Letter

Title	Final Guideline B-2 and Guideline B-3
Category	Prudential Limits and Restrictions
Date	February 11, 2022
Sector	Banks Property and Casualty Companies

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Today, OSFI is issuing its final Guideline B 3, *Sound Reinsurance Practices and Procedures*, and its final Guideline B 2, *Property and Casualty Large Insurance Exposures and Investment Concentration*. This brings to a conclusion Phase II of OSFI's review of reinsurance practices, launched in 2018 through the Reinsurance Framework Discussion Paper.

These revised guidelines come into effect on January 1, 2025. The near three-year transition period permits federally regulated insurers (FRIs) time to effectively adjust their business practices accordingly. FRIs' existing insurance business should remain compliant with the current in-force Guideline B 3 and Guideline B 2 until January 1, 2025.

OSFI will hold industry information sessions in the coming months to provide additional clarity regarding OSFI's expectations and supervisory approach.

Changes to Guideline B 3

Final Guideline B 3 reflects comments received by the insurance industry in response to Draft Guideline B 3, issued in June 2019. Key industry input, as well as OSFI's responses, are summarized in **Annex A**.

This revised guideline expects FRIs to better identify and manage risks arising from the use of reinsurance, particularly counterparty risk. It clarifies OSFI's expectation that reinsurance payments flow directly to a cedant FRI in Canada, and reaffirms OSFI's expectation that a FRI should not cede substantially all of its risks. These changes are primarily clarifications, but may highlight the need for some FRIs to adjust aspects of their reinsurance programs.

Changes to Guideline B 2

Final Guideline B 2 reflects comments received by the property and casualty (P&C) insurance industry in response to Draft Guideline B 2, issued in November 2020. Key industry input, as well as OSFI's responses, are summarized in **Annex B**.

This revised guideline requires a P&C FRI to be able to cover the maximum loss related to a single insurance exposure on any policy it issues, assuming the default of its largest unregistered reinsurer on that exposure. This rule is expressed as a percentage of total capital available (or net assets available for foreign branches). It is prudent and reasonable to expect a P&C FRI to be in a position to fully cover its potential losses with funds available in Canada or from a diversified panel of reinsurers. The investment limits contained in Guideline B 2 remain unchanged.

Annex A – Summary of Key Comments on Draft Guideline B 3 and OSFI Responses

In developing final Guideline B 3, OSFI considered the range of feedback received from stakeholders on the draft revised Guideline B 3, published in June of 2019. Below is a brief summary of the key issues raised and how OSFI responded to each.

Respondent Feedback	OSFI Response
Reinsurance with Home Office	
Many respondents stressed the global nature of reinsurance and the benefits of international diversification in large insurance groups. Some respondents noted that there could be capacity reductions or higher reinsurance premiums as a potential consequence of foreign FRIs not being able to ultimately cede business to the home office through an affiliate.	• OSFI recognizes the benefits of international reinsurance for foreign FRIs operating in Canada. The objective of the Guideline is to protect Canadian policyholders by ensuring the appropriate reinsurance risk transfer, sufficient vested assets in Canada and the collectability of payments. • OSFI also recognizes that there may be unique or exceptional circumstances that could be evaluated on a case-by-case basis.
Ceding "Substantially All" and Fronting	
Some respondents noted that there may be valid business reasons for a FRI to cede large percentages of its business to a reinsurer. Others noted the lack of clarity around OSFI's interpretation of the term "substantially all".	• OSFI acknowledges that FRIs will sometimes enter into fronting arrangements, or will cede "substantially all" of certain lines of business for valid business reasons. • The Guideline does not restrict FRIs from engaging in such arrangements, but rather seeks to address those situations that raise potential prudential concerns. • OSFI generally applies the concept of "substantially all" in a manner consistent with that used in the context of assumption reinsurance and asset sale transactions. OSFI will, however, continue to supervise such business arrangements on a case-by-case basis.
Reinsurance Counterparties	
Some respondents expressed the view that reinsurance arrangements with affiliated counterparties present more operational prudence, minimizing the risk of group insolvency.	• OSFI recognizes that there are operational efficiencies to using affiliated reinsurance. However, in the context of a group-wide stress scenario, OSFI is of the view that the risk of an affiliated reinsurer not honouring its obligations is as great as that of a non-affiliated reinsurer.

