Canadian Institute of Actuaries | Institut canadien des actuaires

September 25, 2018

OSFI Reinsurance Review Committee
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Re: CIA Response to OSFI Reinsurance Framework

The Canadian Institute of Actuaries (CIA) is the national, bilingual organization and voice of the actuarial profession in Canada. Its members are dedicated to providing actuarial services and advice of the highest quality. The Institute holds the duty of the profession to the public above the needs of the profession and its members.

In June 2018, the Office of the Superintendent of Financial Institutions (OSFI) released a discussion paper on its reinsurance framework.

The CIA welcomes this review of the reinsurance framework. We note that the scope of the review includes both the property and casualty (P&C) and life sectors; however, the issues, considerations, and suggested changes have more impact on the P&C sector. If implemented, these are important changes to guidelines addressing prudential limits and restrictions and capital adequacy for P&C federally regulated insurers (FRIs).

At the request of the CIA, OSFI provided an extension to the Institute to provide comments by September 25, so that the CIA could garner further input from the membership at its Seminar for the Appointed Actuary, which took place September 17–18.

Structure of CIA Response

The CIA's Committee on Risk Management and Capital Requirements, Appointed/Valuation Actuary Committee, Committee on Property and Casualty Financial Reporting, and Enterprise Risk Management Practice Committee reviewed the paper. The attached template contains general comments as well as comments on specific proposals made in the consultation document.

The CIA appreciates the opportunity to provide feedback on the reinsurance framework.

Thank you for taking the time to consider our submission. If you have any questions, please contact Chris Fievoli, CIA staff actuary, communications and public affairs, at 613-656-1927.

Yours truly,

[original signature on file]

John Dark
CIA President

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Item #	Item Short Desc.	Phase	Life or P&C	Proposed Change	Comment
GENERAL	GENERAL	–	Both	–	Main observation: Measures/rules proposed in the paper could lead to the following: 1) **More concentration** of risk in the market since only certain federally regulated insurers (FRIs) that satisfy the rules would be able to issue high-limit policies. Small commercial-line insurers may pull out of the market. 2) **Less capacity** in the market as a result of having fewer participants. 3) **Higher costs** to consumers. This could be detrimental to Canadian policyholders. We recommend that OSFI perform a QIS to quantify the impact on the industry of the measures that OSFI has proposed in the paper that are quantitative in nature (e.g., high limit, 15 percent to 20 percent, etc.). The proposed approach seems to apply broad changes to the regulatory regime for reinsurance to address specific entities or particular phenomena in the market. This broad approach may lead to unintended consequences for the market as a whole to address concerns regarding the few. Would it be possible to narrow the scope of some of these reforms to more specific cases? The terms “associate” and “affiliate” appear to be used interchangeably. Also, what is a “reinsurance group”? These terms should be defined in the paper.
1	Guideline B-3 Revision	II	Both	OSFI intends to revise Guideline B-3 to clarify and enhance expectations related to the prudent	In general, there is a need to consider pros and cons of reinsurance as they relate to a total entity. Avoid

				management of reinsurance risks. This will include an expectation that an FRI establish reasonable limits on its overall reinsurance exposure to any one reinsurance entity or group, particularly where the cedant FRI relies on its reinsurance programs to underwrite high-limit policies. Guideline B-3 applies to all FRIs.	providing a financial incentive/reward from spreading reinsurance among many (potentially financially weaker) companies (this could increase risk in an attempt to reduce perceived concentration risk). As OSFI develops the revision to the guideline, differences between P&C and life contexts should be taken into account. For example, changes to reinsurance programs on the life side can be made only to new business going forward. The in-force is mostly locked in to past decisions. It could then take a very long time to rebalance a portfolio that is above a limit or becomes subject to a concentration charge.
2	High-limit policies (Guideline B-2 Revision)	II	P&C	OSFI intends to introduce a rule related to the issuance of high-limit policies by P&C FRIs. Under the proposed rule, the maximum policy limit that a P&C FRI could issue would depend upon its level of capital and excess collateral, as well as the diversity of its reinsurance counterparties. Annex I contains details about the proposed rule. The rule would be included in a revised Guideline B-2 for P&C. It would apply only to P&C FRIs that provide coverage directly to policyholders and to P&C FRI reinsurers in respect of direct business assumed by registered affiliates.	Q: On the graph on page 10, policy limits were used to demonstrate the trends for exposure vs. retention. Do policy limits accurately represent the true exposure? The view is that policy limits could overstate or understate risks. Is there a better metric that OSFI can consider? There is some concern that the new rule is moving very far into the tail. OSFI could consider a probability-based measure (e.g., a one-in-250-year or 500-year loss). At a minimum, we recommend that OSFI perform a QIS to quantify the impact on the industry. Q: Is it appropriate for companies to set their overall risk retention as a function of the single policy or handful of policies that represents its largest insured risks? If not, is it appropriate to compare the maximum policy limit to the retention and draw conclusions based on differences in their movement over time? Q: Another possibility may be to recognize a well-diversified program (through perhaps a capital credit), rather than introducing a limit?

