Guideline

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

This guideline sets out OSFI's expectations for effective reinsurance practices and procedures. It applies to **all** federally regulated insurers [1] (FRIs) that are party to reinsurance cessions, retrocessions and, where applicable, to assumption reinsurance transactions [2] .

Please refer to OSFI's *Corporate Governance Guideline* for OSFI's expectations with respect to ensuring effective oversight and risk management policies and procedures in relation with the business of reinsurance.

I. Key Principles

FRIs should adhere to the following reinsurance principles when developing risk management frameworks for managing their reinsurance risks. OSFI will assess a FRI's reinsurance risk management framework against these principles.

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

Key Elements of the Reinsurance Risk Management Policy (RRMP)

OSFI expects that a FRI's RRMP will form an integral component of its overall enterprise-wide risk management framework. The RRMP should reflect the scale, nature and complexity of a FRI's business, and consider its risk appetite. OSFI expects the RRMP to document the significant elements of the FRI's approach to managing risks through reinsurance, and arising from the use of reinsurance, including:

- The purpose and objectives for seeking reinsurance;
- Ceding limits;
- Counterparty risk; and
- Concentration limits.

Managing risks through reinsurance

Reinsurance can be a key tool for mitigating and managing insurance risks. When a FRI uses reinsurance to reduce its insurance risks, OSFI's capital guidelines recognize this benefit of reinsurance if certain conditions are met.

Under the *Life Insurance Capital Adequacy Test* (LICAT) and the *Minimum Capital Test* (MCT), a FRI may reduce its required capital for insurance risk ceded. [3]

A FRI may use reinsurance to mitigate its exposures to large and catastrophic losses. In this case, a FRI must regularly assess the adequacy and effectiveness of its reinsurance arrangements. This may involve conducting appropriate stress testing to determine if the reinsurance arrangements adequately mitigate losses to acceptable levels, in accordance with the FRI's risk appetite.

Reinsurance may be used for purposes not directly linked to the mitigation of a FRI's insurance risks. Under such circumstances, OSFI will evaluate the reinsurance arrangements, including the appropriateness of capital credit for such arrangements, based on the risk impact to the FRI. In particular, OSFI will generally not recognize or grant credit for a foreign FRI's reinsurance arrangement(s) when risks insured in Canada are ceded back to the foreign FRI's home office through affiliated reinsurers.

Managing risks arising from the use of reinsurance

The RRMP should identify risks to a FRI arising from its use of reinsurance and its approach to managing these risks.

The RRMP should establish appropriate ceding limits. A FRI's ceding limits should be set for its overall book of business, and may also be established by line of business, as appropriate.

While reinsurance is an important risk management tool, a FRI should not, in the normal course of its business, cede 100 per cent, or substantially all, [4] of its insurance risks. [5] When setting ceding limits, a FRI should consider counterparty risks, as described below.

A FRI should monitor and manage the multiple factors that affect counterparty risk. When assessing counterparty risk, a FRI should consider all elements of risk associated with counterparties, including the implications of the legal and insolvency framework of a counterparty's home jurisdiction, and the terms and conditions of reinsurance contracts. Counterparty risk should be considered at an aggregate level (e.g., group of affiliated counterparties) for stress testing. OSFI expects a FRI to assess counterparty risk from the perspectives of both going-concern and gone-concern scenarios of its reinsurers. A FRI's process for assessing counterparty risk should be consistent across all counterparties (i.e., affiliates and non-affiliates).

A FRI should also consider its total exposure to a counterparty as part of its assessment of counterparty risks. The RRMP should establish appropriate counterparty concentration limits both to individual counterparties and also to groups of affiliated counterparties. The limits should reflect the counterparty risks described above, as well as the risks to be ceded.

Where a FRI's reinsurance program exposes it to liquidity risk, the RRMP should set out processes for measuring, monitoring and adequately controlling this risk.

Other information to be included in the RRMP

The RRMP should detail:

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

OSFI expects the level of controls and oversight to be commensurate with the significance of the insurance risk to which the reinsurance program is applied.

Senior Management Oversight of the RRMP

OSFI expects senior management to oversee the development, implementation and operationalization of the RRMP.

Senior management is also responsible for ensuring that appropriate policies, procedures, and internal controls exist to monitor the effectiveness of, and compliance with, the RRMP on an ongoing basis. At a minimum, senior management should review the RRMP annually.

