

MARKET BULLETIN

REF: Y4495

Title	Update regarding the implementation of Canadian B3 Reinsurance Reforms
Purpose	To advise the market of the new Canadian guidelines to be implemented by and effective from 1 July 2011
Type	Event
From	Andrew Gurney, Senior Manager, International Licences International Regulatory Affairs
Date	26 May 2011
Deadline	01 July 2011
Related links	http://www.osfi- bsif.gc.ca/app/DocRepository/1/eng/guidelines/sound/guidelines/B3_e.pdf http://www.osfi- bsif.gc.ca/app/DocRepository/1/eng/guidelines/sound/guidelines/B3_let_e.pdf http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/notices/osfi/rsa_e.pdf

1 Purpose

1.1 The purpose of this Market Bulletin is to highlight to Managing Agent compliance officers, active underwriters and Lloyd's brokers the reforms to the Office of the Superintendent of Financial Institutions (OSFI), the Canadian federal regulators guidance on

- the management of reinsurance; and,
- the use of Reinsurance Security Agreements.

2 Executive Summary

2.1 On 24 December 2010 OSFI published "Guideline B-3 Sound Reinsurance Practices and Procedures" (Guideline B-3) and "Guidance for the Reinsurance Security Arrangements" (Guidance RSA).

2.2 Guideline B-3 and Guidance RSA apply to **all** federally regulated insurers (including life insurers and property and casualty insurers, domestic insurers and foreign insurers in respect of their insurance business in Canada), registered reinsurers and fraternal benefit societies that are party to reinsurance cessions, retrocessions and where applicable to assumption reinsurance transactions (collectively “FRI’s”).

2.3 Effective 30 June 2011 OSFI repeals The Reinsurance (Canadian Companies) Regulations and The Reinsurance (Foreign Companies) Regulations, which placed a limit on reinsurance by cedants of 75% of gross premiums and 25% of their gross premiums to unregistered reinsurance, moving to a principles based guidance as outlined in Guideline B-3 and Guidance RSA.

2.4 Guideline B-3 and Guidance RSA should be consulted for full details.

2.5 **Guideline B-3**

2.5.1 Guideline B-3 sets out four key principles for the sound management of reinsurance:

- **Principle 1:** A FRI should have a sound and comprehensive reinsurance risk management policy (RRMP), subject to the oversight of the FRI’s Board of Directors and implementation by senior management;
- **Principle 2:** A FRI should perform a sufficient level of due diligence on its reinsurance counterparties on an on-going basis to ensure that the FRI is aware of its counterparty risk and is able to assess and manage such risk;
- **Principle 3:** The terms and conditions of the reinsurance contract should provide clarity and certainty on reinsurance coverage; and,
- **Principle 4:** A ceding FRI should not be adversely affected by the terms and conditions of a reinsurance contract.

2.5.2 Implementation

- OSFI encourages each FRI to implement the principles and expectations set out in Guideline B-3 as soon as practically possible, and expects that each FRI will comply with Principle 1 by **1 July 2011**;
- OSFI expects each FRI to implement and fully comply with the remaining principles in the Guideline by **1 July 2012**; and,
- For existing multi-year contracts that do not naturally come up for renewal prior to 1 July 2012, each FRI is expected to take all commercially reasonable efforts to make such contracts compliant with the Guideline.

2.6 Guidance RSA

2.6.1 Guidance RSA sets out the criteria for cedants to claim capital/asset credit for unregistered reinsurance.

2.6.2 Further to market bulletins Y4329 and Y4456, it is Lloyd's policy that all business should be written as licensed, inclusive of reinsurance however there is scope under Part XIII to write unregistered reinsurance. Whilst this is not Lloyd's policy the market should be aware of the following Guidance RSA, which adds significant complexities for cedants who wish to take asset/capital credit for unregistered reinsurance.

2.6.3 A federally regulated insurance company is generally eligible for a capital/asset credit in respect of unregistered reinsurance if it benefits from collateral held in Canada, pursuant to, but not inclusive of the following requirements:

- the cedant has the right to liquidate or take legal possession of the assets in the event of default by the reinsurer;
- pledged assets held in Canada by a Collateral Agent;
- in respect of a particular RSA, the ceding company obtains a legal opinion asserting that a valid and enforceable security interest, that has priority over any other security interest in the pledged assets, has been or will be created in its favour for the type of assets covered by the legal opinion; and
- all documentation is binding on all parties and legally enforceable in all relevant jurisdictions.

