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OSFI Finalizes Guidance for Reinsurance Security Agreements and Reinsurance Practices

Torys releases supporting documentation to comply with new guidance

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On December 24, the Office of the Superintendent of Financial Institutions (OSFI) released in final form its *Guidance for Reinsurance Security Agreements* (the RSA Guidance) and *Guideline B-3, Sound Reinsurance Practices and Procedures*, following public consultations on draft versions issued in August 2010. Earlier today, Torys released the following draft documentation to comply with the RSA Guidance: (i) a form of Reinsurance Security Agreement (RSA); (ii) a form of Control Agreement; and (iii) forms of legal opinions to be provided by Canadian and foreign counsel. We have also created a chart that summarizes the basis on which the forms of draft documentation purport to comply with the RSA Guidance. This documentation (collectively, the RSA Supporting Documentation) is available here.

The RSA Guidance

The RSA Guidance provides that (i) all new unregistered reinsurance arrangements entered into after July 1, 2011 should comply with the new guidance, and (ii) existing arrangements are expected to be modified to comply by January 1, 2012. However, we strongly recommend that all new and existing arrangements be made to comply with the RSA Guidance as soon as possible – the time, effort and expense required to renegotiate those arrangements within one year, in our view, make this the only reasonable approach. In fact, after the draft guidance was released by OSFI in August, we successfully negotiated, on behalf of a ceding company, supporting documentation (which is substantially similar to the linked RSA Supporting Documentation) drawn up for our client in connection with a reinsurance transaction. Since our client was entering into an unregistered reinsurance arrangement contemporaneously with the finalization of the RSA Guidance, OSFI agreed to review the documentation for that transaction and confirmed that the documentation negotiated was consistent with the expectations contained in the RSA Guidance.

Summary of Key Changes from the Draft Guidance

The following is a summary of the key changes made in the final form of the RSA Guidance, compared with the draft version released by OSFI in August 2010, which we previously summarized in a bulletin. An updated version of that previous summary bulletin, revised to reflect changes in the final form of the RSA Guidance, is available here. In addition to the following changes, several technical changes were made, particularly regarding the minimum standards for an RSA and the rendering of the accompanying legal opinions.

General Changes

- OSFI clarified that for purposes of obtaining a capital/asset credit for an RSA, only Canadian, not foreign, depositories (e.g., CDS Clearing and Depository Services Inc.) are accepted in respect of pledged assets.
- OSFI expects the management of ceding companies, under a board-approved policy, to confirm to the board from time to time, but at least every two years, that a valid and enforceable security interest that has priority over any other security interest in the pledged assets continues to be maintained in the company's favour. A footnote accompanying this requirement stipulates that "the confirmation should either state that the opinion [which accompanied the RSA when it was put in place in accordance with the RSA Guidance] may still be relied upon or that subsequent changes to legislation do not affect the validity of the opinion or, alternatively, a new opinion can be provided."

  While the footnote quoted above may be somewhat ambiguous, it is our understanding that OSFI interprets the footnote as essentially creating three scenarios: (i) no legislative changes have occurred; (ii) legislative changes have occurred but do not impact the previous opinion; and (iii) legislative changes have occurred that do impact the previous opinion. It is our understanding that in the first two scenarios, OSFI would not require a new opinion, but in the third scenario OSFI would require a new opinion to be provided.

Changes to Guidance on Legal Opinion

- In respect of each RSA, OSFI expects the accompanying legal opinion to 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." Although this statement was contained in the draft guidance as well, we highlight it here because we believe that an assertion using the exact quoted phrase is not standard or possible to provide within the type of legal opinion required under the RSA Guidance. However, we note that the RSA Guidance goes on to say that the opinion may be subject to "customary qualifications," a statement that was not included in the draft guidance. We expect that OSFI will accept customary opinion language with customary qualifications.
- If the ceding company approves a new type of asset not already covered by the accompanying legal opinion, OSFI expects that the company will obtain an additional legal opinion asserting that a valid and enforceable security interest has been or will be created in its favour in respect of this new type of asset.

Changes to Guidance on Supervision of RSAs

- OSFI eliminated the requirement for ceding companies to obtain approval from their relationship manager (or other person designated by OSFI) to remove pledged assets or for any transaction involving foreign currency assets.
- OSFI removed Schedule A that was included in the draft guidance, which set out permissible assets that a ceding company may accept as pledged assets without OSFI prior approval and that would be permissible for asset credit. Instead, OSFI incorporated a prudent person type of standard with respect to pledged assets by stating that it expects ceding companies to incorporate within a policy relating to unregistered reinsurance arrangements "the types of prudentially acceptable pledged assets and the limits (e.g. credit ratings as outlined in the capital/asset guidelines; counterparty concentrations, foreign denominated securities) as well as the practices and procedures for managing and controlling risks related to pledged assets."

