IMPLEMENTATION OF REINSURANCE SECURITY AGREEMENTS: AN UPDATE AND NEW GUIDANCE FROM OSFI

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As described in a previous article, the Office of the Superintendent of Financial Institutions ("OSFI"), Canada's federal regulator of banks, insurers, loan and trust companies and similar institutions, issued new Guidance in December 2010 (the "RSA Guidance") which requires Canadian insurance companies that reinsure with reinsurers not registered in Canada ("unregistered reinsurers") to convert their existing security arrangements governed by reinsurance trust agreements ("RTAs") into reinsurance security agreements ("RSAs") in order to continue to receive capital/asset credit in respect of the unregistered reinsurance.

converting to RSAs: issues and challenges

The RSA Guidance targeted January 1, 2012 as the deadline for completing RTA conversions for all insurers in Canada. We understand that although many RTA conversions have been started, relatively few have been finalized to date. One reason for the slow progress is that various practical issues that were not anticipated are coming to light as the conversion process unfolds. Another probable reason is that ceding insurers and their unregistered reinsurers have no single standard-form template for the RSA, which has necessitated negotiation of the RSA terms on a one-off basis. In contrast, the template RTA formerly in use had been prepared on OSFI's behalf and was, by OSFI's edict, virtually immutable. Having a single form of RTA whose terms could not be altered came with the obvious benefit of forestalling any negotiation of those terms. Although "neutral" templates for RSA arrangements are generally publicly available in Canada, no de facto standard has evolved, partly because each custodian appears to have its own views and preferences as to what RSA provisions it favours. The difficulty arises when these views and preferences diverge from the available "neutral" templates, and indeed in some cases, from the RSA Guidance. Consequently, negotiating the RSA terms has been taking more time (and effort and expense) than the ceding companies or their unregistered reinsurers had initially expected.

new OSFI Q&As

In the course of these negotiations some insurers and their counsel have been appealing to OSFI to help deal with some of the practical realities involved in the conversion process as well as to act as a sort of umpire to

rule on whether including certain proposed RSA and other related agreement provisions would comply with the RSA Guidance. In response to these enquiries, on November 25, 2011, OSFI issued a helpful document entitled Questions and Answers – Guidance for Reinsurance Security Agreements (the "Q&As"). The following summarizes some of the highlights of the Q&As, which should bring greater certainty (if not speed) to the conversion process.

termination of RTAs and transition period

In the Q&As, OSFI outlines its reasons for choosing to replace the RTA with the RSA regime, describes the main features of the RSA regime and confirms that it has moved away from the approach of providing a standard-form RSA to replace the standard-form RTA.

In addition, OSFI clarifies the approval requirements (an OSFI 298 form) and other documentary requirements needed to release the assets from the existing RTAs. The Q&As also note that "Pursuant to RSA Guidance, OSFI expects companies to take all commercially reasonable efforts to replace existing RTAs" with RSAs by the original January 1, 2012 deadline and state that all insurers that anticipate that they will not be able to meet the deadline must notify their OSFI relationship managers ("RMs"). RMs will apparently have the authority to determine whether "commercially reasonable" efforts have been made and to determine whether, and under what conditions, capital/asset credit should be permitted for arrangements that have not been converted by the deadline.

alternatives to RSAs

The Q&As also address alternatives to converting to an RSA, such as the use of letters of credit (albeit restricted) and "funds-withheld arrangements". The latter vehicle is proving to be a somewhat cumbersome and difficult alternative due to OSFI's requirements with respect to the enforceability of the arrangement, for example, on insolvency of the reinsurer.

RSA minimum standards

As a result of questions raised by the ceding companies, unregistered reinsurers and their counsel, the Q&As attempt to clarify a number of other questions, such as:

- the amount of collateral that is required in order to meet the capital/margin requirements for unregistered reinsurance;
- the types of assets that are permitted as collateral and possible legal issues associated with posting cash collateral;
- the location where assets must be held (namely, in Canada) and the corresponding non-permitted use of foreign custodians;

- the types of documents that may be used to evidence the RSA arrangement;
- which party is responsible for monitoring the RSA arrangement's compliance with OSFI guidance; and
- the limited circumstances in which OSFI will permit the custodian to include a right of set-off or a priority security interest in the custodian's favour in the RSA documentation.

RSA legal opinion

A hallmark of the OSFI Guidance is the requirement for a legal opinion on which the ceding company and *OSFI* will be entitled to rely which asserts that the ceding company has obtained and will maintain a valid and enforceable first-priority security interest in the collateral pledged by the unregistered reinsurer.

The Q&As reiterate that the opinion must be provided by legal counsel with the appropriate expertise in personal property security legislation in the Canadian province where the assets are held and contain guidance where a "local" opinion is provided by in-house counsel. The Q&As also address the circumstances in which an additional legal opinion will be required for the RSA arrangement, namely, where a new type of asset not already covered by the legal opinion is approved by the ceding company. They also confirm that the ceding company need not file the legal opinion with OSFI but should instead keep it on file to be produced on request.

