

Torys on Financial Institution Regulation

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OSFI Finalizing New Guidance for Reinsurance Security Agreements in Canada

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On August 9, the Office of the Superintendent of Financial Institutions (OSFI) released draft guidance for reinsurance security agreements (the RSA Guidance), marking a shift away from the use of standard form reinsurance trust agreements. The RSA Guidance (i) sets out OSFI's minimum standards for reinsurance security agreements, (ii) includes a requirement to secure a legal opinion to accompany each agreement, and (iii) outlines expectations regarding the operation of the reinsurance security agreement process.

This RSA Guidance applies to all federally regulated insurers, including life insurers and property and casualty insurers, domestic and foreign insurance companies in respect of their business in Canada, and registered reinsurers and societies for reinsurance cessions and retrocessions. All newly entered agreements should follow the RSA Guidance beginning January 1, 2011. OSFI expects companies to replace existing agreements by January 1, 2012. The draft guidance is expected to be finalized later this year.

Background

In the past, OSFI had developed standard form reinsurance trust agreements that federally regulated companies (ceding companies) were required to use in order to be eligible for a capital/asset credit for risks that had been reinsured with an unregistered reinsurer. The move away from these standard form agreements is motivated in part by discussions within the legal community, including our firm, as to whether their enforceability could be challenged and whether alternative arrangements might offer better protection.

Under the new approach, OSFI will require ceding companies to negotiate and enter into suitable reinsurance arrangements, and to take all necessary practical and operational measures to create and maintain a valid first-ranking security interest in assets of an unregistered reinsurer that are held in Canada. Ceding companies will also have to provide a legal opinion addressed to the ceding company and OSFI, upon which OSFI may rely, asserting that such an interest has been created. Further, ceding companies will be expected to approve assets that are pledged or withdrawn.

Overview of RSA Guidance

As set out in the RSA Guidance, a ceding company is generally eligible for a capital/asset credit in respect of risks reinsured by an unregistered reinsurer where the ceding company obtains and maintains a valid first-ranking security interest in assets of the unregistered reinsurer that are held in Canada. Such security interest can be obtained through a reinsurance security agreement, and the RSA Guidance provides minimum standards for such agreements.

To discuss these issues, please contact the authors.

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This bulletin is a general discussion of certain legal and related developments and should not be relied upon as legal advice. If you require legal advice, we would be pleased to discuss the issues in this bulletin with you, in the context of your particular circumstances.

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Security Agreement Minimum Standards

A reinsurance security agreement must, in addition to certain other requirements,

- provide that the pledged assets will be held in the province in which the agreement is made and may not be used as part of a securities lending program;
- set out specific events of default and remedies and/or rights upon default;
- provide that the “Collateral Agent” will act solely as agent for the ceding company and set out certain representations by the Collateral Agent and provisions regarding how the Collateral Agent will hold the pledged assets and related obligations;
- provide that the pledged assets will secure the reinsurer’s present and future obligations to the ceding company to pay the reinsurer’s share of any loss or liability, or both, sustained by the ceding company for which the reinsurer is liable under the reinsurance agreement; and
- provide that the reinsurer agrees to deliver to, and maintain with, the Collateral Agent as collateral under the security agreement assets having a market value at all times at least equal to a specific amount or to an amount determined by a formula.

In addition, OSFI expects that all contracts related to reinsurance coverage of a ceding company be subject to Canadian laws, or to the laws of another jurisdiction acceptable to OSFI, that disputes between the ceding company and the reinsurer be subject to the non-exclusive jurisdiction of a Canadian court and that any foreign or non-Canadian counterparty has taken steps necessary to ensure it may be served in Canada to commence a legal proceeding (e.g., appointing an agent for service process).

In general, OSFI expects a higher level of due diligence by a ceding company in respect of any reinsurance arrangement with an unlicensed reinsurer. The assessment of counterparty risk should include a review of the regulatory and supervisory regime, and the legal and insolvency frameworks of the unregistered reinsurer’s home jurisdiction. The assessment should also consider how such a reinsurer and its affiliates are likely to react during a period of extreme, but plausible, stress.

Legal Opinion

The legal opinion obtained by the ceding company must be provided by a lawyer who has expertise in the area of personal property security legislation in the province in which the assets are held, and should include

- an assertion that the security interest in the pledged assets is valid and enforceable against all other creditors of the unregistered reinsurer, including in the event of insolvency;
- a reference to the applicable provincial statute governing the arrangement;
- a statement on the validity and enforceability of the security interest in the context of the applicable rules governing conflict of laws;
- an assertion that a first-ranking priority is created by such security interest; and
- an attached copy of all arrangements to which the opinion applies.

In many situations, it would be prudent, although not expressly required by the RSA Guidance, for the ceding company to obtain a legal opinion from foreign counsel on the effectiveness of the arrangements in the event of foreign insolvency proceedings relating to the reinsurer. The opinion may include conflict-of-law opinions from foreign counsel relating to the validity, perfection and priority of the security interest.

Supervision of Reinsurance Security Agreements

OSFI will continue to require ceding companies to obtain approval from their relationship manager (or other person designated by OSFI) for the removal of pledged assets, to obtain an asset credit for assets that are not designated as “Permissible Assets” by OSFI or for any transaction involving foreign currency assets. OSFI will also require regular reporting on the market value of assets subject to each reinsurance security agreement. On or before the 15th of each month, the ceding company must ensure that its Collateral Agent files a specific declaration in this respect with OSFI .

Complying with the New Requirements

Torys lawyers are in the process of drafting a form of reinsurance security agreement that will meet the requirements of the RSA Guidance; we have experience in drafting and obtaining the types of opinions that are required, including the supporting foreign law opinion. We would be pleased to discuss the RSA Guidance with you and the issues that need to be addressed to comply with it. 