OSFI RELEASES FINAL REVISED REINSURANCE GUIDELINES TO TAKE EFFECT IN 2025

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On February 11, 2022, the Office of the Superintendent of Financial Institutions (" **OSFI** ") published the final revised Guideline *B-3, Sound Reinsurance Practices and Procedures* and the final Guideline *B-2, Property and Casualty Large Insurance Exposures and Investment Concentration* (the "**Guidelines**"). The Guidelines are designed the ensure Canada's reinsurance framework remains appropriate and effective given changing industry practices since the last review, conducted over a decade ago. The Guidelines will take effect on January 1, 2025, providing federally regulated insurers and foreign branches (as the context requires, " **FRIs** ") with a three-year transition period.

Reinsurance is an important risk and capital management tool, as it allows FRIs to purchase insurance from other insurers, reinsurers or counterparties (the ceding company or cedant) as a means of sharing risk and limiting the FRI's exposure to large and catastrophic losses. It also allows insurers to make more efficient use of capital and increase their underwriting capabilities. However, reinsurance practices also carry a number of risks.

OSFI's Discussion Paper on the Reinsurance Framework

In 2018, in recognition of increasing reliance on reinsurance and the emergence of new and evolving business models and risks (for example, ceding a substantial portion of risks offshore to unregistered cedants), OSFI began a broad review of Canada's reinsurance framework applicable to FRIs.

As part of the review, OSFI released a discussion paper highlighting possible issues with the current reinsurance framework. While both the Property and Casualty ("P&C") sector and the life insurance sectors were reviewed, OSFI concluded that the issues it identified were most prominent in the P&C sector. The two key findings of the review were that:

1. risks associated with large exposures and concentration of reinsurance counterparties must be better managed; and

2. adjustments should be made to the capital framework for reinsurance.

The final Guidelines reflect input received from stakeholders in response to Draft Guideline B-3, issued in June 2019, and Draft Guideline B-2, issued in November 2020.

Revisions to Guideline B-3 – Sound Reinsurance Practices and Procedures

Guideline B-3 contains principles applicable to both life and P&C sectors that are intended to guide FRIs in developing prudent approaches to managing reinsurance risks. It stipulates that FRIs should have a sound and comprehensive Reinsurance Risk Management Policy (" **RRMP** ") and outlines the expected key elements of the RRMP.

Revised Guidelines B-3:

1. Requires an enhanced assessment of counterparty risk that:
    - Considers the legal and insolvency framework of a counterparty's home jurisdiction, and the terms and conditions of reinsurance contracts.
    - Considers counterparty risk at an aggregate level (eg, group of affiliated counterparties) for stress testing. A FRI should assess counterparty risk from the perspectives of both going-concern and gone-concern scenarios of its reinsurers.
    - Assesses the risk consistently across all counterparties (ie, affiliates and non-affiliates).
    - Consider the FRI's total exposure to a counterparty.
    - Establishes appropriate counterparty concentration limits both to individual counterparties and also to groups of affiliated counterparties in the RRMP. These limits should be based on the associated risks, as evaluated using the factors above.

2. Clarifies that reinsurance payments are expected to flow directly to a cedant FRI in Canada.

3. Reaffirms the expectation that FRIs establish appropriate ceding limits (which should not be "substantially all" of its risks) and consider counterparty risks when doing so. OSFI will generally apply the concept of "substantially all" in a manner consistent with that used in the context of assumption reinsurance and asset sale transactions (ie, 75% or more), but will continue to supervise such business arrangements on a case-by - case basis.

FRI's should adjust aspects of their RRMPs and practices, particularly with respect to counterparty risk, accordingly. In some cases, the revisions may require insurers to substantially increase the amount of capital (or assets in the case of foreign branches) held in Canada.

Guideline B-2 – Property and Casualty Large Insurance Exposures and Investment Concentration

Gross Underwriting Limit Policy

New Guideline B-2 stipulates that P&C FRIs should have a Gross Underwriting Limit Policy that defines what constitutes a single insurance exposure by class of insurance, and establishes maximum limits that the P&C FRI is willing to accept in respect of a maximum loss related to a single insurance exposure. OSFI expects FRIs to develop and establish their own criteria and approach for determining and measuring the maximum loss on a single insurance exposure. Note, however, that the determination of maximum loss on a single insurance exposure should be made without regard to the probability of the loss event occurring, and should be based on a risked-based and forward-looking approach.

Insurance Exposure Limit

FRIs must 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 is a welcome departure from the initial draft guideline, pursuant to which FRI's were expected to cover three of its largest policy limit losses. The rule is expressed as a percentage of total capital available for insurance companies (or net assets available for foreign branches).

Investment Concentration

Guideline B-2 requires that a P&C FRI's aggregate market value of investments in any one entity or group of affiliated companies not exceed, for an FRI, 5% of the company's total value of assets reported on the balance sheet of the regulatory return filed with OSFI or, for a foreign branch, 5% of the company's total value of assets vested in trust in Canada as reported on the balance sheet of the regulatory return filed with OSFI.

Conclusion

Although the Guidelines are not effective until January 1, 2025, OSFI has already started asking insurers for information on how they intend to address the new requirements, including their policy on gross underwriting limits, criteria and approach for determining and measuring the maximum loss on a single exposure and policies with respect to the management of investment concentration. As such, FRIs should begin evaluating and adjusting their business practices in order to provide fulsome responses and to ensure a smooth transition to the new requirements.

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

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against