AUTORITÉ
DES MARCHÉS
FINANCIERS

5 YEARS OF A COMMITMENT TO
INFORMATION, REGULATION, PROTECTION.

REINSURANCE RISK MANAGEMENT GUIDELINE

July 2009

Table of Contents

Preamble 3

Introduction 4

Scope 6

Coming into effect and updating 7

1. Reinsurance risks 8

2. Reinsurance risk management governance 8

Principle 1: Roles and responsibilities of board of directors and senior management 8
Principle 2: Incorporation of reinsurance risk management in the insurer's integrated risk management 9

3. Reinsurance risk management practices 10

Principle 3: Reinsurance risk management policy 10
Principle 4: Reinsurance process management 12

Supervision of sound and prudent management practices 13

Preamble

The *Autorité des marchés financiers* ("AMF") establishes guidelines setting out its expectations with respect to financial institutions' legal requirement to follow sound and prudent management practices. These guidelines therefore cover the execution, interpretation and application of this requirement.

The AMF favours a principles-based approach rather than a specific rules-based approach. As such, the guidelines provide financial institutions with the necessary latitude to determine the requisite strategies, policies and procedures for implementation of such management principles and to apply sound practices based on the nature, size and complexity of their activities as well as their risk profile.

The AMF considers governance, risk management and compliance (GRC) as the foundation stones for sound and prudent management of financial institutions and, consequently, as the basis for the prudential framework provided by the AMF.

This guideline is part of this approach and sets out the AMF's expectations regarding sound and prudent reinsurance risk management practices.

Introduction

Reinsurance is one of the most important risk management tools used by insurers. An insurer can use reinsurance to reduce its insurance risks and the volatility of its financial results, stabilize its solvency, earmark its available capital more efficiently, improve its ability to withstand disasters, increase its underwriting capacity and draw on the reinsurer's expertise with respect to product development. However, reinsurance exposes an insurer to other risks, including residual insurance risk, legal risk, counterparty risk and liquidity risk. The interrelation of these risks can make reinsurance a complex matter. Consequently, inadequate reinsurance management can threaten an insurer's financial soundness and, ultimately, sully its reputation.

This guideline addresses reinsurance solely as an insurance risk management tool. It therefore applies to transactions whereby an insurer transfers a portion of the insurance risks it has underwritten by in turn buying insurance from one or more other insurers, under conditions set out in a contract, or through the use of other coverage methods. Thus, the guideline deals with management of the risks of reinsurance ceded, including retrocession, as well as management of the risks of alternative risk transfer mechanisms. For purposes of this guideline, "alternative risk transfer mechanism" refers to an arrangement allowing for the transfer or mitigation of insurance risks without necessarily resorting to reinsurance. Such arrangements primarily involve a transfer of risk to the capital markets, such as the securitization of policy liabilities or the issuance of catastrophe bonds ("Cat Bonds").

Transactions carried out by insurers that do not cover insurance risks are not addressed in this guideline. For example, such transactions may involve reinsurance that only covers financial risks (sometimes referred to as financial reinsurance), interest rate hedging risks or financial market risks. Similarly, activities related to assumed reinsurance are not subject to this guideline.

Accordingly, the use of the generic term "reinsurance" in this guideline refers to reinsurance ceded and alternative risk transfer mechanisms related to insurance risks.

The core principles and guidance published by the International Association of Insurance Supervisors ("IAIS")[1] explain the need for insurers to implement sound reinsurance management practices. Moreover, regulators are encouraged to provide financial institutions with the regulatory framework to do so.

The AMF adheres to the principles and guidance published by the IAIS that foster sound and prudent management practices. Pursuant to the authority conferred upon it under the *Act respecting insurance*,[2] the AMF is issuing this guideline to explicitly inform insurers of its expectations regarding reinsurance risk management.

---

1 International Association of Insurance Supervisors, Insurance Core Principles and Methodology, October 2003.

International Association of Insurance Supervisors, Supervisory Standard on the Evaluation of the Reinsurance Cover of Primary Insurers and the Security of their Reinsurers, January 2002.

2 *An Act respecting insurance,* R.S.Q. c. A-32, ss. 325.0.1 and 325.0.2.

This guideline sets out the principles of reinsurance risk governance and the practices for managing these risks. The reinsurance impacts on capital adequacy requirements are covered by the guidelines on capital adequacy.[3]

[3] Autorité des marchés financiers, Guideline on Capital Adequacy Requirements (“MCT”), Property and Casualty Insurance.