2.6.4 Implementation

- Guidance RSA sets out OSFI's minimum standards with respect to collateral secured through the establishment of a RSA, and sets out the criteria that must be met to enable a ceding company to obtain and maintain a valid and enforceable security interest that has priority over any other security interest in assets of an unregistered reinsurer that are held in Canada, and therefore claim capital/asset credit in its Minimum Capital Test (MCT) or Branch Adequacy of Assets Test (BAAT);
- OSFI encourages ceding companies to take steps to enter into RSA's that meet the requirements of the guidance as soon as possible. All new agreements should comply with the guidance starting **1 July 2011**; and,

- For existing multi-year contracts that do not naturally come up for renewal prior to 1 July 2012, each FRI is expected to take all commercially reasonable efforts to replace such contracts with Guidance RSA compliant contracts.

2.7 Guideline B-3 Key Principles

2.7.1 Principle 1

- The RRMP should reflect the scale, nature and complexity of a FRI's business, and have regards for its risk appetite and risk tolerance.;
- OSFI expects the RRMP to document significant elements of the FRI's approach to managing risk through reinsurance, risk diversification objectives, risk concentration limits, ceding limits, and the practices and procedures for managing and controlling its reinsurance risks;
- the FRI's board should review and approve the FRI's RRMP annually; and,
- the RRMP should detail:
 - The roles and responsibilities for those positions charged with implementing the RRMP;
 - 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.

2.7.2 Principle 2

- A FRI should evaluate the ability of all current and prospective reinsurance counterparties to meet their liabilities under exceptional 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. OSFI requires a significantly higher level of due diligence for the use of unregistered reinsurance, as outlined in Guidance RSA;
- When performing its due diligence, a FRI should give consideration to, 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.
- 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.
 - In cases where there may be a material exposure to incurred but not reported losses, management should ensure that the evaluation continues beyond the expiration date of the contract to ensure that the FRI assesses potential reinsurance recoverables from expected future claims.

2.7.3 Principle 3

- A FRI should have processes and procedures in place to ensure that a comprehensive, written, and binding reinsurance contract is executed prior to the effective date of reinsurance coverage.
- The 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 FRI's to:
 - a** 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;
 - where applicable, any exclusions to terms of coverage; and,
 - any standard clauses that are to be relied upon or incorporated by reference into the reinsurance contract;
- b** Address, within the summary document, any material issues most likely to arise, including all variable or unique agreement terms; and,
- c** Ensure that all final comprehensive reinsurance contracts, including any amendments thereto, bear the duly authorized signature of both the ceding company and the reinsurer(s) within a relatively short timeframe having regard for the nature, complexity and materiality of the agreement (e.g., within 120 days of execution).
- OSFI acknowledges 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 be transparent with 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.

2.7.4 Principle 4

- The terms and conditions of a binding reinsurance agreement should provide that funds will be available to cover policyholder claims in the event of either the cedant's or reinsurer's insolvency.
- Reinsurance contracts should include an "insolvency clause". Ceding FRI's 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.

- 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 Winding-up and Restructuring Act (WURA).
 - In the 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 relating 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 Insurance Companies Act.
- OSFI expects all contracts related to reinsurance coverage to stipulate a choice of forum, a choice of law, and the appointment of agents for service of legal processes, subject to the laws and courts of a Canadian province or another legal jurisdiction of, in the reasonable opinion of the FRI, equivalent or greater reliability and certainty which has a natural connection to the transaction.

3 Actions

- 3.1 Compliance officers, underwriters and Lloyd's brokers should be aware that FRI's may require changes to their reinsurance contracts, risk management frameworks and reinsurance purchasing procedures and may seek to conduct due diligence checks in order to comply with OSFI Guideline B-3 and Guidance RSA.
- 3.2 The requirements of OSFI's Guideline B-3 and Guidance RSA also apply to Lloyd's syndicates. Lloyd's central guidance to the market for syndicate's business plans meets the requirements of Guideline B-3 and there are no individual reporting requirements for syndicates. Those syndicates wishing to seek asset/capital credit for unregistered reinsurance for their Canadian business must meet the requirements of the OSFI Guidance RSA, which may require a change to their reinsurance contracts, risk management frameworks and reinsurance purchasing procedures.

- 3.3 The guidance in Principle 4 of Guideline B-3 should be considered as equivalent to industry best practice and the precise wording of reinsurance policies will be a commercial decision driven by the parties to the contract.

Further Information

If you require additional information or wish to discuss this matter in more detail, please contact:

Lloyd's International Trading Advice

Lloyd's Desk, Ground Floor, Underwriting Room

Telephone: 020 7327 6677

Email: LITA@Lloyds.com

www.lloyds.com/crystal