

Reinsurance Governance and Regulation

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Robert McDowell
Koker Christensen

Background and Context

- Policy review of reinsurance by OSFI
- International initiatives relating to reinsurance
- OSFI's concern regarding governance and risk management relating to reinsurance
- The financial crisis has influenced OSFI's views
- *Response Paper: Reforming OSFI's Regulatory and Supervisory Regime for Reinsurance*

The Current Regime *Reinsurance Regulation and Guidance*

- 25% limit on unregistered reinsurance (P&C)
- 75% fronting limit (P&C)

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The Current Regime *Reinsurance Regulation and Guidance (cont)*

- Collateral requirements in relation to unregistered reinsurance
 - Straightforward collateral regime
 - No differentiation between reinsurers of different financial strength
 - As a result of capital and collateral requirements, OSFI regulates both registered and unregistered reinsurance

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The Current Regime *Reinsurance Regulation and Guidance* (cont)

- Restrictions on use of letters of credit as collateral
 - Recently increased from 15% to 30%

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The Current Regime *Reinsurance Regulation and Guidance* (cont)

- OSFI Draft Guideline B-13
 - Risks arising from the use of informal documents
 - Expectations regarding the timing of executing informal documents and final agreements
 - Issues relating to the wording of reinsurance agreements

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The Current Regime *Reinsurance Regulation and Guidance* (cont)

- OSFI Guideline B-3 (revoked)
 - Addressed unregistered reinsurance
 - Applied to life companies only
 - Stated that a life company must have written policies, approved by the Board or a committee, establishing its reinsurance practices
 - Guideline B-3 was revoked because it was seen as inadequate

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The Current Regime *Governance and Risk-Management*

- The Supervisory Framework
- OSFI's risk-based and reliance-based approach
- Focus of risk-management is identifying, assessing and mitigating risks

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The Current Regime *Corporate Governance Guideline*

Effective Board performance

- Hallmarks of effective governance by the Board include judgement, initiative, responsiveness and operational excellence

The Current Regime *Corporate Governance Guideline (cont)*

Risk Management

- Institutions should have integrated policies that apply to the company's significant activities regarding the corporate philosophy on risk management, the company's permissible exposure to risk, objectives of risk management, delegation of authorities and responsibilities, and processes for identifying, monitoring and controlling/managing risk

The Current Regime *Corporate Governance Guideline (cont)*

Role of the Board in risk management

- Have a general understanding of the types of risks to which the company may be exposed and of the techniques used to measure and manage those risks
- Review and approve the overall risk philosophy and risk tolerance of the company. Be aware of material changes to the company's business strategies or risk tolerance and the limits within which individuals are authorized to act
- Review and approve significant policies or changes in policies for accepting, monitoring, managing and reporting on the significant risks to which the company is exposed

The Current Regime *Corporate Governance Guideline (cont)*

- Require that management have a process for determining the company's desired level of capital, taking into account risks assumed, and for ensuring that capital management strategies are in place
- Require timely and accurate reporting on significant risks faced by the company, the procedures and controls in place to manage these risks, and the overall effectiveness of risk management processes
- The Board should be aware of, and satisfied with, the manner in which material exceptions to policies and controls within the institution are identified and monitored, the nature of reporting to the Board and the consequences within the institution, when exceptions are identified

The Current Regime *Corporate Governance Guideline (cont)*

- Assure itself that risk management activities of the institution, however organized, have sufficient independence, status and visibility and are subject to periodic reviews
- Include in its reviews of changes in strategies or new business initiatives, a review of requisite/related changes in risk management and controls

The Current Regime *Corporate Governance Guideline (cont)*

Internal controls

- Internal controls encompass the policies, processes, culture, tasks and other aspects of an institution that support the achievement of its objectives

The Current Regime *Corporate Governance Guideline (cont)*

The Board and internal control mechanisms

- The Board is responsible for ensuring that a proper system of internal controls is established and maintained
- It is the role of the Board to review the system of internal controls to determine that it works as expected and remains appropriate

The Current Regime *Corporate Governance Guideline (cont)*

Independent oversight functions

- Internal oversight functions: internal audit and compliance, appointed actuary, and risk management
- External oversight function: external auditor
- These functions are to provide independent and objective assessments, help validate whether internal controls are working and whether the institution's operations and results are reliably reported

The Current Regime *Corporate Governance Guideline (cont)*

Role of the Board

- Actively exercise its responsibility for recommending a suitable nominee for appointment as external auditor
- Take an active interest in the selection of heads of internal oversight functions
- Review the mandates and organizational structures of the internal control functions and approve any major changes thereto

The Current Regime *Corporate Governance Guideline (cont)*

- Regularly review the scope of the proposed activities of these internal functions and of the external auditors
- Require that those responsible for fulfilling these functions are independent
- Require that internal oversight providers and the external auditor have unrestricted access to the Board, including periodic meetings without management present