Autorité des marchés financiers, Guideline on Capital Adequacy Requirements (“CAR”), Life and Health Insurance.

Scope

This reinsurance risk management guideline is intended for the following legal persons or associations governed by the *Act respecting insurance*:

- insurers of persons (life and health);
- damage insurers (property and casualty);
- mutual insurance associations;
- federations of mutual insurance associations;
- mutual benefit associations; and
- professional orders, as regards their insurance funds.

In this guideline, the generic term “insurer” refers to all entities covered by the scope of this guideline.

This guideline applies to insurers operating independently as well as to insurers operating as members of a financial group.[4] As regards mutual insurance associations that are members of a federation, the standards or policies adopted by the federation should be consistent with—and even converge on—the principles of sound and prudent management prescribed by law and detailed in this guideline.

[4] For purposes of this guideline, “financial group” refers to any group of legal persons composed of a parent company (financial institution or holding company) and legal persons affiliated therewith.

Coming into effect and updating

This reinsurance risk management guideline will come into effect on month XX, 20XX.

With respect to the legal requirement of insurers to follow sound and prudent management practices, the AMF expects each insurer to develop strategies, policies and procedures based on its nature, size, complexity and risk profile, to ensure the adoption of the principles underlying this guideline by month XX, 20XX. Where an insurer has already implemented such a framework, the AMF may verify whether it enables the insurer to satisfy the requirements prescribed by law.

This guideline will be updated based on developments in reinsurance and in light of the AMF's observations in the course of its supervision of insurers.

1. Reinsurance risks

Notwithstanding the advantages reinsurance provides insurers, it can expose them, at varying degrees, to various risks inherent in its use. For example, a new or continuing reinsurance agreement could give rise to any of the following risks:

- residual insurance risk - it may arise from discrepancies between reinsurance needs and the actual coverage provided for in the agreement, resulting in the insurer retaining greater risk than anticipated. Similarly, an insurer may face a basis risk related to alternative risk transfer mechanisms where the amounts obtained by the insurer through the mechanisms do not match the losses incurred by the insurer;

- legal risk – it may arise when the terms of the agreement do not accurately reflect the intent of the insurer or when the agreement cannot be legally enforced;

- counterparty risk – it may result from the inability or potential refusal of the reinsurer, or a stakeholder in the case of an alternative risk transfer mechanism, to honour its obligations towards the ceding insurer;

- liquidity risk – it may arise from the possible lag time between the payment of a claim by the insurer to its insured and receipt of the reinsurance recoverable.

In short, it is important that an insurer apply sound and prudent management practices when using reinsurance. In this regard, the AMF sets out the following principles.

2. Reinsurance risk management governance

Principle 1: Roles and responsibilities of board of directors[5] and senior management

The AMF expects a reinsurance risk management framework to be supported by effective governance.

The AMF considers the board of directors and senior management to be ultimately responsible for decisions made and actions taken with respect to reinsurance, and, as such, given the risks inherent in this type of activity, they should closely oversee reinsurance activities.

In light of the shared roles and responsibilities incumbent upon them under the Governance Guideline,[6] the board of directors and senior management should, in particular:

[5] A reference to the board of directors can also include a board committee, such as a board committee established to examine specific issues.

[6] Autorité des marchés financiers, Governance Guideline, April 2009.

- as part of the integrated risk management framework, develop, approve and implement a reinsurance strategy tailored to the insurer's overall risk profile, based on the nature, size and complexity of its activities. To this end, they should:
    - regularly identify, assess, document and review the insurer's risk appetite and risk tolerance levels in respect of reinsurance;
    - define the objectives of reinsurance use, such as managing insurance risks, managing capital and mitigating the volatility of the insurer's financial results;
    - develop, approve and implement a reinsurance risk management policy;
    - 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;
- adequately monitor reinsurance transactions through activity management reports and internal audit reports;
- review the reinsurance strategy and policy on a regular basis and as required, in particular when the situation of the insurer or its reinsurers changes;
- ensure that the rules of ethics address reinsurance transactions between affiliates.

Principle 2: Incorporation of reinsurance risk management in the insurer's integrated risk management

The AMF expects reinsurance risk management to form an integral part of the insurer's integrated risk management framework.

