Insurance & Reinsurance - Canada

New collateralisation rules for unlicensed reinsurance

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As promised, the Office of the Superintendent of Financial Institutions (OSFI)(1) issued the final version of its new guidance on reinsurance security agreements before the end of 2010.(2) Except for a few revisions and a later implementation date for new reinsurance collateral arrangements, the final version contained no significant changes from the draft issued in August 2010. Under the finalised guidance, commencing July 1 2011, all new collateral arrangements involving unlicensed reinsurance should be in the form of a reinsurance security agreement. The implementation target date of January 1 2012 remains for all existing ongoing reinsurance arrangements.

Change of collateral regime

By introducing the new guidance, OSFI has changed the mechanism by which Canadian insurers are allowed capital or asset credit(3) for reinsurance placed with non-Canadian licensed reinsurers. Formerly, an OSFI-regulated insurer and its unlicensed reinsurer were required to enter into a reinsurance trust agreement in the exact form prescribed by OSFI. Under the former arrangement, assets were vested in trust with a trustee for the benefit of the ceding insurer. The ceding insurer, the reinsurer, OSFI and the trustee were all parties to the reinsurance trust agreement. Among other things, withdrawals from the trust account could not be made without OSFI's approval, unless the assets withdrawn were replaced with assets of an authorised category with the same or higher value. OSFI and the company could instruct the trustee to deliver assets to the company or to OSFI to cover claims under the reinsurance agreement.

Under the new regime, in order for a ceding insurer to be eligible for capital or asset credit for reinsurance with an unlicensed reinsurer, the unlicensed reinsurer will be required to pledge assets in favour of the ceding insurer under a reinsurance security agreement (replacing the trust arrangement with a pledge arrangement). In addition, the ceding company will be required to obtain a legal opinion, on which the cedant and OSFI are entitled to rely, confirming that the cedant has a first priority security interest in the pledged assets. It will not be necessary for OSFI to be a party to the reinsurance security agreement and under OSFI's finalised guidance, the cedant and reinsurer do not require OSFI's approval to deposit or withdraw assets. Rather, the cedant is required to establish its own prudential requirements for categories of acceptable assets and limitations on percentages of the collateral that can be invested in certain categories, as part of the cedant's general policies on reinsurance with unlicensed reinsurers. Each month, the institution that acts as custodian (or 'collateral agent', as defined in the guidance), on the cedant's behalf, must report to OSFI's Securities Administration Unit the market value of the assets pledged.

The guidance provides that the pledged collateral must be held in Canada in a location that is permitted in accordance with the provincial law under which the reinsurance security agreement is made.

Pledge documents and legal opinion

The form of reinsurance security agreements and control agreements contemplated by the OSFI guidance can be standard form securities pledge and securities account control agreements, but will need to be customised so that the events of default, remedies and collateral eligibility comply with the OSFI guidance. The sort of legal opinion contemplated by the OSFI guidance will be relatively straightforward to provide.

It would be based on a typical opinion as to the creation, perfection by control and priority of the security interest of the secured party (here, the cedant) in collateral under the Personal Property Securities Act and the Securities Transfer Act of the relevant province. This assumes that all the collateral consists of investment property (eg, marketable securities) or cash held in a securities account. A priority opinion could not be given to the extent that the collateral consists of cash held in a bank account.

Perfection by control and governing law

In order to provide the priority opinion that OSFI requires, the ceding company's security interest in the collateral pledged must be perfected "by control". Perfection by control is achieved through the securities account control agreement with the collateral agent. The law that governs perfection by control under the Personal Property Securities Act and the Securities Transfer Act is dictated by the "securities intermediary's jurisdiction" (which is the collateral agent's jurisdiction), as determined under the Securities Transfer Act. This is not necessarily the same as, and bears no necessary relationship to, where the securities will be located or even the physical location of the collateral agent or where its records are kept. It depends in practice on the jurisdiction that is specified in the agreement which governs the securities account (ie, the custodial agreement between the collateral agent and the reinsurer). If that agreement specifies a particular province as the collateral agent's jurisdiction for purposes of the applicable Securities Transfer Act, or states that it is governed by the law of a particular province, the law of that province will govern perfection of the security interest. These conflict of laws rules are now uniform in all common law provinces that have Securities Transfer Act legislation (Prince Edward Island is the exception). Quebec's legislation is somewhat similar. These provisions would, in theory, give the collateral agent and the reinsurer considerable latitude in selecting by contractual agreement the provincial law that will govern perfection of the security interest in collateral pledged under a reinsurance security agreement. In practice, however, institutional custodians tend to select the law of the province in which the agreement will be administered.