					Q: What will be the frequency requirement for the Annex I stress scenario calculation: annually or quarterly? One concern is that the increased capital requirement outlined in Annex I could lead to a lack of capacity for some types of risks including nuclear, oil, and gas. The new rule could limit Canadian insurers' ability to write large-limit policies if there are no available financial resources in Canada to do so. The high limit requirements and volatility of such business means that only globally diversified balance sheets can efficiently absorb such exposures by accepting such risks from various geographical areas of the world. OSFI could potentially consider the credit rating and jurisdiction of the unregistered reinsurers in the formula. If the unregistered has a strong rating and is regulated in a market with strong solvency regulation (e.g., Solvency II), a credit could be considered in the formula. OSFI proposed other measures to cover the shortfall in financial resources, such as using subscription policies. However, insurers in Canada already use subscription policies in writing large risks, so this will not address the shortfall if the new formula is implemented and additional capital will be required. Moreover, very large risks are already part of the global diversification that is favourable to Canada. Overall, we think this formula could limit the ability for FRIs to write large risks, and we recommend some future investigation on the rule and the formula.

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<tr><td>3</td><td>P&C FRI reinsurers</td><td>III</td><td>P&C</td><td>OSFI is also considering the merits of developing a rule to address similar concerns with P&C FRI reinsurers, and welcomes industry’s views in that regard. The potential development of a rule specific to FRI reinsurers would form part of Phase III.</td><td>Same concerns as above.

Reinsurers currently actively manage their treaty limits, exposures and accumulations (geographic concentrations of exposure). They do this on a local and global basis. Is it necessary for OSFI to superimpose a Canadian regulatory requirement? If so, could this be handled through disclosures of these practices to OSFI, rather than by applying this type of rule?</td></tr>
<tr><td>4</td><td>Counterparty credit risk</td><td>I</td><td>P&C</td><td>In the 2019 MCT Guideline, OSFI intends to introduce counterparty credit risk factors for receivables and recoverables from associated FRIs. The proposed credit risk factors are equal to those applied to unassociated FRIs, as follows:

<table><tr><th>Balance Sheet Asset</th><th>Risk Factor</th></tr><tr><td>Insurance receivables</td><td>0.7%</td></tr><tr><td>Unearned premium recoverables</td><td>2.5%</td></tr><tr><td>Unpaid claim recoverables</td><td>2.5%</td></tr></table>
There is no intention at this time to apply counterparty credit risk charges to cessions within an OSFI approved intercompany pooling arrangement.</td><td>Q: Did OSFI consider the possibility of having different risk factors for associated vs. unassociated companies? For example, one could argue that with associated entities the cedant may have a better line of sight into the associated reinsurer’s operations and perhaps the proposed risk factors should be different from unassociated entities. Conversely, as another example, regulators may be more concerned about the cedant being restrained in the selection of its reinsurers, and in the ability to seek legal recourse when in a dispute with an associated company.

