Guideline

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This chapter describes the treatment of reinsurance in the determination of the LICAT ratios, collateral requirements for unregistered reinsurance, and the conditions necessary in order for an insurer to take credit for reinsurance.

10.1. Definitions

The term “registered reinsurance” as used in this guideline means reinsurance that is deemed to constitute registered reinsurance as a result of meeting the conditions either in section 10.1.1 or in section 10.1.2 below. The term “unregistered reinsurance” refers to all reinsurance that is not deemed to constitute registered reinsurance.

10.1.1. Registered reinsurance

An arrangement is deemed to constitute registered reinsurance if it is conducted with a registered reinsurer. OSFI considers a reinsurer to be registered if it is:

a. a reinsurer that is either:
   i. incorporated federally and has reinsured the risks of the ceding insurer; or
   ii. a foreign insurer that has reinsured in Canada the risks of the ceding insurer,

   and is authorized by order of the Superintendent to do so; or
b. a provincially/territorially regulated insurer that has been approved by the Superintendent.

Note that in respect of item (a)(ii) above, a ceding foreign insurer will be permitted to treat a reinsurance arrangement as registered reinsurance only where the arrangement provides that the reinsurer does not have any right of set-off against obligations of the ceding foreign insurer other than those obligations related to the insurance business in Canada of the ceding foreign insurer.

Subsection 578(5) of the *Insurance Companies Act* requires a foreign insurer, in respect of risks it reinsures in Canada, to set out in all premium notices, applications for policies and policies (which may include cover notes offer letters or quotations) a statement that the document was issued or made in the course of its insurance business in Canada. In cases where the cover note, offer letter or quotation can be considered neither an application for a policy nor a policy, an insurer will be permitted to treat a reinsurance arrangement as registered reinsurance only if the foreign reinsurer includes, in the cover note, offer letter or quotation, a statement that the reinsurer intends to issue the reinsurance contract under negotiation in the course of its insurance business in Canada, and that it will take measures to ensure that the cedant's risks will be reinsured in Canada in accordance with OSFI's Advisory No. 2007-01-R1 entitled *Insurance in Canada of Risks*.

10.1.2. Unregistered reinsurance

OSFI considers an entity to be an unregistered reinsurer if it is not a registered reinsurer as defined in section 10.1.1 above. Special purpose vehicles formed for the purpose of securitizing insurance risks are considered to be unregistered reinsurers.

All reinsurance arrangements under which an insurer or one of its subsidiaries cedes or retrocedes business to an unregistered reinsurer are treated as unregistered reinsurance for the purpose of this guideline, unless:

a. the ceding insurer is a Canadian insurer or a subsidiary of a Canadian company; and

b. all of the underlying policies ceded under the arrangement were directly written outside of Canada, and the ceding insurer has not assumed in Canada the risks[1] of these policies; and

c. either:

i. the branch or subsidiary of the Canadian insurer issuing (reinsuring) the policies is subject to local solvency supervision by an OECD country in respect of the risks being ceded, and the reinsurance (retrocession) arrangement is recognized[2] by that country's solvency regulator, or

ii. the risks being ceded relate to policies that have been issued (reinsured) by a subsidiary of the Canadian insurer that is incorporated in a non-OECD country, and the reinsurance (retrocession) arrangement is recognized[2] by that country's solvency regulator,

and;

d. either:

i. the reinsurer is regulated and subject to meaningful risk-based solvency supervision (including appropriate capital requirements) for insurance risks, or

ii. the foreign solvency regulator has recognized the reinsurance arrangement on the basis that it has been fully collateralized by the reinsurer.

Reinsurance meeting all of conditions (a) through (d) above is deemed to constitute registered reinsurance.

10.1.3. Ceded liabilities

In the remainder of this chapter, "ceded" liabilities refer to liabilities that are covered by a reinsurance arrangement. For the purpose of calculating the requirements in the following sections, ceded liabilities should be measured on the same basis as that of the direct liabilities appearing on the balance sheet. In particular, the value of the ceded liability for any policy should be calculated using the same underlying policy cash flow assumptions and discount rate that are used to value the direct liability. Ceded liabilities should be measured without any reduction for the risk of non-performance of the reinsurer.