The Q&As also modify OSFI's statement in the RSA Guidance to the effect that copies of the reinsurance agreements in question must be appended to the legal opinion. As the RSA process has unfolded, it has become apparent that some arrangements with unregistered reinsurers are annual reinsurance programs that have spanned a number of years, sometimes dating well back into the prior century. As a consequence, locating and appending all reinsurance agreements to the legal opinion has proven to be impractical if not impossible. Although not directly addressing this difficult issue, OSFI has left it to the insurers and their legal counsel to determine what if any documentation must be appended to the legal opinion.

reinsurance agreement provisions

Finally, the Q&As clarify that OSFI does not provide or endorse particular language or wording for reinsurance agreements. OSFI notes that industry associations, such as the Reinsurance Research Council and the Property and Casualty Insurance Compensation Corporation issue various wordings for reinsurance contracts. In addition, companies are encouraged to consult with their legal counsel to ensure that reinsurance agreement provisions are consistent with OSFI's specific guidance on reinsurance security agreements.

other practical and legal issues

In addition to the questions addressed in the Q&As, a number of other issues may arise in the course of negotiating RSA documentation. The following elaborates on some of the Q&A issues and highlights some others that insurers may encounter.

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Documentation. As noted above and in the Q&As, there is no standard form RSA, and in the Q&As OSFI confirms that it is acceptable to combine a securities account control agreement and the RSA into a single document. Besides reducing the number of documents, this approach has the advantage of ensuring consistency in definitions, remedies, boilerplate and other provisions that must work together in the two documents. However, as a party to the combined agreement, the custodian may want to take part in negotiations that would otherwise involve only the reinsurer and the ceding company, potentially protracting the process and increasing costs. Some institutional custodians prefer to go even further and combine the RSA, the control agreement and the custodian's own form of custodial agreement between the custodian and the reinsurer into a single omnibus agreement. While this approach also has advantages, the custodian's principal concern may be to protect its own interests by including appropriate disclaimers of liability, rights of indemnity and security and ensuring that, operationally, the custodian is able to meet the needs of the other two parties. However, counsel for the ceding company and the reinsurer must take care to ensure that the documentation meets the OSFI requirements for a satisfactory RSA and control agreement and that the custodian's input in the negotiations is restricted to provisions that directly impact the custodian's duties, liabilities and obligations. Otherwise costs and time may escalate.

First priority security interests. As noted above, one of the OSFI requirements is that the legal opinion to be delivered in connection with an RSA confirm that the security interest in the collateral "has priority over any other security interests". However, the custodian (whether in a separate custodial agreement or a combined RSA) may ask for a first priority security interest in and right of set-off against the collateral to secure all obligations owed to it from time to time by the reinsurer. If such a security interest were permitted the first priority opinion obviously could not be given and the RSA itself would be off side. As alluded to above, in the Q&As OSFI notes that "it will not object to the parties including a right of set-off or allow a priority interest in favour of the custodian (i) to secure the payment of the custodian's customary fees and commissions payable under the custodian or control agreement and (ii) with respect to an involuntary overdraft (e.g., to settle a transaction that could otherwise fail). However, OSFI will not accept a broad right of set-off or priority created in favour of the custodian for other types of obligations, liabilities, indebtedness, or indemnification". Often the form of RSA offered by the custodian will initially include an "all obligations" security interest and right of set-off. The scope of these provisions must be cut down to the parameters acceptable to OSFI. In addition, since the custodian will typically be the securities intermediary, and as such, will automatically have a first priority security interest in the assets credited to the collateral account maintained with it, the agreement must contain language expressly subordinating the custodian's security interest to that of the ceding company except with respect to the two classes of obligations acceptable to OSFI. In addition, the legal opinion as to the priority of the ceding company's security interest also must expressly carve out the limited security interest in favour of the custodian.

Payment of interest on collateral to the reinsurer. Existing RTAs typically provide that interest, dividends and other income on assets held in trust by the trustee are remitted to the reinsurer. However, some RSA custodians have refused to implement such arrangements with respect to securities in the collateral account, advising that their internal controls cannot accommodate such a request and that instead any withdrawals from the account will not be permitted except on the joint direction of the reinsurer and the ceding company or the ceding company alone after it has notified the custodian that it has assumed exclusive control of the account.

Location of collateral. As noted above, OSFI requires that all RSA collateral be "held in Canada". Since most of the collateral will typically consist of book-based or "dematerialized" securities that may only be evidenced by entries in the computer ledgers of the issuer or a clearing agency, it may be difficult to determine exactly where the securities are "held". However the RSA Guidance implied and the Q&As confirm that securities held with CDS Clearing and Depository Services will be regarded as being "held in Canada". One difficult issue that may require some negotiation with the custodian is obtaining confirmation that all the securities credited to the collateral account are indeed ultimately held with CDS. The custodian may resist warranting that all the collateral will be held through CDS, partly because custodians commonly use sub-custodians who in theory could use other clearing agencies. However since in the Q&As OSFI has expressly ruled out using foreign sub-custodians and since CDS is now in effect the only Canadian clearing agency that handles debt securities of the type likely to be pledged as collateral, giving such a warranty should in principle not be difficult.

As the January 1, 2012 deadline draws near, Canadian ceding companies that use unregistered reinsurers will no doubt be spending some long hours this December pondering these and many other questions that must be answered before their RTAs become RSAs in the new year.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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