It was noted that on page 12 there is a statement that “there is no intention at this time to apply counterparty risk charges to cessions within an OSFI approved intercompany pooling arrangement”. Specifically, there is a concern with the phrase “at this time”. Does OSFI contemplate applying risk charges to cessions within an OSFI-approved intercompany pooling arrangement at some point in the future?</td></tr>
<tr><td>5</td><td>Funds withheld</td><td>I</td><td>Both</td><td>As part of Phase I of its reinsurance review, OSFI intends to remove the funds withheld restriction for domestic P&C FRIs and recognize the amount of funds held to secure payment from reinsurers that are associates and non-qualifying</td><td>No comments.</td></tr>
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				subsidiaries. Therefore, OSFI plans to allow a credit in the calculation of the margin required for risks ceded to unregistered associated reinsurers. However, conditions will be added to the MCT Guideline (and also to LICAT) in order to recognize funds withheld payables for cessions to both registered and unregistered associated and non-associated insurers. The proposed conditions, which would apply to all FRIs effective January 1, 2019, are:	
			P&C	For the MCT Guideline: In order for a ceding insurer to obtain credit for funds held under a funds withheld reinsurance arrangement, the arrangement must not contain any contractual provision that would require payment of funds withheld to the reinsurer before all subject policies have expired and all claims settled (e.g., an acceleration clause). Furthermore, the ceding insurer may not provide non-contractual or implicit support, or otherwise create or sustain an expectation that any funds withheld could be paid to the reinsurer before all subject policies have expired and all claims settled.	Funds withheld should be allowed to decline to match the underlying liability as per the reinsurance treaty. It might be difficult to demonstrate the second sentence (i.e., that we have not provided “non-contractual or implicit support, or otherwise create[d] or sustain[ed] an expectation”).
			Life	For LICAT: In order for a ceding insurer to obtain credit for funds held under a funds withheld reinsurance arrangement, the arrangement must not contain any contractual provision that would require payment of funds withheld to the reinsurer before the end of the reinsurance term (e.g. an acceleration clause). Furthermore, the ceding insurer may not provide non-contractual or implicit support, or otherwise create or sustain an	Funds withheld should be allowed to decline to match the underlying liability as per the reinsurance treaty. It might be difficult to demonstrate the second sentence (i.e., that we have not provided “non-contractual or implicit support, or otherwise create or sustain an expectation”).

				expectation that any funds withheld could be paid to the reinsurer before the end of the reinsurance term.	
6	Margin for reinsurance ceded to unregistered reinsurers	I	P&C	In the 2019 MCT Guideline, effective January 1, 2020, OSFI intends to increase the margin required for reinsurance ceded to an unregistered reinsurer from 15 percent to 20 percent in order for a FRI to obtain full capital/asset credit for that reinsurance. This change is part of Phase I of OSFI's reinsurance review.	Q: Could OSFI share the background behind the 20 percent selection for the margin? How was it calibrated? Q: There could be a significant increase in trust funds on a large loss (e.g., Fort McMurray wildfires). While this may be answered through a QIS, what is OSFI's view on the impact of such an increase? Q: Would the new margin apply retroactively? This could be a problem, as existing reinsurance contracts may require collateral at the 115 percent requirement. How could the insurer force the reinsurer to put 120 percent collateral on claims under these existing agreements? OSFI states: "*If a FRI cedes risks to another FRI, the latter must increase its capital (or vested assets) held in Canada because it is exposed to more insurance risks, and has increased its potential insurance liability. The net result of this is a 'balancing out', between the two insurers, of the insurance risk and the capital in Canada to support it.*" "Diversification credit" is given to the latter FRI in the calculation of capital required. Q: Was diversification credit considered in the calculation of the proposed 20 percent margin? Q: Assuming the rationale for increasing this charge was to bring the collateral requirements in line with the capital levels implied by the MCT ratios maintained by

					Canadian insurers. If the effect of these proposed reforms (higher risk charges, higher reinsurance costs, removal of 10 percent consolidated/worldwide capital in earthquake reserve) is to lower the overall level of MCT ratios in Canada, will this charge be reduced accordingly?
7	EQ reserve/10 percent worldwide capital	III	P&C	OSFI welcomes views from stakeholders on the removal of the 10 per cent of consolidated/world-wide capital and surplus as an eligible financial resource for domestic and foreign FRIs in the calculation of the earthquake reserve. OSFI also welcomes views on whether alternatives exist for addressing the issues raised in this section. Any changes in respect of this matter will be part of Phase III of OSFI's reinsurance review.	In cases where the probable maximum loss (PML) exceeds the current reinsurance limit, the FRIs would be required to add an additional 1.25 times of their catastrophe loss net retention as capital (margin) required in their MCT/BAAT calculation. Based on our quantification and using limited publicly available information, assuming the removal of the 10 percent of consolidated/worldwide capital and surplus had been effective and nothing else had been changed as of December 31, 2017, the total Canadian P&C consolidated MCT could have been significantly lower than its actual level. We suggest that OSFI quantifies the industry MCT/BAAT impact as a consequence of the increase in reinsurance limits purchased (e.g., via QIS). If OSFI decides to proceed with this reform, it is important that, if the perceived double-counting of capital is removed, the 10 percent capital should be allowed to continue to contribute to the reduction of required capital (i.e., it should be removed from the available capital), rather than allowing the required capital to increase and keeping the 10 percent capital in the available capital. Also, many companies are not using the full 10 percent capital credit, so this elimination of double-counting should be restricted only to the capital amount applied