10.2. Adjustments to Available Capital for unregistered reinsurance

Insurers should adjust Available Capital to account for ceded liabilities arising from unregistered reinsurance. All of the adjustments in this section are calculated in respect of ceded liabilities for:

1. existing business, and
2. future business assumed through reinsurance contracts issued, and retroceded through unregistered reinsurance.

10.2.1. Requirement for aggregate positive liabilities ceded

For every unregistered reinsurer, an insurer should include, within its Deductions/Adjustments (q.v. section 2.1.2.10) or Assets Required (q.v. section 12.2.5), the higher of zero, or the aggregate Best Estimate Liability ceded to the unregistered reinsurer. This requirement may be reduced to a minimum of zero through application of any credit available in respect of the unregistered reinsurer (q.v. section 10.3).

10.2.2. Requirement for offsetting policy liabilities ceded

The amount of offsetting policy liabilities ceded to an unregistered reinsurer is defined to be the sum of:

1. The amount of negative Best Estimate Liabilities ceded to the reinsurer, calculated on a policy-by-policy basis without any reductions; and
2. the lower of zero, or the aggregate Best Estimate Liability ceded to the reinsurer.

For every unregistered reinsurer, the amount of offsetting policy liabilities ceded should be deducted from Tier 1 as a negative reserve and included in Tier 2 for Canadian insurers, or included in both Assets Required and Other Admitted Assets for foreign insurers operating in Canada on a branch basis. This requirement may be reduced to a minimum of zero through application of any credit available in respect of the unregistered reinsurer (q.v. section 10.3).

Example: Offsetting Policy Liabilities Ceded

A Canadian insurer cedes policy liabilities whose aggregate best estimate value is negative $700 to an unregistered reinsurer, where the ceded liabilities contain $800 in negative best estimate liabilities calculated policy-by-policy.

The requirement under section 10.2.1 for aggregate positive liabilities ceded is zero.

The requirement under section 10.2.2 for offsetting policy liabilities ceded is $100, which is calculated as:

1. $800 of ceded negative reserves calculated policy-by-policy, plus
2. negative $700 in aggregate Best Estimate Liabilities.

10.2.3. Differences between reinsurance contracts held and direct liabilities

For every unregistered reinsurer, an insurer should calculate the following amount:

1. all reinsurance contract held assets and other obligations of the unregistered reinsurer appearing in the Life return, excluding any contractual service margins included in these assets; less
2. all reinsurance contract held liabilities due to the unregistered reinsurer appearing in the Life return, excluding any contractual service margins included in these liabilities; less
3. the Best Estimate Liability and risk adjustment for all business ceded to the unregistered reinsurer.

If the above amount is positive, the insurer should include it within Deductions/Adjustments (q.v. section 2.1.2.10) or Assets Required (q.v. section 12.2.5), and may not reduce the amount through application of credit for unregistered reinsurance. If the above amount is negative, it may be taken as a credit under section 10.3.1.

Examples: Differences between reinsurance contracts held and direct liabilities

1. An insurer cedes business having a best estimate liability of $300 and a risk adjustment of $50 to an unregistered reinsurer. However, the insurer is reporting $365 in reinsurance contract held assets (net of

contractual service margin) due from the reinsurer on its Life return balance sheet because it has paid $15 in claims on the direct business that the reinsurer has not yet reimbursed. The insurer should therefore add $15 to its Deductions/Adjustments.

2. An insurer cedes business having a best estimate liability of negative $800 and a risk adjustment of $200 to an unregistered reinsurer. Instead of reporting a reinsurance contract held liability, the insurer does not report any liability owing to or asset due from the reinsurer because the compensation it is receiving for the negative cession is deferred. In this example, the insurer should add $600 to its Deductions/Adjustments.

10.2.4. Requirement for negative liabilities ceded with recourse

Where the total value of the aggregate Best Estimate Liability that an insurer has ceded to an unregistered reinsurer is negative, a Canadian insurer should deduct from Tier 1 and add to Tier 2, and a foreign insurer operating in Canada on a branch basis should include in both Assets Required and Other Admitted Assets, all amounts that:

1. may become payable in the future with respect to negative policy liabilities ceded to an unregistered reinsurer that have not been transferred permanently (e.g. ceded negative reserves for which the reinsurer, in the event of lapse or other contingency, has the right to demand payment from the insurer or to cancel liabilities owed to the insurer), and
2. are neither reported as liabilities nor captured as deductions in sections 10.2.2 and 10.2.3.

