Canada, they are not subject to the same legislative requirements, supervision, or capital requirements as FRIs. Therefore, in order to obtain the "balancing out" referred to above, OSFI requires that either (1) the ceding FRI continues to hold capital in Canada for the ceded insurance risk, or (2) the unregistered reinsurer posts collateral in Canada (in which case the ceding FRI may then reduce its required capital).

The collateral requirement is, in essence, an alternative to OSFI's capital (or vested assets) requirements for FRIs. Accordingly, OSFI does not intend that its collateral requirement either encourage or discourage the placement of reinsurance with FRIs or unregistered reinsurers, but rather that there be an adequate level of capital/collateral in Canada to protect the policyholders and creditors of the cedant FRI from undue loss.[5]

Currently, for a P&C FRI to obtain a full capital credit for risks ceded to an unregistered reinsurer, the collateral requirement is established at 115 per cent of the ceded unpaid claim reserve and unearned premiums. At this level, the amount of collateral is calibrated to the equivalent of a 150 per cent MCT (i.e., the minimum supervisory capital ratio at which FRIs are expected to operate).

In practice, however, P&C FRIs maintain capital ratios at or in excess of their internal capital target, which OSFI requires to be above the 150 per cent supervisory target ratio. As a result, the 15 per cent margin required may not effectively balance the insurance risks and capital/collateral normally maintained in Canada. In other words, the current calibration of the margin requirement may result in fewer assets in Canada to support insurance risks when those risks are ceded to unregistered reinsurers.

To correct for this, OSFI will increase collateral requirements for unregistered reinsurance to a level that more closely reflects the capital levels maintained by P&C FRIs to support insurance risk.

Changes to the calculation of the credit for unregistered reinsurance, which were aimed at balancing the insurance risks and capital/collateral normally maintained in Canada, were made in the 2018 LICAT for the life insurance sector.

[5] It is important to note that collateral maintained in Canada is generally based on incurred claim liabilities. Given the long-tail exposures and latent claims development in P&C insurance, such collateral can at times still be insufficient to cover claims in the event of a failure of an unregistered reinsurer.

In the 2019 MCT Guideline, effective January 1, 2020, OSFI intends to increase the margin required for reinsurance ceded to an unregistered reinsurer from 15 per cent to 20 per cent in order for a FRI to obtain full capital/asset credit for that reinsurance. This change is part of Phase I of OSFI's reinsurance review.

Financial Resources Supporting Earthquake Risk Exposures

OSFI requires the establishment of an earthquake reserve, which is part of capital requirements for the purposes of the MCT Guideline. A FRI can reduce its earthquake reserve using eligible financial resources. OSFI is reviewing the appropriateness of this reduction, as it may result in counting the same resource twice, which may inappropriately reduce the overall level of capitalization.

The reinsurance review of catastrophe risk raised a potential issue with respect to the use of capital and surplus as one of the eligible financial resources in the calculation of the earthquake risk reserve. The issue is different for foreign FRIs and domestic FRIs, as explained below.

Both domestic and foreign FRIs may include 10 per cent of their consolidated/world-wide capital and surplus as an eligible financial resource to reduce the earthquake risk reserve. The concern that arises is that the portion of capital and surplus is used as an eligible financial resource to reduce the earthquake reserve, which reduces capital requirements, and then is also included as part of the FRI's capital available used to cover the overall capital requirement. There is potential double counting of the same financial resource.

In addition to including 10 per cent of their consolidated worldwide capital and surplus as an eligible financial resource to reduce the earthquake risk reserve, foreign FRIs can also claim a capital credit for reinsurance when earthquake risk is reinsured with an associated reinsurer. OSFI is concerned that the credit for associated reinsurance and the reduction obtained using a portion of the consolidated worldwide capital and surplus use, at least partially, the same financial resource. That is, the consolidated worldwide capital and surplus that is used in support of the reduction in reserve includes, as a result of accounting standards that apply to subsidiaries, the capital and surplus of the associated reinsurer that is backing the credit for reinsurance.