					to reduce required capital (often far less than 10 percent of consolidated/worldwide capital). The current MCT/BAAT does not require specific capital (margin) for the catastrophe loss net retention due to any perils. If the 10 percent of capital and surplus is removed from eligible financial resources, there would be a required earthquake (EQ) reserve for an FRI with a net retention after its use of reinsurance and other forms of risk transfer. This EQ reserve would result in a MCT/BAAT Capital (Margin) Required for the Insurance Risk – Catastrophes component. We would recommend that OSFI consider the consistency of capital (margin) required for different catastrophe perils and diversification between perils.
8	Reinsurance concentration risk charge/limit	III	Both	OSFI welcomes views from stakeholders on considerations related to the introduction of a reinsurance concentration risk charge/limit. Any such change would be part of Phase III of OSFI's reinsurance review.	There are some concerns with the approach to concentration risk. Consideration could be given to the following: Credit rating: – The concentration risk charge should not be overly penalizing; otherwise, FRIs may be forced to purchase reinsurance from lower-rated reinsurers, reinsurers with lower solvency ratios, or unregistered reinsurers. The requirement for more market participants could result in narrower coverage and contractual provisions, as consensus is sought amongst more parties. – Having more reinsurers does not necessarily lead to risk reduction as this ignores counterparty financial strength. There should be a consideration of the credit-worthiness of the

					counterparties. Reducing concentration but having riskier (lower-rated) partners would be counterproductive. – Differentiated charges for counterparty credit risk depending on the financial strength of the reinsurer/counterparty should be explored. Such a measure would encourage FRIs to select financially strong counterparties instead of leading them towards less-capitalized carriers which might offer cheaper but less secure protection. Geographical concentration: – The geographical diversification should be considered. For example, where does the risk ultimately reside, and is the risk being retroceded? – Ultimately, fewer better-rated global well-diversified reinsurers would be less risky than more partners that are less capitalized/less diversified. Introducing a concentration risk charge may increase the reinsurance expense for smaller players. In the paper, OSFI did not specify whether this applies to unregistered reinsurers only, or to all reinsurers. This should be clarified. It would also be worth clarifying whether this charge will apply to quota share and per-risk/CAT treaty together, or by type of reinsurance structure. With respect to unregistered reinsurers, consideration

					could be given to the regulatory jurisdiction of the entity. There could be merit in a similar approach to Solvency II, where regulatory regimes may be classified as "equivalent" when assessing the financial position of reinsurers. Reinsurers operating under equivalent regulatory regimes can reasonably be expected to provide the same level of protection to their cedants and to Canadian customers as reinsurers operating in Canada. The long-term nature of life insurance products means that ceded reserves build up over time. With these products, concentration risk might not be apparent at the beginning of the contract, and can increase or change over time. OSFI references Australia, the UK, and other regulatory regimes, but the products in those regimes might be different from those sold in Canada. Reducing concentration (increasing the number of reinsurers) may increase operational risks and costs for reducing potential/perceived risk. Does this make the industry less efficient and less attractive? In the Canadian life insurance space, there are only a few players. These entities are also subject to stringent regulatory requirements and are required to hold adequate capital, so why is concentration risk in Canada an issue? Life: it should be noted that under LICAT there is already a reinsurance counterparty risk charge.
9	Worldwide treaties	II	Both	OSFI invites views on its intention to amend Guideline B-3 to provide additional guidance regarding worldwide treaties, and to clarify that OSFI expects reinsurance payments to flow	Per OSFI's 2017 Memorandum to the AA: "*the Appointed Actuary should identify whether the terms and conditions of the reinsurance/retrocession*