Examples: Negative Liabilities Ceded With Recourse

1. A Canadian insurer cedes business with an aggregate Best Estimate Liability of negative $100 and offsetting policy liabilities of $600 to an unregistered reinsurer. The reinsurer has the right to net any portion of the $600 in ceded negative liabilities that lapse against payments owed on the positive liabilities. If the insurer has not applied any credit for reinsurance to the requirement in section 10.2.2, then it is not required to deduct anything under this section, as the negative liabilities have already been deducted from Tier 1 and added to Tier 2 under section 10.2.2. However, if the insurer has applied any amount of credit to the

requirement in section 10.2.2, then it should deduct this amount from Tier 1 and add it to Tier 2. Stated differently, the insurer loses the ability to cover the section 10.2.2 requirement with collateral if the negative policy liabilities are ceded with recourse.

2. Continuing example 2) from section 10.2.3, suppose that the reinsurer has the right to withhold up to $600 of future payments that form part of the $0 net reinsurance asset if the negative policy liabilities ceded lapse. No deduction is required under this section, as the $600 has already been deducted under section 10.2.3.

10.2.5. Adjustment for the effect of income taxes

The adjustment for the effect of income taxes on business ceded to an unregistered reinsurer is defined to be:

$$OL + \min(D, \max(-AL - RA, 0)) \quad NR \quad \times T$$

where:

1. *OL* is the requirement in section 10.2.2 for offsetting policy liabilities ceded to the reinsurer, before the application of any credit available;
2. *D* is the total amount added to Deductions/Adjustments or Assets Required for the reinsurer under sections 10.2.3 and 10.2.4;
3. *AL* is the aggregate Best Estimate Liability ceded to the reinsurer;
4. *RA* is the risk adjustment for all business ceded to the reinsurer;
5. *NR* is the amount of negative Best Estimate Liabilities ceded to the reinsurer, calculated on a policy-by-policy basis without any reductions; and
6. *T* is the tax adjustment for negative reserves ceded to the reinsurer, equal to 30% of ceded best estimate policy-by-policy negative reserves arising from:
    a. active life reserves for individually underwritten Canadian health business, or
    b. individually underwritten Canadian life business.

A Canadian insurer may reclassify the above adjustment from Tier 2 to Tier 1, and a foreign insurer operating in Canada on a branch basis may deduct the adjustment from both Assets Required and Other Admitted Assets.

10.2.6. Adjustment for amounts recoverable on surrender

Subject to the limit below, a Canadian insurer may reclassify amounts recoverable on surrender for policy-by-policy negative reserves ceded to an unregistered reinsurer from Tier 2 to Tier 1. Subject to the same limit, a foreign insurer operating in Canada on a branch basis may deduct these amounts from both Assets Required and Other Admitted Assets. For any insurer, the maximum adjustment in total for amounts recoverable on surrender is limited to:

1. 90% of the amount of Eligible Deposits available in respect of the reinsurer, plus
2. any unused portion of the corresponding limit in section 2.1.2.9 that is allocated to the unregistered reinsurer.

The amounts recoverable on surrender for a policy are those specified in section 2.1.2.9 as calculated for the policy's ceded risks. The amount recoverable on surrender that may be recognized for any policy is limited to 70% of the policy's ceded Best Estimate negative reserve if it arises from business specified in items 6a) or 6b) in section 10.2.5, and 90% of the policy's ceded Best Estimate negative reserve if it arises from any other business.

10.2.7. Aggregate negative liabilities ceded

For aggregate negative liabilities ceded to an unregistered reinsurer without recourse (q.v. section 10.2.4), a Canadian insurer may include in Tier 2, and a foreign insurer operating in Canada on a branch basis may include in Other Admitted Assets, the value of the aggregate negative Best Estimate Liability ceded to the unregistered reinsurer up to a limit of:

1. the amount added to Deductions/Adjustments or Assets Required for the reinsurer under section 10.2.3, plus
2. the Eligible Deposit limit in section 6.8.1 for the reinsurer, minus
3. the amount of Eligible Deposits available in respect of the reinsurer.

10.3. Collateral and letters of credit

This section describes the conditions under which the deductions from Available Capital that are required under section 10.2 may be reduced, and replaces the rules that would otherwise apply under sections 3.2 and 3.3.

