Canadian Institute of Actuaries | Institut canadien des actuaires

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Office of the Superintendent of Financial Institutions (OSFI)
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Subject: OSFI Draft Guideline B-2 (*Property and Casualty Large Insurance Exposures and Investment Concentration*)

The Canadian Institute of Actuaries (CIA) welcomes this opportunity to offer feedback on Draft Guideline B-2 issued by OSFI in November 2020.

The Discussion Paper on OSFI's Reinsurance Framework released in June 2018 outlined proposed changes to the supervisory framework. Some principles presented in this discussion paper were included in Draft Guideline B-3 (*Sound Reinsurance Practices and Procedures*) published in June 2019. The CIA provided comments on the reinsurance discussion paper in September 2018 and also provided comments on Draft Guideline B-3 in August 2019.

The scope of Draft Guideline B-3 is limited to reinsurance practices and procedures, while the scope of Draft Guideline B-2 includes large insurance exposures, as well as investment concentrations. With respect to large limits and the reinsurance protection required to support those exposures, Draft Guideline B-2 is seen as a softer version of OSFI's Reinsurance Framework (i.e., a lower capital impact overall for the industry).

The CIA Committee on Risk Management and Capital Requirements formed a working group to review Draft Guideline B-2 and provide questions and comments to OSFI. Members of the CIA's Property and Casualty Insurance Financial Reporting Committee were also involved in the discussion.

The working group has identified some areas of concern and some instances where clarification would be required in Draft Guideline B-2.

1. **The test proposed is not statistically based**

   Under the test proposed in Draft Guideline B-2, insurers would need to test the occurrence of a maximum loss on a single insurance exposure and, at the same time, the failure of an individual unregistered reinsurer.

   The proposed adverse scenario is less severe than what was implied by OSFI's Reinsurance Framework (e.g., three largest policy limit losses PLUS the failure of the company's largest unregistered reinsurer on each policy, i.e., up to three unregistered reinsurers). However, it should be noted that the severity of this scenario could be materially different from one insurer to another. A statistical approach would provide a more level playing field for insurers.

2. The test does not take into account the financial rating of the reinsurer

Insurers are required to test the sudden failure of an individual unregistered reinsurance counterparty. However, nowhere in the guideline, is the financial strength of the unregistered reinsurer taken into account. The only elements taken into account are any acceptable counterparty risk mitigation techniques.

The CIA believes that consideration could be given to the rating of the counterparty unregistered reinsurers. One option available would be to assume partial default of the unregistered reinsurer ranging from 0% to 100% depending on its financial strength rating.

Each FRI is required to maintain a Reinsurance Risk Management Policy. The test proposed in Draft Guideline B-2 represents an additional safeguard. However, Draft Guideline B-2 does not currently encourage the purchase of reinsurance with a stronger reinsurer.

3. The determination of a "single insurance exposure"

Based on Draft Guideline B-2, the gross underwriting limit policy should define what constitutes a single insurance exposure. Insurers should calculate the maximum loss on a single insurance exposure without regard to the probability of the loss event occurring.

A principle-based approach is generally preferred over a more prescriptive approach as long as the range of practice does not vary extensively. The table at the bottom of page 2 provides some guidance on how to assess the single insurance exposure for the following lines of business: property, credit, surety, and title. However, judgment and interpretations could lead to widely differing determinations of single insurance exposure between insurers with similar risks. Once the guideline becomes effective, OSFI may need to consider the implementation of audits and trainings to ensure that similar risks are accounted for in a consistent fashion across the industry.

4. The distinction between insurance companies and P&C FRI subsidiaries in Canada should be clarified by adding definitions of these terms in Annex 1, including eligible parent company relationships

The amount of exposure concentration permitted for an FRI satisfying the criteria set out in Annex 2 is 100% of total capital available, if it is considered to be a P&C FRI subsidiary in Canada, but only 25% of total capital available if it is considered to be an insurance company.

This term "P&C FRI subsidiary in Canada" is not clearly defined in this guideline. We believe it would be important to provide further guidance on how a "parent company" is defined for the purpose of Annex 2. Examples of parent company relationships may include:

- another Canadian FRI;
- a foreign insurer;
- a Canadian holding company; and/or
- a foreign holding company.

Given the materiality of the difference in the proportion of capital available permitted to support the maximum net retention and associated largest unregistered reinsurance exposure, explicit guidance should be provided on these terms.

5. **The criteria set out in Annex 2 of Draft Guideline B-2 permitting subsidiaries and branches to expose up to 100% of their total capital available (or net assets available in the case of a foreign branch) against their net retention plus largest net counterparty unregistered reinsurance exposure could be clarified**

   If the criteria listed in Annex 2 of Draft Guideline B-2 are not met, the maximum net retention and associated largest unregistered reinsurance exposure under this test would be limited to 25% of the company's total capital available (or net assets available in case of a foreign branch).