OSFI is reviewing the appropriateness of the 10 per cent of consolidated/world-wide capital and surplus as eligible earthquake financial resources for domestic and foreign FRIs. OSFI will complete a review of the issue and determine its position at a later date.

OSFI welcomes views from stakeholders on the removal of the 10 per cent of consolidated/world-wide capital and surplus as an eligible financial resource for domestic and foreign FRIs in the calculation of the earthquake reserve. OSFI also welcomes views on whether alternatives exist for addressing the issues raised in this section. Any changes in respect of this matter will be part of Phase III of OSFI's reinsurance review.

Reinsurance Concentration Risk

The use of reinsurance introduces credit risk. OSFI has observed that some FRIs have material reinsurance programs with a single or only a few reinsurers, or a few groups of related reinsurers, which raises the risk of an adverse impact on the financial position of the cedant FRI should one of its reinsurance counterparties encounter financial difficulty. As standard tests, the MCT Guideline and LICAT implicitly assume that, on average, a FRI's reinsurance program is well diversified; OSFI has observed instances where this may not be the case.

A number of jurisdictions include capital requirements relating to concentration risk, such as Australia (APRA), the United Kingdom (Solvency II), and the IAIS Insurance Capital Standard that explicitly consider reinsurance assets within the concentration risk requirements. Within their frameworks, the focus on the concentration risk charge/limit is on name concentration. Name concentration relates to the risk arising from a concentration of exposures to an entity or a group of related entities. Accordingly, name concentration exposure is not limited to exposure to a single legal entity.

OSFI is considering introducing a concentration risk charge/limit on reinsurance assets in a future update of the capital guidelines. OSFI has not completed its review and is raising the matter with the industry for comments.

OSFI welcomes views from stakeholders on considerations related to the introduction of a reinsurance concentration risk charge/limit. Any such change would be part of Phase III of OSFI's reinsurance review.

Clarifications to Guideline B-3 and Other Potential Reinsurance Framework Adjustments

A number of clarifications and other adjustments to OSFI's reinsurance framework – and to Guideline B-3 in particular – are under consideration. Changes to OSFI's regulatory data forms and Transaction Instruction DA 21 are also being considered. In this regard, OSFI welcomes comments on all of the items discussed below.

Worldwide Treaties and Flow of Reinsurance Funds

It is not uncommon for large, international insurance groups to use "worldwide treaties", that is, reinsurance treaties that provide coverage in respect of multiple insurance operations in different countries. OSFI has observed situations in which the home office of a foreign FRI enters into a reinsurance treaty that includes, but is not limited to, risks that have been insured in Canada by the foreign FRI.[6]

Worldwide treaties present unique benefits and risks to cedent FRIs. Benefits of worldwide treaties for a FRI and its group include the centralization and control of reinsurance risk management, and lower reinsurance costs due to bulk buying and diversification of risks reinsured. However, worldwide treaties also have drawbacks. Given the multiple risks and

[6] OSFI has also observed situations where a foreign parent of a Canadian subsidiary FRI enters into a treaty that covers the risks insured in Canada by the Canadian subsidiary FRI.

locations covered by worldwide treaties, it is possible that a treaty's coverage limit could be exhausted following an event in another jurisdiction, such that subsequent events affecting Canadian policyholders are not covered. This possibility should normally be considered in a FRI's Own Risk and Solvency Assessment (ORSA), and in the determination of appropriate operating targets. Another potential issue is created when the proceeds of a reinsurance treaty flow to the entity arranging the coverage, in the foreign jurisdiction, rather than directly to the FRI in Canada. In the event of a distress situation, there is a risk that reinsurance payments for claims of the FRI would not be recovered in a timely manner, and the FRI is left to cover payments using only the assets maintained in Canada.

As a result, OSFI's expectation is that worldwide reinsurance treaties should only be granted credit in the determination of target operating capital levels if the reinsurance payments flow directly to the FRI in Canada.