10.3.1. Credit available

An insurer is given credit, for each unregistered reinsurer, equal to the sum of:

1. any excess of direct liabilities over the corresponding reinsurance contracts held and other obligations of the reinsurer, as calculated under section 10.2.3.
2. the value of assets pledged by the unregistered reinsurer that are located in Canada and subject to the ceding insurer's claim under a valid and perfected first priority security interest under applicable law in accordance with OSFI's guidance for reinsurance security agreements. All pledged assets must:
    a. be held to secure the payment to the ceding insurer by the reinsurer of the reinsurer's share of any loss or liability for which the reinsurer is liable under the reinsurance agreement[3],
    b. be in the form of cash[4] or securities,
    c. be owned by the reinsurer, and
    d. be freely transferrable.

and

3. the amount of acceptable letters of credit[5] held to secure the payment to the ceding insurer by the reinsurer of the reinsurer's share of any loss or liability for which the reinsurer is liable under the reinsurance agreement.

In order for an insurer to obtain credit for a funds withheld reinsurance arrangement under 1) above, 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.

All collateral must be available for as long as the assuming insurer will have financial obligations under the reinsurance agreements for which the ceding insurer is taking credit. Where contract stipulations regarding the collateral may vary during the period, credit may only be taken if the ceding insurer maintains the exclusive option to retain the collateral and the additional cost of that option, if any, is fully recognized and explicitly accounted for at inception of the agreement.

Examples: Collateral for Unregistered Reinsurance

1. An insurer has entered into an unregistered coinsurance arrangement with a term of 30 years. However, the unregistered reinsurer is contractually obligated to provide collateral in Canada only for 5 years, and there is no mechanism in place to procure additional collateral after the 5-year term ends. As a result, the ceding insurer may not take credit for the collateral provided under this arrangement.
2. Suppose that the reinsurance arrangement is the same as in 1), with the exception that the ceding insurer has the option to retain the collateral after 5 years at an annual cost equal to the Canadian 1-year treasury bill rate plus 3%. Under this arrangement, the insurer may take credit for the collateral provided that the present value of total collateral costs from years 6 to 30 is taken into account as a reduction of the reinsurance contract held, is covered by an additional liability set up by the insurer, or is otherwise excluded from reported Tier 1 capital.

All letters of credit used to obtain credit in respect of an unregistered reinsurer must be issued by or have a separate confirming letter from a Canadian bank that is listed on Schedule I or Schedule II of the *Bank Act*. In aggregate, the amount of credit taken for letters of credit is limited to 30% of the gross requirement for aggregate positive liabilities ceded to unregistered reinsurers (q.v. section 10.2.1), plus 30% of the gross requirement for offsetting liabilities ceded to unregistered reinsurers (q.v. section 10.2.2).

The assets used to obtain credit for a specific unregistered reinsurer may not be obligations of the unregistered reinsurer itself or any of its affiliates. With respect to the above three sources available to obtain credit, this implies that:

1. To the extent that a ceding insurer is reporting obligations of one or more affiliates of an unregistered reinsurer as assets in its Life return, the ceding insurer is precluded from taking credit for the excess of direct liabilities over obligations of the reinsurer[6];
2. Assets located in Canada in which a ceding insurer has a valid and perfected first priority security interest under applicable law may not be used to obtain credit if they are obligations of the unregistered reinsurer or one of its affiliates; and
3. A letter of credit is not acceptable if it has been issued by the unregistered reinsurer or one of its affiliates.

Guideline B-2: *Large Exposure Limits* applies to assets used to obtain credit in respect of unregistered reinsurance. As a consequence, an insurer may not take credit for assets in which it has perfected a security interest or letters of credit, held under an unregistered reinsurance transaction or a series of such transactions (not necessarily all with the same reinsurer), if consolidating these assets[7] on the insurer's balance sheet, along with the ceded liabilities they support, would cause a large exposure limit to be breached[8]. An insurer should comply with all other OSFI guidelines and advisories concerning investments (e.g., Guideline B-1: *Prudent Person Approach*, Guideline B-5: *Asset Securitization*) in respect of the aggregate of the assets it has used to obtain credit for unregistered reinsurance with the assets it holds in its own portfolio.

10.3.2. Application to requirements for ceded liabilities

The credit available in respect of an unregistered reinsurer is first applied to the requirement for aggregate positive liabilities ceded to the reinsurer (q.v. section 10.2.1) until it is reduced to zero. At the choice of the ceding insurer, any remaining credit available may be allocated to either:

1. The requirement for offsetting policy liabilities ceded to the reinsurer (q.v. section 10.2.2) until it is reduced to zero, or
2. Eligible Deposits in respect of business ceded to the reinsurer, subject to the conditions in section 10.4 and the limit in section 6.8.1.