Respondent Feedback	OSFI Response
Some respondents argued that the current practice of relying on third parties, such as reinsurance brokers and rating agencies, including ongoing discussions between the parties to the reinsurance contract, is sufficient to assess the reinsurance counterparty risk. Conducting further due diligence on the counterparty would be burdensome for both the cedant and the reinsurer.	• The ceding FRI retains the liability in the event a reinsurer is unable to meets its obligations. In order to protect policyholders, therefore, OSFI expects the ceding FRI to be responsible for, and to monitor, its ceded business. • For example, if an FRI is ceding a significant portion of its business to a reinsurer who, in turn, retrocedes 100 percent of this business to a single entity, OSFI expects the FRI to actively monitor the solvency position of the retrocessionaire.
Flow of Reinsurance Payments	
Some respondents argued that the requirement for reinsurance payments to flow directly to a cedant in Canada goes against the global nature of reinsurance, whose purpose is to centralize purchases of reinsurance for a group. Other respondents also argued that such a requirement would increase the administrative burden on FRIs, and would be duplicative of other measures designed to protect Canadian policyholders.	• OSFI recognizes the global nature of reinsurance contracts. However, insolvency regimes are unique to each jurisdiction, which determines the collectability of reinsurance in a distress scenario. • The requirement for reinsurance to be collectible in Canada is an alternative to additional capital or collateral being held in Canada. • Most jurisdictions have similar requirements designed to protect the interests of their policyholders in the event of an insolvency of the FRI.

Annex B - Summary of Key Comments on Draft Guideline B 2 and OSFI Responses

In developing final Guideline B 2, OSFI considered the range of feedback received from stakeholders on the draft revised Guideline B 2, published in November 2020. Below is a brief summary of the key issues raised and how OSFI responded to each.

Respondent Feedback	OSFI Response
Definition of a “Single Insurance Exposure”	
Many respondents requested clarification on the definition of a “Single Insurance Exposure”. Some respondents argued for a shift away from certain prescriptive requirements to allow for greater flexibility for P&C FRIs to make this determination.	• Every insurance contract is unique, both in its underlying insurance risks and its coverage. As such, OSFI will leave the determination of what constitutes a “Single Insurance Exposure” to P&C FRIs themselves, as they have the requisite knowledge and expertise. • Much of the prescription that existed in the draft guideline, by classes of insurance, has been deleted in the final guideline. • However, OSFI may, at its discretion, advise a P&C FRI to use specific criteria or an approach to determine a “Single Insurance Exposure”.
Large Exposure Limits	
Many respondents noted that varying limits on the maximum loss on a Single Insurance Exposure, depending on the type of P&C FRI, could result in an uneven playing field.	• OSFI is comfortable with the limits in this Guideline. They are consistent with similar limits on large exposures for life insurance companies and banks. • P&C FRIs that have access to additional funding (e.g., from a regulated foreign parent company), if ever needed, have a higher limit on their exposures (100 percent of total capital available/net assets available).
Definition of a “P&C FRI Subsidiary in Canada”	
Some respondents indicated that the term “P&C FRI Subsidiary in Canada” is not clearly defined, and there could be several interpretations. For example, there are various types of relationships that a P&C FRI can have with a parent company. These can include a parent company that is another Canadian FRI, a foreign insurer, a Canadian holding company, and a foreign holding company.	• For clarity and simplicity, the term “P&C FRI Subsidiary in Canada” has been deleted and replaced with the general term “Insurance Companies”, defined in paragragh 8 of the Guideline. This is now clearly differentiated from “Foreign Branches”.
Criteria for Foreign Companies	

Respondent Feedback	OSFI Response
Some respondents raised questions as to how OSFI would evaluate whether a parent company or home office of a P&C FRI is subject to “robust regulation and supervision”, is not subject to “legal, regulatory, statutory and fiscal restrictions” and “is a continuing source of financial strength” (see Annex 2 of the draft Guideline B 2).	• Upon further evaluation, OSFI has removed the requirement to meet this criteria from the Guideline. Annex 2 has also been removed. • OSFI conducts a thorough assessment of a P&C FRI’s operations and its regulatory oversight upon entry into the Canadian market. It is then subject to OSFI supervision on an on-going basis.
Use of Letters of Credit	
Some respondents argued that the use of letters of credit as a risk mitigation technique should not be restricted. Letters of credit are deemed to be legally enforceable instruments.	• There are specific considerations related to the use of letters of credit that are different than for other types of collateral accepted for MCT purposes. In particular, a letter of credit requires additional actions be undertaken to convert it to liquid assets available to pay claims, which may take time. Concentration risk could also become an issue in the absence of a limit. • OSFI revised the Guideline so that the limit on letters of credit is measured against the value of the insurance exposure and not restricted by unearned premium reserves and outstanding balances under Guideline A, *Minimum Capital Test.*