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

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

A FRI should evaluate the ability of all current and prospective reinsurance counterparties to meet their liabilities under severe but plausible adverse events on an ongoing basis. The level of a FRI's due diligence on any reinsurance counterparty should be commensurate with its level of exposure to that counterparty. The level of due diligence should not be any less thorough if the counterparty is an affiliate of the FRI.

A FRI's evaluation of its current and prospective reinsurance counterparties should not rely solely on third parties, including rating agency assessments or broker analysis and recommendations. [6] Prudent practice dictates that the FRI should, to an extent proportional to the importance of such counterparty, conduct its own due diligence on the financial strength and capabilities of reinsurance counterparties.

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

- claims payment record;
- expected future claims obligations;
- balance sheet strength;
- funding sources, including its level of and access to capital, and form, amount and sources of liquidity;
- management, including the quality of its governance practices and procedures; and
- retrocession arrangements and the direct or indirect impact they may have on the FRI's own arrangements with the reinsurer. [7]

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

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

OSFI expects a higher level of due diligence by a FRI in respect of any current or prospective reinsurance arrangement with an unregistered reinsurer [8] or with a cedant that is not regulated by OSFI. When assessing counterparty risk, a FRI should consider the home jurisdiction of the unregistered reinsurer. This would include the robustness of the regulatory and supervisory regime, as well as the legal and insolvency frameworks.

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

A FRI should have processes and procedures in place to ensure that a comprehensive, written, and binding [9] reinsurance contract is executed prior to the effective date of reinsurance coverage. To achieve clarity and certainty on reinsurance coverage, a reinsurance contract should be unambiguous, and there should be complete and final agreement of all material terms and conditions of the contract, documented in writing, by all parties prior to the contract's effective date.

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

1. obtain contractually binding summary documents prior to the effective date of the reinsurance coverage, including, but not limited to electronic copies, or original hard copies, of signed documents that set out:
    - the premium / consideration paid by the cedant;
    - the percentage of risk assumed by each reinsurer;
    - the risk(s) reinsured;
    - the duration of the coverage;

- exclusions to terms of coverage, where applicable; and
- standard clauses that are to be relied upon or incorporated by reference into the reinsurance contract;

2. address, within the summary document, material issues most likely to arise, including all variable or unique agreement terms; and
3. ensure that all final comprehensive reinsurance contracts, including amendments thereto, bear the duly authorized signature of both the ceding company and the reinsurer(s) [10] within a relatively short timeframe having regard for the nature, complexity and materiality of the agreement (e.g., within 120 days of execution).

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

4. The terms and conditions of a reinsurance contract should not adversely affect the ceding FRI.

The terms and conditions of a binding reinsurance agreement should provide that funds will be available to cover policyholder [11] claims in the event of either the cedant's or reinsurer's insolvency. To this end, reinsurance contracts should include an insolvency clause. A FRI should pay particular attention to the appropriate use [12] of off-set or cut-through clauses, the structure of funds withheld arrangements [13], and other such types of terms or conditions that may frustrate the scheme of priorities under the *Winding-Up and Restructuring Act* (WURA).

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

OSFI expects reinsurance contracts with third-party reinsurers (i.e., entities that are not in the same corporate group as the FRI-cedant) to contain an insolvency clause stipulating that, in the event of the insolvency of the FRI-cedant, all reinsurance receivables are to be paid directly to a FRI-cedant in Canada, or to a person acting for, or on behalf of, the FRI-cedant in Canada.

OSFI expects reinsurance contracts with affiliated reinsurers (i.e., entities within the same corporate group as the FRI-cedant) to contain a clause stipulating that all reinsurance receivables are to be paid directly to a FRI-cedant in Canada, or to a person acting for, or on behalf of, the FRI-cedant in Canada.

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

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

OSFI expects reinsurance contracts, and any disputes arising from such contracts, to be subject to the laws and courts of Canada or another equivalent legal jurisdiction. Accordingly, all contracts related to reinsurance coverage should stipulate a choice of forum, a choice of law, and the appointment of agents for service of legal processes in a manner consistent with this expectation.

II. Guideline Administration

A FRI should maintain (and provide to OSFI, upon request):

- its RRMP;
- a complete description of all its reinsurance arrangements;
- the due diligence performed on reinsurance counterparties; and
- the stress testing performed on the reinsurance program.