Example: Adjustments and Credit for Liabilities Ceded

A Canadian insurer cedes policy liabilities having an aggregate best estimate value of $400 and a risk adjustment of $200 to an unregistered reinsurer. The reinsurance contract held asset net of contractual service margin is equal to $600. The ceded business contains a total of $1000 of negative policy-by-policy best estimate liabilities, all of which are ceded without recourse, and $900 of which are eligible for a 30% tax adjustment. The negative policy-by-policy liabilities have a total of $300 in offsets available for amounts recoverable on surrender. The limit in section 2.1.2.9 on amounts recoverable on surrender that can be recognized, before taking into account the cession to the unregistered reinsurer, is $1000, and the insurer has $850 of amounts recoverable on its retained business. The total credit available for the reinsurer from section 10.3.1 is $1400, and the section 6.8.1 Eligible Deposit limit for the ceded business is $1200.

The requirement under section 10.2.1 for aggregate positive liabilities ceded is equal to $400, which is the aggregate best estimate liability ceded. This requirement is covered with $400 of the credit available, leaving $1000 to allocate to offsetting policy liabilities and Eligible Deposits.

The requirement under section 10.2.2 for offsetting policy liabilities ceded is $1000, calculated as:

1. $1000 negative reserves ceded calculated policy-by-policy, plus
2. $0, as the aggregate best estimate cession is positive.

and may be reduced to a minimum of zero, depending on how the insurer allocates its remaining credit available.

Under section 10.2.3, there is no deduction or credit, as the reinsurance contract held asset is equal to the best estimate liability plus risk adjustment ceded.

Under section 10.2.5, the amount reclassified from Tier 2 to Tier 1 is $270: the amount T is $270, equal to 30% of the $900 of negative reserves calculated policy-by-policy that are eligible for the tax adjustment, while max $(-AL - RA, 0)$ is zero and both OL and NR are equal to $1,000.

The amount reclassified from Tier 2 to Tier 1 under section 10.2.6, as well as the negative reserve deduction offset in section 2.1.2.9, both depend on how the insurer allocates the remaining $1000 credit between offsetting policy liabilities and Eligible Deposits. If the insurer allocates all of the $1000 to offsetting policy liabilities then:

- There will be no deduction from Tier 1 on account of the ceded offsetting policy liabilities.
- The insurer will be able to use all of the $850 of amounts recoverable on surrender as an offset to the negative reserve deduction for its retained business in section 2.1.2.9.
- Since the insurer will have no Eligible Deposits from the reinsurer, the limit on amounts recoverable that it can recognize for its ceded business in section 10.2.6 will be $150, which is the left-over portion of the limit for retained business, and is lower than the $300 of amounts recoverable available.

The total impact of allocating the credit this way will be to increase the numerator of the insurer's Core Ratio by $1000, without affecting the numerator of the Total Ratio. On the other hand, if the insurer allocates all of the $1000 to Eligible Deposits then:

- The Eligible Deposit will increase the numerator of the Core Ratio by $700, and the numerator of the Total Ratio by $1000.
- There will be a $1000 deduction from Tier 1 on account of the ceded offsetting policy liabilities.
- None of the $850 of amounts recoverable on surrender will be available as an offset to the negative reserve deduction for the insurer's retained business in section 2.1.2.9, as the offsetting policy deduction will have reduced the limit on amounts recoverable to zero.
- The insurer will be able to use all of the $300 of amounts recoverable on surrender for its ceded business in section 10.2.6, as it is below the limit of $900 (equal to 90% of the amount of Eligible Deposits available for the reinsurer).

The total impact of allocating the credit this way will be to increase the numerator of the Total Ratio by $1000, without affecting the numerator of the Core Ratio. The insurer is able to decide whether to use the $1000 credit as an effective Tier 2-to-Tier 1 reclassification (using the first allocation), as an effective component of Tier 2 (using the second allocation), or to achieve an intermediate result.