OSFI has recently revised its P&C Memorandum to the Appointed Actuary for 2017 to draw attention to the above issues and considerations.[7] OSFI is also considering providing more detailed guidance regarding its expectations for worldwide treaties that reinsure FRIs, and collecting more information from FRIs to identify when such treaties are used.

OSFI invites views on its intention to amend Guideline B-3 to provide additional guidance regarding worldwide treaties, and to clarify that OSFI expects reinsurance payments to flow directly to a FRI in Canada. OSFI may also amend its regulatory data forms to capture more information about the use of worldwide treaties. These changes would be made as part of Phase II of OSFI's reinsurance review.

Significant Quota Share Treaties

A number of FRIs have implemented increasingly significant quota share treaties in recent years. In aggregate, P&C FRIs used quota share for an estimated 50 per cent of the premiums ceded in Canada in 2011. This has risen to more than 60 per cent as of 2017. Some FRIs have implemented quota share treaties that cede a majority of their earned premiums. 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

[7] OSFI's Property and Casualty Memorandum to the Appointed Actuary specifies the contents of the annual Appointed Actuary's Report to OSFI. For 2017, OSFI is asking for additional information about reinsurance, specifically, the AA should identify (i) whether the reinsurance arrangements are specific to the Canadian operations only and (ii) whether the terms and conditions require payments to be made directly to the company in Canada, including in the event of a cedant's insolvency.

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.

Guideline B-3 states that a FRI should not, in the normal course of its business, cede substantially all of its risks. There is, however, a range of interpretations with respect to the term "substantially all of its risks", with the result that this principle may not always be effective at encouraging reasonable limits on cessions and discouraging over reliance on reinsurance. OSFI is also of the view that FRIs should avoid unduly relying upon a single reinsurer or reinsurance group when reinsuring a significant activity of the FRI.

OSFI invites views on its intention to strengthen Guideline B-3 with respect to the management of the risks related to significant quota share treaties, and the expectation that FRIs not cede substantially all of their risks. In particular, OSFI is seeking views on the concept of "substantially all of [an insurer's] risks" and how this concept could be expressed in a more objective manner. Guideline B-3 is being amended as part of Phase II of OSFI's reinsurance review.

Fronting Arrangements

The term "fronting" in the context of this reinsurance review refers to the practice of insuring a risk and then reinsuring 100 per cent of that risk with another insurer. Fronting arrangements between a FRI and an unregistered unrelated foreign insurer (UUFI) may be undertaken for a variety of reasons. Traditionally, UUFI's pursued fronting arrangements to leverage the Canadian market expertise and presence of an FRI and to gain experience and exposure to the Canadian market (often with a view to potentially entering the Canadian market in the future as a licensed insurer). In other cases, fronting arrangements have been common practice in circumstances where the underwriting expertise for niche, specialty risks rests with the reinsurer. Some FRIs are also involved in fronting arrangements involving an insured's captive-UUFI; for example, this commonly occurs when a large commercial entity facilitates self-insurance by setting up an offshore captive reinsurer that only reinsures the risks of its parent/group (which are insured in the first instance by a FRI). All of these are generally acceptable fronting arrangements and typically do not represent a material portion of the FRI's business operations nor a material exposure to the UUFI.

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:

- 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.

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.

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.

OSFI invites views on its intention to revise Guideline B-3 to clarify its expectations related to fronting arrangements. OSFI plans to include an expectation in Guideline B-3 for FRIs to take reasonable measures to satisfy themselves that legal risks related to contract wording in respect of reinsurance arrangements with captive UUFIs are appropriately managed. OSFI also intends to apply other relevant reinsurance measures identified in this paper to fronting arrangements (e.g., large exposures). Guideline B-3 is being amended as part of Phase II of OSFI's reinsurance review.

Foreign FRIs Ceding Risks back to the Home Office

OSFI has observed situations where foreign FRIs cede risks insured in Canada to an unregistered affiliated reinsurer, which then retrocedes the risks back to the home office of the FRIs. These foreign FRIs then generally recognize this reinsurance arrangement for the purposes of determining their required vested assets, even though the economic reality of these arrangements is that the FRIs retain insurance risk originally ceded to the unregistered affiliate. When a loss occurs in Canada, reinsurance proceeds flow from the FRI's foreign accounts, to the FRI's affiliated reinsurer in the first instance, before flowing to the FRI's branch in Canada. This practice has been undertaken by both life and P&C FRIs.