   Further clarifications, and possibly real-life examples, for the following criteria could be beneficial in interpreting the guideline:
   - *The parent company is a continuing source of financial strength for the subsidiary, and*
   - *There are no legal, regulatory, statutory or fiscal restrictions in the parent's (or home office's) home jurisdiction to obtaining capital (funds) from the parent (home office) in the event of losses.*

6. **The limit of 25% of capital available in Draft Guideline B-2 vs. 100% of excess capital in OSFI's Reinsurance Framework represents a significant decrease in acceptable exposure concentration**

   In Draft Guideline B-2, the largest maximum loss on a single insurance exposure (assuming the default of the company's largest unregistered reinsurer on that insurance exposure) is compared against 25% of the capital available.

   In OSFI's Reinsurance Framework, three tests were proposed. Under the first scenario proposed ("Test #1"), the exposure concentration risk of an insurer was assessed under a single largest policy limit loss scenario along with the failure of the company's largest unregistered reinsurer covering that policy:

L1 <= [Excess over 100% MCT or BAAT (30.61, line 79)] + C1 - Max(0,R1 – E1)

   The test proposed under Draft Guideline B-2, which is based on 25% of capital available, is therefore more severe than Test #1 in OSFI's Reinsurance Framework, which is based on the excess capital (i.e., Excess over 100% MCT).

   The following table provides a comparison of the company's capital available that would be available to support the insurance exposures under each of these two tests. In this table, the term "backed" is used to denote satisfaction of the criteria listed in Annex 2 of Draft Guideline B-2 and "not backed" is used to denote failure to satisfy the Annex 2 criteria.

Maximum Loss on Single Insurance Exposure
% of Available Capital

Current	Companies		Branches/Subsidiaries		
	Original	New Draft	Original	New Draft Proposal	
MCT	Proposal	Proposal	Proposal	Backed	Not Backed
150%	33.3%	25.0%	33.3%	100.0%	25.0%
175%	42.9%	25.0%	42.9%	100.0%	25.0%
200%	50.0%	25.0%	50.0%	100.0%	25.0%
225%	55.6%	25.0%	55.6%	100.0%	25.0%
250%	60.0%	25.0%	60.0%	100.0%	25.0%
275%	63.6%	25.0%	63.6%	100.0%	25.0%
300%	66.7%	25.0%	66.7%	100.0%	25.0%
350%	71.4%	25.0%	71.4%	100.0%	25.0%
400%	75.0%	25.0%	75.0%	100.0%	25.0%
450%	77.8%	25.0%	77.8%	100.0%	25.0%
500%	80.0%	25.0%	80.0%	100.0%	25.0%

For example, for an insurer with an MCT ratio of 200%, the excess capital which could be exposed to the largest policy limit under Test #1 from OSFI's Reinsurance Framework would represent (200% - 100%) / 200% = 50% of the company's total capital available. In contrast, under the test proposed in Draft Guideline B-2, the same company could only use 25% of its total capital available to support the maximum loss on its single insurance exposure by class of insurance, irrespective of the level of its MCT/BAAT ratio and excess capital/assets.

7. **An insurer may need to inject up to 4x the additional limit in capital to support a single risk.**

For a Canadian-domiciled insurance company, its net retention, plus its largest net counterparty unregistered reinsurance exposure, due to the occurrence of a maximum loss on a single insurance exposure, should never exceed 25% of capital available. However, as an example, suppose that a company has significant excess capital, e.g., 80% of available capital, and identifies a large risk underwriting opportunity within its risk tolerance, but this single risk represents 50% of its available capital, i.e., less than its excess capital. Under the proposed rule, this very well capitalized company would have to double its capital in order to underwrite that single risk.

In addition, having thus strengthened its capital level, this company would now have a strong incentive to underwrite a significant volume of similarly large risks to support the decision to inject this additional capital into the company. This incentive to underwrite many large risks, arising from having written one such risk, will likely serve to increase the overall proportion of large risks in a given company's portfolio, which may be counter to OSFI's intention in establishing this rule.

The CIA appreciates the opportunity to provide these comments, and we would welcome further discussions throughout this process. If you have any questions, please contact Chris Fievoli, CIA Staff Actuary, Communications and Public Affairs, at 613-656-1927 or chris.fievoli@cia-ica.ca.

Sincerely,

[original signature on file]

Michel St-Germain, FCIA
President, Canadian Institute of Actuaries

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