The Current Regime *Corporate Governance Guideline (cont)*

- Satisfy itself that those responsible for fulfilling these functions have the necessary resources and authority and receive support from senior management; seek assurances that work plans provide adequate coverage in light of the risks faced by the institution
- Satisfy itself that remuneration of key individuals and incentives are appropriate

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The Current Regime *Corporate Governance Guideline (cont)*

- Discuss key findings of the reports produced by these functions, understand how material disagreements are dealt with and follow-up on concerns raised by these functions
- Regularly review the nature of the function being carried out as well as the effectiveness and independence of those fulfilling these functions

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Governance, Risk Management and Compliance

Governance

- Refers to oversight mechanisms, including the processes, structures and information used to direct and oversee the management of an institution
- Encompasses the means by which the Board and senior management are held accountable for their actions and for the establishment and implementation of oversight functions and processes

Governance, Risk Management and Compliance

Risk Management

- Refers to the process of identifying, assessing and mitigating the risks to which a company is exposed
- Also refers to the independent function responsible for planning, directing and mitigating the impact on a company of risks arising from its operations

Governance, Risk Management and Compliance

Enterprise Risk Management (ERM)

- A holistic and integrated approach to risk management
- Casualty Actuarial Society Committee on Enterprise Risk Management definition:

“ERM is the discipline by which an organization in any industry assesses, controls, exploits, finances and monitors risks from all sources for the purpose of increasing the organization’s short- and long-term value to its stakeholders.”

Governance, Risk Management and Compliance

Compliance

- Compliance refers to the process for ensuring compliance with legal and regulatory requirements
- Compliance also refers to the independent function responsible for setting policies and procedures for adherence to legal and regulatory requirements, monitoring an institution’s compliance with these policies and procedures, and reporting on compliance matters to senior management and the Board

OSFI's Discussion Paper

- Provided an overview of Canada's reinsurance regime, summarized OSFI initiatives, and sought industry input
- Set out five guiding principles:
 1. Policyholders of federally regulated insurers must be adequately protected
 2. Regulation and supervision should be proportionate to risk
 3. OSFI must have the ability to effectively assess risks
 4. A level playing field among financial sector players should be maintained where appropriate
 5. Effective coordination with other insurance regulators is critical

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OSFI's Response Paper

Major Themes

1. Move from a rules-based approach to a principles-based approach
2. Ensuring regulating "neutrality" between registered and unregistered reinsurance
3. Harmonization of requirements applicable to Life and P&C sectors
4. Need for enhanced governance

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OSFI's Response Paper *Industry Concerns*

- Is this necessary given existing risk-management guidance?
- OSFI's guidance may be overly prescriptive (although OSFI says that it will take a principles-based approach)
- OSFI may regulate to the highest common denominator
- Will requirements driven by Life or P&C be applied to both sectors?
- If new requirements are too high, may discourage the use of reinsurance

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OSFI's Response Paper *Elimination of Certain Limits on Reinsurance*

- Elimination of 25% limit on unregistered reinsurance (P&C)
 - Once Guideline B-3 is revised and reinstated and insurance companies are required to report to OSFI, if requested, a description of all reinsurance arrangement
- Elimination of 75% fronting limit (P&C)
 - Once Guideline B-3 is revised and reinstated, insurance companies are required to disclose all fronting/ceding arrangements, if requested, and a minimum operational risk capital requirement is imposed on the P&C sector in the MCT

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OSFI's Response Paper *Changes to Guideline B-3*

- OSFI Guideline B-3 will be expanded and reinstated
- Guideline B-3 will be renamed *Guideline on Sound Reinsurance Practices and Procedures*
- Key principles: reinsurance strategy, due diligence, senior responsibility, certainty of coverage, and policyholder protection

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OSFI's Response Paper *Changes to Guideline B-3 (cont)*

1. The Guideline on Corporate Governance applies to all insurance companies with respect to effective risk management practices and procedures
 - The Response Paper notes in the context of internal controls that pure fronting is not acceptable; concerns have been raised that this is overly prescriptive and vague

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OSFI's Response Paper *Changes to Guideline B-3 (cont'd)*

2. Ceding companies should have a sound and comprehensive reinsurance risk management strategy and processes
 - Overall reinsurance strategy, processes and material reinsurance contracts should be reviewed and approved by the Board – this is a high standard
 - Particular attention should be paid to the management of potentially large risk exposures under catastrophe reinsurance arrangements