Practical considerations regarding custodial accounts

All pledged assets must be registered in the name of the collateral agent, a depository such as CDS Clearing and Depository Services Inc (CDS) or its nominee, or in the name of the secured party, but not in the name of the reinsurer or payable to the reinsurer. However, this does not mean that the securities account must be held in the name of the collateral agent. The securities account may be in the name of the reinsurer and be maintained with the collateral agent as securities intermediary. The underlying securities pledged under the arrangement are likely to be held with CDS and registered in the name of CDS & Co. Most Canadian trust companies or custodians are participants in CDS and maintain accounts with it. The reinsurer will have an account with the collateral agent and will be the 'entitlement holder' to the 'security entitlements' to the collateral carried in the account, as defined in the Securities Transfer Act.

For ease of implementation, where existing trust arrangements are being replaced with a reinsurance security agreement, the same financial institution that acts as trustee for an existing reinsurance trust arrangement could be used to act as collateral agent under the reinsurance security agreement arrangement. OSFI has indicated that trustees under existing trust arrangements will determine whether new accounts will have to be established where ceding companies and the unlicensed reinsurers move from a reinsurance trust agreement to a reinsurance security agreement. Trustees, such as RBC Dexia Investor Services, are currently evaluating their options for how this change can be implemented to minimise the amount of paperwork for clients and to avoid, if possible, the necessity of a technical transfer of assets between accounts. Insurers and unlicensed reinsurers that have existing trust arrangements should contact the trustee to determine the extent of the changes that will be required.

The parties and OSFI will need to coordinate the termination of the existing reinsurance trust agreement with the implementation of the new reinsurance security agreement. OSFI has indicated that it will require a Form 298 (which must be approved by OSFI) releasing the assets from the existing trust agreement.

Alternative: funds withheld?

As an alternative to converting an existing trust arrangement into a reinsurance security agreement, it may be possible for cedants that reinsure with unlicensed reinsurers to collapse the trust and administer the reinsurance on a 'funds withheld'(4) basis and still receive capital or asset credit for the reinsurance. OSFI's related new guidance(5) on reinsurance generally contemplates these arrangements, but cautions that the reinsurance agreement must clearly state that in the event of insolvency of the ceding insurer or the reinsurer, the funds withheld (minus amounts properly due to the reinsurer) form the property of the cedant under applicable Canadian insurance law. This appears to be a matter of legal drafting and as yet OSFI has not stated that a legal opinion confirming the legal effect of the wording will be required. However, it is uncertain whether this type of legal arrangement could have a regulatory impact on the reinsurer. In addition, it is unclear whether the P&C 1 and P&C 2 annual returns will

require amendment to permit capital credit for these arrangements. Therefore, cedants considering converting to a 'funds withheld' arrangement should contact OSFI to confirm in advance that capital or asset credit will be given for the particular arrangement.

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Endnotes

(1) Canada's federal insurance regulator and primary insurance solvency regulator.

(2) OSFI Guideline, Guidance for Reinsurance Security Agreements, December 2010.

(3) This refers to the circumstances in which OSFI-regulated companies and branches are allowed to take credit for reinsurance for purposes of calculating their solvency ratios (which are based on a capital test for companies and an asset test for branches).

(4) 'Funds withheld' refers to an arrangement whereby the ceding insurer retains the premium ceded under the reinsurance agreement, applying the funds itself to cover losses.

(5) OSFI Guideline B-3 Sound Reinsurance Practices and Procedures, December 2010.