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OSFI Finalizes New Guidance for Reinsurance Security Agreements in Canada: An Update*

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On December 24, 2010, the Office of the Superintendent of Financial Institutions (OSFI) released 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 July 1, 2011. OSFI expects companies to make all commercially reasonable efforts to replace existing multi-year agreements before January 1, 2012.

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 was 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, on which OSFI and the ceding company will be entitled to rely, asserting that such an interest has been created. Further, ceding companies will be expected to approve assets offered as pledge or withdrawn.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 when the

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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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* This bulletin is an update to Torys' bulletin of September 24, 2010, on this topic.

ceding company obtains and maintains 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. Such security interest can be obtained through a reinsurance security agreement, and the RSA Guidance provides minimum standards for such agreements.

Security Agreement Minimum Standards

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

- provide that the pledged assets (i) will be held in Canada in a location permitted under the provincial statute pursuant to which the security agreement is made and (ii) may not be used as part of a securities lending program;
- set out specific events of default and remedies and/or rights upon default;
- 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 either a specific amount or 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 addition, 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 that are necessary to ensure that the reinsurance contract and any disputes arising from the contract are subject to the laws and courts of a Canadian province or another legal jurisdiction that is, in the reasonable opinion of ceding company, equivalent or of greater reliability and certainty and that has a natural connection to the transaction.

In general, OSFI expects a higher level of due diligence by a ceding company in respect of any current or prospective reinsurance arrangement with an unregistered reinsurer or with a cedant that is not regulated by OSFI. This 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.

Legal Opinion

The legal opinion obtained by the ceding company must be provided by a lawyer who either has expertise in the area of personal property security legislation in the province where the assets are held or is reasonably relying on the legal opinions of those who have this expertise. The opinion, which may be subject to customary qualifications, 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 confirmation of the validity and enforceability of the security interest in the context of the applicable rules governing conflict of laws (Canadian counsel may elect to request a legal opinion from a lawyer who has expertise in this area in the jurisdiction of the unregistered reinsurer to ensure that the security interest is recognized in the foreign jurisdiction);
- an assertion that this security interest has priority over any other security interest; and
- an attached copy of all reinsurance arrangements to which the opinion applies.

Supervision of Reinsurance Security Agreements

OSFI eliminated the requirement for ceding companies to obtain approval from their relationship manager (or other person designated by OSFI) for the removal of pledged assets or for any transaction involving foreign currency assets. OSFI also opted not to 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 into the RSA Guidance 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 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.

OSFI will require monthly 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 have released the following draft documentation to comply with the RSA Guidance: (i) a form of Reinsurance Security Agreement, (ii) a form of Control Agreement, and (iii) forms of legal opinions from 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](#).

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. 