10.3.3. Credit and market risk requirements

Consistent with the substitution capital treatment used for collateral and guarantees, insurers should include, in required capital or required margin, the capital requirements for credit risk (as determined under Chapter 3) and market risk (as determined under sections 5.2, 5.3, and 5.4) for all assets subject to the insurer's claim under a perfected security interest, and for all letters of credit, that are used to obtain credit for ceded liability capital requirements relating to unregistered reinsurance or that are included in Eligible Deposits. A separate calculation is also required for currency risk as described in section 5.6.8. Available assets and letters of credit that are not used to obtain credit for ceded liability requirements and are not included in Eligible Deposits are excluded from all capital requirement calculations. A ceding insurer may designate which assets and letters of credit (or portions thereof) among those available that it will apply towards ceded requirements or include in Eligible Deposits.

10.4. Calculation of required capital/margin or Eligible Deposits

10.4.1. Necessary conditions for credit

In order for a ceding insurer to obtain a reduction in its Base Solvency Buffer or Required Margin on account of a registered reinsurance arrangement, or to recognize an Eligible Deposit on account of an unregistered reinsurance arrangement, the arrangement must conform to all of the principles contained in Guideline B-3: *Sound Reinsurance Practices and Procedures*. The arrangement must also meet all of the conditions necessary for effective risk transfer specified in this section. The ceding insurer should be able to demonstrate that the change in risk it is exposed to as a result of the arrangement is commensurate with the amount by which it reduces its Base Solvency Buffer or Required Margin, or with the amount of Eligible Deposits that it recognizes[9].

Risk transfer must be effective in all circumstances under which the ceding insurer relies on the transfer to cover the capital/margin requirement. In assessing an arrangement, the ceding insurer should take into account any contract terms whose fulfilment is outside the ceding insurer's direct control, and that would reduce the effectiveness of risk transfer. Such terms include, among others, those which:

1. would allow the reinsurer to unilaterally cancel the arrangement (other than for non-payment of reinsurance premiums due under the contract);
2. would increase the effective cost of the transaction to the ceding insurer in response to an increased likelihood of the reinsurer experiencing losses under the arrangement;
3. would obligate the ceding insurer to alter the risks transferred for the purpose of reducing the likelihood that the reinsurer will experience losses under the arrangement;
4. would allow for the termination of the arrangement due to an increased likelihood of the reinsurer experiencing losses under the arrangement;
5. could prevent the reinsurer from being obligated to pay out any amounts due under the arrangement in a timely manner; or
6. could allow for early maturity of the arrangement.

The ceding insurer should also take into account circumstances under which the benefit of the risk transfer could be undermined. For example, this may occur if the ceding insurer provides support (including non-contractual support) to the arrangement with the intention of reducing potential or actual losses to the reinsurer.

In determining whether there is effective risk transfer, the reinsurance arrangement must be considered as a whole. Where the arrangement consists of several contracts, the entire set of contracts, including contracts between third parties, must be considered. The ceding insurer should also consider the entire legal relationship between itself and the reinsurer.

No reduction of the Base Solvency Buffer or Required Margin, or recognition of Eligible Deposits, is allowed for a reinsurance arrangement that has material basis risk with respect to the reinsured business (for example if payments under the arrangement are made according to an external indicator instead of actual losses). Reinsurance contracts held arising from arrangements that are subject to basis risk may be subject to capital charges for insurance risk in addition to the capital charge for credit risk.

In assessing the effectiveness of risk transfer, the economic substance of an arrangement must be considered over the legal form or its treatment for financial statement purposes.

10.4.2. Retained loss positions

If a coinsurance arrangement does not cover all losses up to the level of the ceded insurance contract Best Estimate Liability plus the marginal insurance risk requirement for the ceded business (the Requisite Level), then it is necessary for the ceding insurer to increase its required capital or margin, or reduce the limit on Eligible Deposits recognized. In particular, any coinsurance arrangement containing a provision under which the reinsurer is required to cover losses only in excess of a certain amount will require an adjustment, regardless of the treatment for financial statement purposes. Such provisions include, but are not limited to:

a. experience rating refunds,
b. claims fluctuation reserves and reinsurance claims fluctuation reserves, and
c. variable risk transfer mechanisms other than a) or b) above whereby the level at which losses are reinsured depends upon prior experience.