FRIs should regularly report to senior management to confirm that the FRI's reinsurance risk management practices and procedures meet, except as otherwise disclosed, the principles set out in this guideline. The reporting should include assurances that the FRI's reinsurance arrangements effect a risk transfer and that they have been accounted for in an appropriate manner.

A FRI should promptly inform OSFI if it becomes aware of any reinsurance issues that could materially impact its financial condition. A FRI should also document and disclose any deviations from the principles set out in this guideline to senior management and to OSFI. The disclosure should address the nature and extent of the deviation, and the measures taken or proposed to correct or mitigate any associated risks.

A reinsurance program or reinsurance contract that does not adhere to the principles and expectations set out in this guideline may not provide the intended protection to the ceding company and could compromise the availability of balances that may have been otherwise recoverable. OSFI may not grant a capital credit for the reinsurance arrangement, or may adjust the FRI's capital requirements or target solvency ratios in such circumstances.

Federally approved provincial and territorial reinsurers may lose their approved status if they fail to meet the principles set out in this guideline.

III. Other OSFI Guidance

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

- *Guidance for Reinsurance Security Agreements*, which sets out OSFI's minimum standards for reinsurance security agreements;
- Guideline B-10 - *Outsourcing of Business Activities, Functions and Processes*, if a FRI uses the services of a reinsurance intermediary to facilitate its reinsurance RRMP;
- Guideline A - *Life Insurance Capital Adequacy Test* for federally regulated life insurers and societies, which includes the Life Insurance Margin Adequacy Test for foreign life insurance companies; *Minimum Capital Test* for federally regulated domestic property and casualty insurers; and the Branch Adequacy of Assets Test for foreign property and casualty companies;
- *Corporate Governance* guideline, which provides information to Boards and management of FRIs about OSFI's expectations on corporate governance.
- Guideline E-17: *Background Checks on Directors and Senior Management of Federally Regulated Entities* (FRE), which outlines principles to assess the suitability and integrity of directors and senior management by FREs.

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

Footnotes

1 The term federally regulated insurer includes life insurers and property and casualty insurers, domestic insurance companies and foreign insurance companies in respect of their insurance business in Canada, registered reinsurers, and fraternal benefit societies. For complete definitions of "registered reinsurer", please refer to Guideline A - *Life Insurance Capital Adequacy Test* and the *Minimum Capital Test*, as applicable. Note that these definitions include federally approved provincial / territorial reinsurers.

2 Please refer to the Other OSFI Guidance section of this guideline for guidance on the statutory approval requirements for assumption reinsurance transactions.

3 In the case of foreign companies, the applicable guidelines are the Life Insurance Margin Adequacy Test for life insures and the Branch Adequacy of Assets Test for P&C insurers. Similarly, the reference to "capital" in this sentence and throughout this guideline should be interpreted as "assets" in the case of foreign insurers.

4 For the purposes of this guideline, OSFI generally applies the concept of "substantially all" in a manner consistent with that used in the context of assumption reinsurance and asset sale transaction approvals.

5 Such an arrangement could potentially increase risks to the FRI, e.g., by weakening the underwriting standards and discipline at the ceding FRI.

6 Any significant outsourcing of this due diligence function to a third party must be in accordance with OSFI's Guideline B-10: *Outsourcing of Business Activities, Functions and Processes*.

7 If a FRI is aware that a reinsurance counterparty relies significantly on retrocessions, the FRI should seek greater visibility of the identities and financial standing of the retrocessionaires.

8 Generally, an "unregistered reinsurer" is a reinsurer that is not reinsuring in Canada risks in accordance with OSFI *Advisory 2007-01-R1: Insurance in Canada of Risks*, and, as such, is not regulated and supervised by OSFI. For complete definitions of "unregistered reinsurer", see Guideline A - *Life Insurance Capital Adequacy Test* and the *Minimum Capital Test* for property and casualty insurance companies.

9 "Binding" means that the parties are bound to the terms and conditions of the contract.

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

11 No policyholder in the (re)insurance chain should be adversely affected, including the cedant and its policyholders.

12 OSFI recognizes that there may be situations where the interests of a cedant FRI and its policyholders may be better served by the use of off-set and cut-through clauses. OSFI does not intend to restrict the use of such terms or conditions where they do not give preferential treatment over other claims under the scheme of distribution in the *Winding-Up* and *Restructuring Act*.

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