OSFI's Response Paper *Changes to Guideline B-3 (cont)*

3. Ceding companies should perform an adequate level of due diligence on their reinsurance partners
 - Thorough evaluation of the financial ability of reinsurers to meet claims obligations
 - This will result in significantly more work
 - Consider the reinsurer's retrocession arrangements
 - Concerns have been raised that this is very prescriptive and may not be workable
 - Question has been asked as to why retrocession arrangements are being singled out

OSFI's Response Paper *Changes to Guideline B-3 (cont)*

4. There should be clarity and certainty in insurance coverage under the terms of the reinsurance agreement
- OSFI is sending a message that this is an area of weakness
 - Concerns about clarity and certainty should be addressed by having final signed agreements soon

OSFI's Response Paper *Changes to Guideline B-3 (cont)*

5. Ceding companies should not be adversely affected by the terms of a reinsurance agreement
- Insolvency clause
 - Ensure provisions that could effectively give certain creditors preferential treatment over policyholders are understood and prudent (cut-through and offset provisions)
 - Arrangements under reinsurance contracts should not raise legal questions regarding the availability of funds in the event of reinsurer insolvency

OSFI's Response Paper *Changes to Guideline B-3 (cont)*

- Reinsurance agreements should be subject to Canadian laws and disputes should be heard in a Canadian court
- Availability of a capital credit will be contingent on meeting expectations set out in the Guideline B-3

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OSFI's Response Paper *Risk Management and Due Diligence*

- Incorporation of reinsurance risk management in companies' integrated risk management framework (i.e., Enterprise Risk Management)
- Due diligence – assessing risks

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OSFI's Response Paper *Changes to MCT and MCCR*

- Changes to MCT and MCCR
 - Currently, the Life sector has a minimum capital charge and the P&C sector has a charge for counterparty credit risk
 - Minimum operational risk capital requirement to be imposed on the P&C sector in the MCT Guideline
 - Counterparty risk capital charge will be developed and applied to the Life sector in the MCCR

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OSFI's Response Paper *Changes to MCT and MCCR (cont)*

- Some industry players have raised the concern that it is inappropriate to impose a counterparty risk capital charge on the Life sector as this is an unnecessary frictional cost of reinsurance

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OSFI's Response Paper *New Disclosure Requirements*

- Insurance companies will be required to report to OSFI, if requested, a description of all reinsurance arrangements, including the levels of reinsurance and the proportion of registered and unregistered reinsurance
- Insurance companies will be required to disclose all fronting/ceding arrangements to OSFI, if requested

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OSFI's Response Paper *Regulatory Approvals Regime*

- A new reinsurance approval framework was brought into force in 2007
- No changes planned at this time
- OSFI will re-examine approval requirement for unregistered related party reinsurance

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Risks presented by Reinsurance

- Counterparty risk
 - Risk that a reinsurer will not honour its obligations
 - Can occur from two key sources: (i) the insolvency of the reinsurer, and (ii) the reinsurer's unwillingness to pay
 - Factors that may increase counterparty credit risk:
 - Reinsurers in run-off
 - Long-tail lines of business
 - Distance from regulatory authority (i.e., unregistered reinsurance)¹

¹ From PACICC's paper "(Re) Assurance of Solvency: Reinsurance assets in insurance company liquidations"

Risks presented by Reinsurance

- Assessing counterparty risk goes beyond relying on rating agencies and requires due diligence on the reinsurer's financial ability to meet claims
- OSFI's Response Paper states that a ceding company should consider, to the extent possible, the retrocession arrangements of its reinsurance partner and the extent to which those arrangements can indirectly affect its own agreement with the reinsurer
- PACICC's 2008 paper notes that reinsurance counterparty risk needs to be incorporated into insurance companies' ERM frameworks

Risks presented by Reinsurance

- Concentration risk
 - How much business is ceded to a reinsurer?
- Legal risk
 - Does the agreement accurately reflect the parties' intentions?
 - Is the agreement enforceable?

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Risks presented by Reinsurance

- Liquidity risk
 - Possible lag time between payment of claim and receipt of reinsurance recoverable
- Residual insurance risk
 - Potential discrepancy between reinsurance needs and actual coverage
- Additional risks associated with unregistered reinsurance
 - Recoverability in light of laws governing the reinsurer
 - Risks associated with collateral (i.e., quality of collateral)

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Elements of a Reinsurance Governance and Risk Management Regime - *Role of Senior Management*

- Creating and developing the reinsurance strategy/plan/program
- Setting underwriting guidelines that specify the types of insurance to be underwritten, policy terms and conditions, and aggregate exposure by type of business

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Elements of a Reinsurance Governance and Risk Management Regime - *Role of Senior Management* (cont)

- Establishing limits on the amount and type of insurance that will be automatically covered by treaty and facultative reinsurance
- Ensuring organizational and procedural controls are effective, including that the management information system in place meets all Board requirements, that all underwriting is carried out in accordance with company policy, and that planned reinsurance cover is in place