This change may give rise to a market practice of requiring the reinsurer to adopt an investment policy relating to assets that may be pledged under the reinsurance arrangement to the ceding company and for the ceding company to have a right to approve any changes to such policy.

Implementation

- The designated OSFI relationship manager will follow each ceding company's efforts and progress in implementing the RSA Guidance within the timeframes mentioned above.

Guideline B-3

Guideline B-3, which applies to all federally regulated insurers (FRIs), outlines OSFI's expectations for sound reinsurance risk-management practices and procedures. We provide below a summary of Guideline B-3, which includes several important excerpts from this guidance.

OSFI sets out the following four key reinsurance principles (italicized below) intended to assist FRIs in developing prudent approaches to managing reinsurance risks. OSFI will assess an insurer's reinsurance risk-management policy against these principles:

1. *A FRI should have a sound and comprehensive reinsurance risk management policy, subject to the oversight of the FRI's Board of Directors and implementation by senior management.*

   OSFI expects that a FRI's reinsurance risk-management policy (RRMP), which should be an integral part of its overall enterprise risk-management plan, should reflect the scale, nature and complexity of a FRI's business and reflect its "risk appetite" and "risk tolerance." OSFI provides guidance on what should be included in the RRMP and emphasizes that the RRMP should detail the FRI's policy on the use of registered and unregistered reinsurance. Therefore, practically, any reinsurance security arrangement established in accordance with the RSA Guidance must comply with the RRMP and, by extension, with Guideline B-3.

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.*

   OSFI specifies that the level of a FRI's due diligence on any reinsurance counterparty should be commensurate with its level of exposure to the counterparty. OSFI provides guidance regarding the way the due diligence of a proposed reinsurance arrangement should be conducted by a FRI and states that it expects a higher level of due diligence regarding any current or prospective reinsurance with an unregistered reinsurer or with a cedant that is not regulated by OSFI.

3. *The terms and conditions of the reinsurance contract should provide clarity and certainty on reinsurance coverage.*

   OSFI expects that 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 the reinsurance coverage. Guideline B-3 contains provisions about what should be included in a reinsurance contract under various circumstances and outlines the way such contracts should be drafted.

4. *A ceding FRI should not be adversely affected by the terms and conditions of a reinsurance contract.*

   OSFI stipulates that the terms and conditions of a reinsurance agreement should provide that funds will be available to cover policyholder claims in the event of either the cedant's or the reinsurer's insolvency. The agreements should have an "insolvency clause," and terms and conditions that may frustrate the scheme of priorities under the *Winding-up and Restructuring Act* (WURA), such as "off-set" or "cut-through" clauses or "funds withheld" arrangements, should be drafted in accordance with Guideline B-3.

   Generally, reinsurance contracts should not include terms and conditions that may limit a troubled or insolvent cedant's ability to enforce the contractual arrangements of a reinsurer or that may adversely affect the treatment of any claims by 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 WURA. OSFI does not intend to restrict the use of such clauses if they do not give preferential treatment over other claims under the scheme of distribution in the WURA. In the case of off-set clauses, for example, where the ceding company is a foreign insurance company authorized to insure risks in Canada, the reinsurer should not have any right of off-set against the obligations of the ceding company other than those related 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 Canadian assets of a foreign insurance company. OSFI also expects all reinsurance contracts to stipulate a choice of forum, a choice of law and the appointment of agents for service.

   If a FRI fails to meet the principles set out in Guideline B-3, OSFI indicates that it may not grant a capital/asset credit for the reinsurance arrangement or may use its discretionary authority under the *Insurance Companies Act* (Canada) to adjust the FRI's capital/asset requirements or target solvency ratios.

   A senior officer of a FRI should make an annual reinsurance declaration to the board or chief agent, as appropriate, to confirm that the FRI's reinsurance risk-management practices and procedures meet Guideline B-3, except as otherwise disclosed in such declaration.

Implementation

OSFI expects that each FRI will comply with Principle 1, including securing board approval of its RRMP, by July 1, 2011. Each FRI should file an approved copy of its RRMP with its designated OSFI relationship manager. Once the RRMP has been approved, each FRI is expected to implement and fully comply with the remaining principles and expectations of Guideline B-3, including the filing of its first reinsurance declaration to the board, by July 1, 2012. FRIs that have ceded business to an unregistered related party need not seek a new Superintendent approval if the only amendments to the contract are to reflect the expectations set out in this guideline.

With respect to existing multi-year contracts that do not naturally come up for renewal during the transition period, OSFI expects that FRIs will take all commercially reasonable efforts during the transition period to make these contracts compliant with Guideline B-3. The designated OSFI relationship manager will follow each FRI's efforts and progress.

Next Steps

We note that the insurance community has expressed considerable concern regarding the cost of complying with the RSA Guidance. We would be pleased to meet with you or representatives of your company early in 2011 to discuss the RSA Supporting Documentation and ways in which your company may be able to comply in a cost-effective and efficient manner with the new requirements.