If a registered coinsurance arrangement does not cover all losses up to the Requisite Level then the ceding insurer should add to its required capital or margin the total amount of losses at or below this level for which it remains at risk. If an unregistered coinsurance arrangement does not cover all losses up to the Requisite Level then the quantity SB0 – SB1 used in determining the limit on Eligible Deposits for the coinsurance arrangement (q.v. section 6.8.1) is reduced by the total amount of losses at or below the Requisite Level for which the ceding insurer remains at risk.

Reinsurance arrangements, other than coinsurance, that provide tranched protection or under which the ceding insurer otherwise retains a loss position, are treated as stop loss reinsurance and are subject to the conditions in section 6.8.5.

The amount of the loss position that a ceding insurer retains under a reinsurance arrangement should be recalculated, according to the treaty, at each reporting date.

10.4.3. Registered reinsurance

All capital requirements for which it is possible to obtain credit for reinsurance may be calculated net of registered reinsurance. For example, policy liabilities ceded under registered reinsurance arrangements are excluded from the policy liability cash flows used to calculate all LICAT insurance risk components.

The 2.5% credit risk requirement for registered reinsurance contracts held may be reduced in accordance with this section using the substitution approach described in section 10.3.3 if the asset is secured by collateral meeting the conditions in the introduction to section 3.2 and in section 3.2.1[10], or a guarantee (including a letter of credit) meeting the conditions in section 3.3.

If an insurer cedes business under a funds withheld coinsurance or modified coinsurance arrangement that constitutes registered reinsurance, it is possible that the asset risks covered in Chapter 3 and sections 5.2 to 5.4 are transferred to the reinsurer. Such a transfer may occur if, for example, the contractual rate of accrual of the funds withheld liability or modified coinsurance adjustment is not fixed, and instead depends on the returns of a pool of assets held by the ceding insurer.

If a registered reinsurance arrangement transfers asset risks associated with on-balance sheet assets to the reinsurer, the arrangement must meet all of the requirements of section 3.3 in order for the ceding insurer to take credit (e.g., the reinsurance must provide protection at least as strong as a guarantee, and the reinsurer cannot be an affiliate of the ceding insurer). If an insurer is eligible to take credit for the transferred asset risks, the capital treatment follows the substitution approach. The credit risk factor substituted is the factor corresponding to the reinsurer's claims-paying ability rating (rather than 2.5%), with maturity the longer of:

1. the maturity of the underlying asset, or
2. the frequency with which the reinsurer settles losses arising from the assets whose risks it has assumed.

For assets covered under the risk transfer that are subject to market risk factors, the factor substituted should be the reinsurer's credit risk factor corresponding to a 10-year maturity. If the term of a reinsurance arrangement is shorter than the maturity of a covered fixed-income asset, then the maturity mismatch adjustment in section 3.3.7 should be applied.

Examples: Credit and market risk requirements for business ceded under funds withheld / modified coinsurance

1. Under a registered funds withheld reinsurance arrangement with an unaffiliated reinsurer that has an AA claims-paying ability rating, the amount that is contractually accrued on the funds withheld liability is equal to the return on the following portfolio of on-balance sheet assets, none of which are obligations of the reinsurer or its affiliates:

Asset	Value	Factor
AA-rated bond, 2 year maturity	$20	0.50%
A-rated bond, 3 year maturity	$20	1.50%
BBB-rated bond, 2 year maturity	$20	2.75%
BBB-rated bond, 5 year maturity	$20	4.00%
Common stock	$20	35%

The reinsurance arrangement only provides for payment of the accumulated reinsurance contract held asset, if any, to the ceding insurer at the end of the treaty in 20 years. If the reinsurance meets all of the requirements of section 3.3 (including that the reinsurer is an eligible guarantor per section 3.3.4), the factor substituted for all of the above assets is the lower of the original asset factor, or the factor for a 20-year obligation of an AA-rated counterparty, which is 1.75%. The asset risk requirement for the above assets is therefore lowered from $8.75 to $1.45, based on the following substituted asset factors:

Asset	Value	Substituted Factor
AA-rated bond, 2 year maturity	$20	0.50%
A-rated bond, 3 year maturity	$20	1.50%
BBB-rated bond, 2 year maturity	$20	1.75%
BBB-rated bond, 5 year maturity	$20	1.75%
Common stock	$20	1.75%

2. If, in the previous example, the reinsurance arrangement is instead a modified coinsurance arrangement under which the return on the asset portfolio is included in the modified coinsurance adjustment, and a net payment is made at the end of each quarter so that the reinsurance contract held asset is maintained at zero, then the credit and market risk requirements for the asset portfolio go down to $0.95, based on the following substituted asset factors:

Asset	Value	Substituted Factor
AA-rated bond, 2 year maturity	$20	0.50%
A-rated bond, 3 year maturity	$20	0.75%
BBB-rated bond, 2 year maturity	$20	0.50%
BBB-rated bond, 5 year maturity	$20	1.25%
Common stock	$20	1.75%

10.4.4. Unregistered reinsurance

Collateral and letters of credit that are used to obtain credit for unregistered reinsurance or for insurance risk capital requirements give rise to additional capital requirements for credit and market risks (section 10.3.3).

