Position Paper

Comments on OSFI's draft revised Guideline B-2 "Property and Casualty Large Insurance Exposures and Investment Concentration"

Our reference:	RAB-21-005	Date:	18 March 2021
Referring to:	OSFI's draft revised Guideline B-2		
Contact person:	RAB secretariat	E-mail:	international@insuranceeurope.eu
Pages:	4	Transparency Register ID no.:	341051518380-63

Introduction

The Insurance Europe Reinsurance Advisory Board (RAB), on behalf of its member companies operating in Canada, appreciates the opportunity to provide comments on the Draft Revised Guideline B-2: "Property and Casualty Large Insurance Exposures and Investment Concentration", as part of the series of changes by the Office of the Superintendent of Financial Institutions (OSFI) related to its comprehensive review of Canada's Reinsurance Framework with the aim of meeting its mandate of protecting policyholders.

The RAB appreciates that OSFI's new B-2 draft is more principle-based and focused on supervision, as opposed to the original, prescribed multiple policy limits approach. However, the RAB considers that there are significant points that will require clarification by OSFI. It encourages OSFI to revise the Insurance Exposure Limit by setting it independently from reinsurance counterparty exposure. It also asks that OSFI reconsider the treatment of unregistered reinsurance by explicitly reflecting the size and quality of unregistered reinsurers' capital backing in the proposed treatment.

1. Determination of the loss on a "Single Insurance Exposure"

The draft calls on each insurer to self-define or identify a "Single Insurance Exposure" (SIE). Each federally regulated property and casualty insurer (FRI) is required to create a comprehensive Gross Underwriting Limit Policy (GUWP), defining what constitutes an SIE, demonstrating adequate systems to identify and actively manage insurance exposures along with effective monitoring and internal reporting procedures to ensure ongoing operational compliance with the GUWP. The purpose of SIE identification is to test against total capital or net asset availability (depending on whether the FRI is an insurance company, foreign branch or subsidiary) alongside an FRI's SIE Net Retention and its Largest Net Counterparty Unregistered Reinsurance Exposure.

The RAB understands the goal of encouraging sound counterparty risk management but does not agree with the proposed approach to the Insurance Exposure Limit, as assuming "the sudden failure of an individual unregistered insurance counterparty" is appropriate for this purpose. Adding to an FRI's maximum loss on a Single Insurance Exposure (Net Retention) the FRI's Largest Net Counterparty Unregistered Reinsurance

Insurance Europe's Reinsurance Advisory Board
Secretariat • rue du Champ de Mars 23, B-1050 Brussels
Tel: +32 2 894 30 30
E-mail: international@insuranceeurope.eu

Exposure due to the occurrence of this loss is comparing very different sorts of items. The reinsurance counterparty risk is not homogenous to the maximum loss and based on the same likelihood; it will depend on the financial strength of the reinsurer and is typically uncorrelated to the occurrence of a single loss. There exist risk-based methods in prudential frameworks to measure a cedant's exposure to counterparty risk and keep it under control.

Furthermore, this would impose more restrictive limits on available capacity and capital when applying the large policy exposure test depending on whether an insurer is a domestic insurance company or an unregistered reinsurance counterparty (or a foreign branch/P&C FRI subsidiary in Canada). The impact of this could potentially create an uneven playing field between companies, foreign branches and FRI subsidiaries in Canada. Unnecessarily limiting access to cross-border reinsurance will have very negative consequences for the Canadian insurance market as it would restrict access to international reinsurance capacity, risk management expertise, and global risk diversification (a key reinsurance risk mitigation tool). Therefore, any regulator-imposed limitation or disincentive to cross-border reinsurance ought to be grounded in an objective measure of counterparty credit risk and not local Canadian licensing status. At a time when supervisors collaborate worldwide to ensure the effective supervision of international (re)insurance groups, supervisors should rely on robust mutual regulatory frameworks rather than mandating the ring-fencing of assets to be available in the supervisor's jurisdiction.

In practice, the guideline, by imposing some sort of "pre-funding" of single large losses (be it via capital, guarantees, onshore collateral, etc.), may restrict the Single Risk maximum underwriting capacity of foreign reinsurance groups in Canada. The RAB would recommend that OSFI refrain from implementing such a measure or, if it must be implemented, to at least exclude reinsurers from its scope of the Guideline. Moreover, in the RAB's opinion, OSFI should adopt a less "crude" framework. Currently the Guideline provides 100% credit for registered reinsurance and 0% credit for unregistered reinsurance.

2. Potential counterparty risk mitigation techniques a P&C FRI could use

OSFI has called attention to counterparty risk mitigation techniques in the draft guideline. The guideline does list excess collateral, LOCs and "other CRM techniques deemed accessible by OSFI" as potentially offsetting the need to have hard capital. However, the draft does not clearly identify the full breadth of instruments that represent a valid risk mitigation technique and fails to adequately explain the full impact on an FRI where such techniques are used.