OSFI recognizes that such an arrangement may be motivated by valid business and risk management reasons. In some instances, this practice does not raise prudential concerns. For example, intragroup excess-of-loss reinsurance treaties may be established with the objective of consolidating capital at the foreign FRI home office to support catastrophic losses. In this case, the practice may not involve a material reduction to the assets of the FRI available in Canada.

However, OSFI has observed other arrangements that involve material cessions to a FRI's home office that raise prudential concerns. For example, some arrangements involving material quota share treaties may undermine Canada's vested assets regime applicable to foreign FRIs. Such arrangements have the potential to inappropriately reduce the total available assets in Canada to satisfy the FRIs financial obligations related to its insurance business in Canada. This practice is of concern to OSFI. For example, the assets intended to support the FRI's Canadian risks may not flow as intended – from the FRI's home office in a foreign jurisdiction, to an affiliate, and then back to the FRI in Canada – in a timely manner, or at all.

OSFI continues to review this issue and is raising the matter in this paper, along with possible solutions, to seek views from the industry. One measure under consideration is to deny credit to a foreign FRI for the risks that are ultimately retroceded, exclusively through entities within the FRI's group, back to the FRI in its home jurisdiction. Alternatively, OSFI may require that additional collateral be maintained in Canada to mitigate the concerns related to the reduction of assets in Canada that result from such arrangements.

OSFI invites comments on the practice of ceding to home office, by both life and P&C FRIs, including on the prevalence of the practice. In particular, OSFI is seeking views on possible measures to address the concerns described above, including those measures described above. Guideline B-3 is being amended as part of Phase II of OSFI's reinsurance review.

Legislative Approvals for Reinsurance with Related Parties

OSFI plans to request additional information when a FRI requests the Superintendent's approval to cause itself to be reinsured by an unregistered related party insurer. In addition, OSFI plans to expand the scope of the information to be submitted annually in respect of such reinsurance relationships (for both existing and prospective related party reinsurance arrangements). In this regard, OSFI is currently reviewing Transaction Instruction DA 21. The intent is to collect more information on, and to consider, both the unregistered related party reinsurer and the group to which it belongs. This change would recognize that the financial strength of both the related party reinsurer and its group are generally materially correlated. In this regard, OSFI would generally only recommend that the Superintendent grant an approval where both the related party reinsurer and the group to which it belongs appear to be in sound financial condition. Conversely, OSFI may recommend that the Superintendent revoke an approval if it is subsequently determined that either the related party reinsurer, or the group to which it belongs, no longer appear to be in sound financial condition.

The Transaction Instruction is being amended as part of Phase II of OSFI's reinsurance review.

Insurance Linked Securities

OSFI has received a growing number of inquiries related its expectations in respect of insurance-linked securities (ILS). ILS are financial instruments used by insurers to transfer insurance risks to capital markets. They may include, among other things, catastrophe bonds, swaps, industry loss warranties, derivatives contracts and sidecars.

A reinsurer that transfers the risks it assumes to investors, via ILS, may have a very different risk profile relative to a traditional reinsurer. OSFI expects a FRI to conduct a commensurately higher level of due diligence in respect of its reinsurance counterparty, and to carefully consider the unique risks associated with relying on a reinsurer that itself relies on non-traditional sources of funding.

No change to OSFI's expectations regarding a FRI's direct issuance of capital market instruments, as contemplated in Guideline B-9: *Earthquake Exposure Sound Practices*, is being considered at this time.[8]

OSFI invites comments on its intention to revise Guideline B-3 to include its expectations for FRIs that cede risks to reinsurers that rely upon ILS. Guideline B-3 is being amended as part of Phase II of OSFI's reinsurance review.