If an unregistered reinsurance arrangement transfers on-balance sheet asset risks to the reinsurer, the ceding insurer does not receive any credit for these requirements, as the credit risk factor assigned to the unregistered reinsurer is effectively 100% and does not lead to a credit under the substitution approach.

1 For the sole purpose of determining whether reinsurance is deemed to constitute registered or unregistered reinsurance under this section, all Canadian insurers (i.e., companies, societies, and foreign companies operating in Canada on a branch basis) should refer to the considerations set out in OSFI's Advisory No. 2007-01-R1 titled *Insurance in Canada of Risks* to determine whether it, as the ceding insurer, has assumed in Canada the risks related to the underlying policies, or whether it assumed those risks from outside Canada.

2 The term "recognized", as applied to a reinsurance arrangement by a foreign solvency regulator, means that the ceding company is able to report an improved capital adequacy position to the solvency regulator as a result of the reinsurance arrangement.

3 A foreign insurer ceding risks related to its Canadian business will be given credit for assets located in Canada only where the reinsurance arrangement provides that the reinsurer does not have any right of set-off against the obligations of the foreign insurer other than obligations related to the foreign insurer's insurance business in Canada. In particular, the reinsurer must not be able to set off amounts due to the foreign insurer against any liabilities of the home office or affiliates of the foreign insurer that are not liabilities arising out of the Canadian operations of the foreign insurer.

4 Cash must be in a form in which it is possible to perfect a security interest under applicable law.

5 Insurers should contact OSFI's Securities Administration and Approvals Reporting Unit (SAAR) to obtain OSFI's standards for letters of credit. The SAAR's contact information is:

- Via mail: 255 Albert Street, Ottawa, ON, K1A 0H2; or
- Via email: SAAR-SSAVMRCA@osfi-bsif.gc.ca.
- Via fax : (613) 990-5591

General guidance on requirements for approval of letters of credit can be found in the OSFI document General Guidelines for Use of Letters of Credit (LOC's).

6 If there is more than one affiliated unregistered reinsurer and an insurer reports, in its Life return, assets that are obligations of affiliates of the unregistered reinsurers, then the total credit for the excess of direct liabilities over obligations of the affiliated unregistered reinsurers must be reduced in aggregate, to a minimum of zero, by the reported amount of such assets. If the reduction required is less than the total credit calculated for the affiliated reinsurers, the reduction may be allocated to the reinsurers in any manner such that the credit for each reinsurer is not reduced below zero.

7 The expression “consolidating these assets” means, for letters of credit, recording the full amount of the letters of credit as obligations due from the issuing banks.

8 This consolidation test must be performed in respect of unregistered reinsurance notwithstanding that Guideline B-2 does not establish quantitative limits for exposures to reinsurers. Assets and letters of credit having a residual maturity of less than one year may not be excluded from the definition of exposure. For the purpose of the consolidation test, the additional amount of total capital that a ceding insurer may assume would be available is limited to the amount of Eligible Deposits recognized in the LICAT total ratio.

9 Without limiting the requirement that ceding insurers should abide by the risk transfer principle with respect to all reinsurance transactions, OSFI may, if it is unclear how much risk the ceding insurer bears post-reinsurance and OSFI determines it is desirable to provide greater certainty, issue further guidance (including quantitative requirements) to implement this principle with respect to any reinsurance arrangement. Insurers are encouraged to contact OSFI to discuss reinsurance arrangements for which the measure of risk transfer may be unclear when applying this principle or for which implementation guidance may be required.

10 The conditions for eligible financial collateral from section 3.2.1 that should be used for registered reinsurance are those for capital markets transactions rather than secured lending. If collateral is denominated in a currency different from that of the reinsurance contract, its market value must be reduced by 30%.