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Elements of a Reinsurance Governance and Risk Management Regime - *Role of Senior Management*

- Ensuring compliance with reinsurance related policies and procedures
- Ensure an up-to-date list of approved reinsurers is maintained, specifying the appropriate level of exposure to each
- Ensure there is sufficient staff with appropriate experience and expertise in charge of applying the reinsurance policy
- Clearly define limits of responsibility and monitoring for all matters involving reinsurance

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Elements of a Reinsurance Governance and Risk Management Regime - *Role of the Board*

- Approving and reviewing the reinsurance strategy/plan/program
- Setting limits on net risk to be retained
- Setting limits on the maximum foreseeable reinsurance protection to be obtained from approved reinsurers

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Elements of a Reinsurance Governance and Risk Management Regime - *Role of the Board* (cont)

- Reviewing and approving organizational and procedural controls, including reinsurance related policies and procedures
- Ensuring principal risks associated with reinsurance are identified and appropriately managed
- Providing for independent assessment of management controls

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Elements of a Reinsurance Governance and Risk Management Regime - *Role of Risk Management*

- Identifying risks associated with reinsurance
- Developing measurement systems for these risks
- Assisting the Board in the effective operation of the risk management system by performing specialist analyses and quality reviews

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Elements of a Reinsurance Governance and Risk Management Regime - *Role of Risk Management* (cont)

- Reporting details of risk exposures and actions that have been or should be taken to manage the exposures
- Advising the Board with regard to risk management decisions relating to reinsurance
- Establishing policies and procedures to manage reinsurance risks

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Elements of a Reinsurance Governance and Risk Management Regime - *Role of Internal Audit*

- Assessing adherence to and effectiveness of operational and organizational controls

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Elements of a Reinsurance Governance and Risk Management Regime - *Role of Compliance*

- Understanding applicable laws and regulations that may impact reinsurance operations
- Monitoring compliance with reinsurance related policies and procedures
- Regularly reviewing the adequacy of the compliance system and overall compliance efforts
- Reporting on compliance to senior management and the board

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Elements of a Reinsurance Governance and Risk Management Regime *Reinsurance Risk Management Policy²*

- Needs to address applicable risks: counterparty risk, concentration risk, legal risk, liquidity risk, residual risk and risks relating to unregistered reinsurance
- Define retention limits in light of the company's risk appetite and risk tolerance levels as set forth in the reinsurance strategy
- Address the possible use of intermediaries (e.g., reinsurance brokers)

² Based in part on the July 2009 Reinsurance Risk Management Guideline of the Autorité des marchés financiers

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Elements of a Reinsurance Governance and Risk Management Regime

Reinsurance Risk Management Policy (cont)

- Determine the reinsurer selection process, including selection criteria
- Address reliance on unregistered reinsurers
- Specify the types of reinsurance agreements that are most suitable for managing the company's risks in light of its risk tolerance levels
- Establish limits on the amounts and types of insured risks that are automatically covered by reinsurance

Elements of a Reinsurance Governance and Risk Management Regime

Reinsurance Risk Management Policy (cont)

- Define the conditions and criteria for use of facultative reinsurance
- Determine the conditions to be included in reinsurance agreements
- Establish a contingency plan in the event reinsurance coverage is lost
- Outline the process for monitoring the application of the policy
- Policy review and updating process

What the Future Holds

- Revised Guideline B-3, Guideline on Sound Reinsurance Practice and Procedures
- Repeal of 25% limit on unregistered reinsurance
- Repeal of 75% fronting limit
- Changes to MCT and MCCR
- New disclosure requirements

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What the Future Holds

- Risk-based collateral
 - There is a global move towards collateral regimes that are graduated and risk-based
 - OSFI will undertake developmental policy work in this area
 - OSFI will also fully assess the overall quality of the collateral that is being posted by unregistered reinsurers and will assess its policy on the use of letters of credit as collateral

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What the Future Holds

- Mutual recognition
 - OSFI's Response paper indicates that it is premature to consider adopting a mutual recognition regime
 - OSFI's Discussion Paper identifies elements that OSFI would need to take into account before entering into a mutual recognition agreement

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What the Future Holds

- How companies should behave until the new regime is in place
 - Existing regulations continue to apply
 - Consider new rules in developing reinsurance plans
- Introduction of security agreements in light of concerns regarding enforceability of reinsurance trust agreements.
 - Proposed changes are expected be released for comment in the coming months

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Conclusion

- Questions?
- Comments?

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FASKEN
MARTINEAU 
www.fasken.com

Robert McDowell
416 865 4408
rmcdowell@fasken.com

Koker Christensen
416 868 3495
kchristensen@fasken.com

FASKEN
MARTINEAU 
www.fasken.com