Many unregistered reinsurers are extremely well-capitalised and diversified, thus displaying a high capacity to absorb losses. Such reinsurers prudently manage their capital base through risk pooling and risk diversification. The benefit and the resilience that this model brings to the global insurance industry is acknowledged by the OECD in a 2018 paper[1].

Subsidiaries of a foreign group operating in Canada have access not only to the capital pool in Canada but also to the capital resources of their parent. The RAB would ask that the guideline is clarified to allow for this group capital support to be recognised in the Framework. The RAB acknowledges the objective of finding the "effective balance between protecting policyholders and allowing P&C FRIs to compete and take reasonable risks". This should also be the case for FRIs affiliated with foreign reinsurance groups in jurisdictions with robust prudential frameworks.

[1] OECD (2018), The Contribution of Reinsurance Markets to Managing Catastrophe Risk

It would be preferable for OSFI to identify more pertinent aspects, such as recognition of financial strength. The current draft does not distinguish between global, financially strong reinsurers and other, potentially less solid counterparties.

Recent years have demonstrated that reinsurers do make capital available in Canada, when needed in Canada, for instance to cover flood-related losses. Therefore, the RAB strongly recommends that OSFI takes into consideration the size or capital strength of unregistered reinsurer counterparties and allows financial strength assessment (including consideration of financial strength and ability to pay) as an eligible counterparty risk mitigation technique.

3. Clarification of Annex 2 criteria

It is unclear how a foreign branch or P&C subsidiary in Canada can effectively demonstrate compliance with the criteria set out in Annex 2. The RAB is aware that OSFI is a member of certain supervisory colleges around the world and also has contractual arrangements with certain regulators, providing in those instances for a more harmonised approach to regulation. The RAB believes that it is through these participations and co-operative arrangements that OSFI is best able to understand the regimes of the home office/parent and make the determination that the home office/parent "is subject to robust regulation and supervision with regard to capital adequacy, accounting standards and actuarial practices". The RAB asks that OSFI publish a list of jurisdictions it deems acceptable so that insurers are clear on whether they meet the Annex 2 criteria. If OSFI is unable to publish such a list, the RAB respectfully requests that subparts 1(b), 1(c), 2(b) and 2(c) in the Annex 2 criteria be removed from the Guideline.

4. Treatment of affiliated vs. unaffiliated unregistered reinsurers

The "Largest Net Counterparty Unregistered Reinsurance Exposure" does not distinguish between unregistered reinsurance with an affiliated reinsurer and unregistered reinsurance with an unrelated reinsurer. OSFI already has approval and annual reporting processes for unregistered affiliated reinsurers. Additionally, insurance and reinsurance companies are increasingly operating within affiliated groups, particularly insurers with global operations, and these groups use affiliated reinsurance as part of their overall capital-management programme. The RAB recommends that the other eligible counterparty risk mitigation techniques listed in Section 10 be expanded to include the use of affiliated unregistered reinsurers on the basis that OSFI already has robust approval and annual reporting processes in place for the use of affiliated unregistered reinsurers.

5. Interaction with other guidelines

Last but not least, with regard to the draft B-3 Guideline released in June 2019, it seems that OSFI plans to release finalised B-2 and B-3 Guidelines at the same time later this year, without additional commentary on a new B-3 Guideline. The industry has no clarity on what the new B-3 Guideline will entail and how it would interact with Guideline B-2. It can be noted that footnotes 5 and 6 of draft Guideline B-2 refer to the requirements of Guideline B-3. The RAB suggests providing clarification on this point.

***

The RAB encourage OSFI to take sufficient time to design and implement its guidance, following comprehensive impact assessment of the proposed changes in terms of the behaviour of ceding companies, as well as of the cost and capacity of reinsurance provided in the Canadian market. Any guideline should be applied with sufficient time for companies to document their policies to adhere to it.

The RAB acknowledges the importance of the OSFI consultation process since the start of the Reinsurance Framework Review in 2018 in achieving the best outcomes for policyholders in terms of choice, competition and protection. It thanks OSFI for these discussions and looks forward to the continued collaboration.

Insurance Europe's Reinsurance Advisory Board (RAB) is a specialist representative body for the European reinsurance industry. It is represented at chief executive officer (CEO) level by the seven largest European reinsurance firms: Gen Re, Hannover Re, Lloyd's, Munich Re, PartnerRe, SCOR and Swiss Re, with Insurance Europe providing the secretariat. Through its member bodies, the RAB represents around 60% of total worldwide reinsurance premium income. The RAB promotes a stable, innovative and competitive market environment. It further promotes a regulatory and trading framework that facilitates global risk transfer through reinsurance and other insurance-linked capital solutions.