Conclusion

In light of the increasing reliance on reinsurance and the emergence of new and evolving business models related to the use of reinsurance, OSFI must ensure that its reinsurance framework remains appropriate. This paper represents a key step in OSFI's commitment to engaging stakeholders in this important initiative. Due consideration will be given to all comments received in response to this paper as OSFI continues with its review of its reinsurance framework.

[8] OSFI's Guideline B-9: *Earthquake Exposure Sound Practices* contemplates the direct issuance of ILS by FRIs, and indicates that prior approval from OSFI is required before these instruments can be recognized as a financial resource under the MCT Guideline.

Annex I: Rule to Limit P&C Policy Sizes

This Annex provides more details about a proposed new rule to limit policy sizes to address the concerns detailed in the section of the paper related to large exposure and concentrated counterparty risks.

The proposed rule assumes that, in the context of a severe distress scenario involving an unregistered entity/group to which a cedant FRI has the greatest exposure (an Event), reinsurance payments from that entity/group for claims of the cedant FRI may not be recoverable in a timely manner, other than payments secured by assets maintained in Canada.

Stress-Testing Scenarios

The following are viewed as plausible scenarios occurring during an Event:

(a) the largest direct[9] policy limit loss (single risk only)[10];

(b) the second largest direct policy limit loss (single risk only), in addition to (a) above; and

(c) the third largest direct policy limit loss (single risk only), in addition to (a) and (b) above.

Scenarios (a) through (c) above have been translated into the following formulae, the purpose of which is to measure single-risk contingent counterparty exposure, and limit over reliance on reinsurance with an unregistered entity/group.

The cedant FRI is expected to manage its in-force exposure to policy limit loss(es) to satisfy formulae A, B and C below, for each unregistered reinsurer (or affiliated group) to which it cedes risk:

A) One Large Loss

$$L_1 <= [\text{Excess over 100\% MCT or BAAT (30.61, line 79)}] + C_1 - \text{Max}(0,R_1 – E_1)$$

B) Two Large Losses

$$L_1 + L_2 <= [\text{Total Capital or Net Assets Available (30.61, line 9/19)} – 50\% \times \text{Total Minimum Capital (margin) Required (30.61, line 69)}] + C_1 + C_2 - \text{Max}(0,R_1 – E_1) - \text{Max}(0,R_2 – E_2)$$

C) Three Large Losses

$$L_1 + L_2 + L_3 <= [\text{Total Capital or Net Assets Available (30.61, line 9/19)}] + C_1 + C_2 + C_3 - \text{Max}(0,R_1 – E_1) - \text{Max}(0,R_2 – E_2) - \text{Max}(0,R_3 – E_3)$$

9 Includes per risk reinsurance assumed from a licensed Canadian affiliate.
10 For property risks, this generally represents the largest location limit.

L_1 = Largest in-force Policy Limit Loss **L_2 = Second largest in-force Policy Limit Loss** **L_3 = Third largest in-force Policy Limit Loss** **R_1,R_2,R_3 = largest amount of unregistered reinsurance on L_1 (and L_2, L_3 as applicable) provided by a (re)insurance group (affiliated entities that are part of a (re)insurance group)** **E_1,E_2,E_3 = ∑Excess collateral (70.61 column 48) for all members of R_1,R_2,R_3 (re)insurance group respectively [Excess assets may only be counted once, and only to the extent that the assets are jointly available to cover L_1,L_2,L_3]**	C_1 = All proportional and per risk coverage reinsurance ceded applicable to L_1 C_2 = All proportional and per risk coverage reinsurance ceded applicable to L_2 C_3 = All proportional and per risk coverage reinsurance ceded applicable to L_3

Where a cedent FRI writes a policy/policies that result in a shortfall of financial resources in Canada when the formulae are applied, it would be expected to address that shortfall using one or more measures that could include:

(a) reducing concentration in the reinsurance panel used by the cedant FRI;

(b) arranging for the injection of additional capital;

(c) having the unregistered reinsurance entity/group provide additional collateral in excess of recoverables and the MCT margin required; and

(d) reducing policy limits (e.g., by using subscription policies).