				directly to a FRI in Canada. OSFI may also amend its regulatory data forms to capture more information about the use of worldwide treaties. These changes would be made as part of Phase II of OSFI's reinsurance review.	*arrangements require payments to be made from the reinsurer/retrocessionaire directly to the ceding company in Canada, including in the event of the cedant's insolvency*." Given that this is already a requirement within the AA report, we believe this could remain principle-based and be further tested under ORSA and considered when setting capital targets rather than imposing additional rules. If companies are not taking capital credit, then it is better to have these coverages in place than not to have them at all.
10	Quota share treaties	II	Both	OSFI invites views on its intention to strengthen Guideline B-3 with respect to the management of the risks related to significant quota share treaties, and the expectation that FRIs not cede substantially all of their risks. In particular, OSFI is seeking views on the concept of "substantially all of [an insurer's] risks" and how this concept could be expressed in a more objective manner. Guideline B-3 is being amended as part of Phase II of OSFI's reinsurance review.	Q: Does OSFI share the same concern whether the quota share treaty is placed with a registered or an unregistered reinsurer? How about a quota share with an affiliated reinsurer or an intercompany pooling arrangement? This should be clarified. OSFI is seeking views on the concept of "substantially all of an insurer's risks" and how this concept could be expressed in a more objective manner. Our view is that being more objective or more prescriptive would go against OSFI's intent of being principle-based. Our recommendation is to leave it principle-based, as OSFI can intervene if necessary. A scenario where quota share coverage becomes unavailable when purchased from a multinational reinsurance group could be very remote. There may be blocks of business that are almost totally reinsured for various historical reasons. The

					development of any hard rule around “substantially all” should consider retroactive impacts.
11	Fronting arrangements	II	Both	OSFI invites views on its intention to revise Guideline B-3 to clarify its expectations related to fronting arrangements. OSFI plans to include an expectation in Guideline B-3 for FRIs to take reasonable measures to satisfy themselves that legal risks related to contract wording in respect of reinsurance arrangements with captive UUFIs are appropriately managed. OSFI also intends to apply other relevant reinsurance measures identified in this paper to fronting arrangements (e.g., large exposures). Guideline B-3 is being amended as part of Phase II of OSFI’s reinsurance review.	There is not much difference between significant quota share and a fronting arrangement (except who ultimately holds the risk). Ultimately, the guideline should not favour one over the other. Fronting should not be eliminated as a business model. There are benefits to fronting, as discussed in the OSFI paper. Unusual/exceptional arrangements should be handled on a case-by-case basis.
12	Ceding to home office	II	Both	OSFI invites comments on the practice of ceding to home office, by both life and P&C FRIs, including on the prevalence of the practice. In particular, OSFI is seeking views on possible measures to address the concerns described above, including those measures described above. Guideline B-3 is being amended as part of Phase II of OSFI’s reinsurance review.	Q: Should consideration be given to credit-worthiness and also how diversified the home office is? Q: If the ceded block is backed by a reinsurance security agreement (RSA), is there a concern?
13	Revised DA 21 Transaction Instructions	II	Both	The Transaction Instruction is being amended as part of Phase II of OSFI’s reinsurance review. The intent is to collect more information on, and to consider, both the unregistered related party reinsurer and the group to which it belongs. This change would recognize that the financial strength of both the related party reinsurer and its group are generally materially correlated. In this regard, OSFI would generally only recommend that the Superintendent grant an approval where both the related party reinsurer	No comments.

				and the group to which it belongs appear to be in sound financial condition. Conversely, OSFI may recommend that the Superintendent revoke an approval if it is subsequently determined that either the related party reinsurer, or the group to which it belongs, no longer appear to be in sound financial condition.	
14	ILS	II	Both	OSFI invites comments on its intention to revise Guideline B-3 to include its expectations for FRIs that cede risks to reinsurers that rely upon ILS. Guideline B-3 is being amended as part of Phase II of OSFI's reinsurance review. OSFI has received a growing number of inquiries related its expectations in respect of insurance-linked securities (ILS). ILS are financial instruments used by insurers to transfer insurance risks to capital markets. They may include, among other things, catastrophe bonds, swaps, industry loss warranties, derivatives contracts and sidecars.	Q: "OSFI expects a FRI to conduct a commensurately higher level of due diligence in respect of its reinsurance counterparty […] that itself relies on non-traditional sources of funding." What constitutes a sufficient level of due diligence in this case? Q: Is the reliance by a counterparty on ILS instruments viewed by OSFI as unfavourable? If so, given that a growing number of reinsurers rely on ILS solutions to hedge their assumed risk, will this put pressure on Canadian cedants to work with a shrinking number of counterparties, causing them to be subject to a larger concentration charge?