Given the importance of reinsurance as an insurance risk management tool, the insurer should make sure its use is fully integrated in its overall risk management process. As such, reinsurance risk management should:

- take into account the insurer's overall risk appetite and risk tolerance levels;
- be integrated into the strategic and financial planning process. This process should take the following into consideration:
    - anticipated reinsurance needs and the nature and capacity of the reinsurance offered;

- reinsurance not only as a risk management tool, but also as an additional source of risk, in the scenarios used and stress tests performed when quantifying risks (including in the Dynamic Capital Adequacy Test);
- the impact of reinsurance on capital management, such as decisions regarding the allocation of capital and analyses with respect to the issuance or repayment of capital;

- be considered when developing or renewing products offered by the insurer.

3. Reinsurance risk management practices

Principle 3: Reinsurance risk management policy

The AMF expects an insurer to adopt a reinsurance risk management policy that includes procedures for selecting risk transfer methods and reinsurers as well as procedures for implementing, monitoring, reviewing, amending and documenting reinsurance agreements.

While taking into account the particular nature, size and complexity of the insurer's activities and its risk profile, the reinsurance risk management policy should, in particular:

- define retention limits in light of the insurer's risk appetite and risk tolerance levels as set forth in the reinsurance strategy;
- define the conditions for using alternative risk transfer mechanisms, including their intended use, their anticipated impact on profitability, solvency and capital requirements as well as the specific controls to which they should be subjected;
- address the possible use of intermediaries, such as reinsurance brokers. For example, the policy could discuss the criteria for selecting intermediaries, such as experience and expertise, the tasks to be handled by intermediaries and the important contractual terms, such as the duration of intermediary contracts;
- determine the reinsurer selection process, including selection criteria. The process should generally consider diversification of reinsurance sources as well as the financial position of the reinsurers;
- address reliance on unregistered reinsurers, namely, reinsurers that do not hold an insurer's licence in Québec or another province, or reinsurers that are not authorized to carry on their business in Canada under the *Insurance Companies Act*.[7] In general, the policy should discuss the choice of guarantee instruments, including trust deeds, letters of credit and reinsurer deposits, as well as the risks related to such instruments, such as their cost and counterparty risk;

[7] *Insurance Companies Act* (1991, c. 47)

- specify the types of reinsurance agreements that are most suitable for managing the insurer'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;

- define the conditions and criteria for use of facultative reinsurance;

- determine the conditions to be included in reinsurance agreements, such as an insolvency clause (which defines the applicable terms and conditions in the event of the ceding insurer's bankruptcy) or an offset clause (pursuant to which the reciprocal debts of the insurer and the reinsurer cancel each other in certain circumstances) or a clause whereby the agreement constitutes the final or entire understanding between the parties;

- provide a process for ceding insurance and putting into place alternative risk transfer mechanisms;

- establish a contingency plan in the event reinsurance coverage is lost due to new market conditions or a reinsurer's insolvency;

- outline the process for monitoring the application of the policy. The process is intended to see to it that the insurer complies with the policy. It could address the following, among other things:

    - assessing compliance with the established retention limits;

    - assessing the financial position of reinsurers;

    - monitoring concentration limits for single counterparty exposure per reinsurer;

    - monitoring reinsurance claims recoveries;

    - ensuring that actual risk transfers are as expected;

    - carrying out stress tests and scenario analyses in order to assess how the insurer's policy would stand up to various events or catastrophes which could give rise to significant or particularly numerous claims;

    - the availability, accuracy and adequacy of reinsurance documents to satisfy the needs of the insurer and the reinsurer;

    - timely access by underwriting staff to information regarding any changes in the scope or coverage level of the reinsurance program;

- include a policy review and updating process that is integrated into the auditing and internal control mechanisms. The objective of the process is to ensure the continued adequacy of the policy.

Principle 4: Reinsurance process management

The AMF expects an insurer to put into place a process to implement the reinsurance risk management policy.

When an insurer is in the process of ceding insurance or putting an alternative risk transfer mechanism into place, it should have a prior in-depth understanding of the nature, limits and inherent risks of the type of agreement it wishes to conclude. Accordingly, it should establish a process for ceding insurance and putting into place alternative risk transfer mechanisms. Before entering into an agreement, the process should, in particular:

- ensure the proposed agreement complies with legislative requirements;
- consider the effect of the agreement on insurance risk exposures and on the underwriting policy;
- ensure that all underlying material risks related to the agreement have been identified and that mitigation measures have been set up to manage these risks. Such risks are usually more significant when the agreement is with an unregistered reinsurer or when alternative risk transfer mechanisms are put into place. For example, the agreement could give rise to risks such as residual insurance risks, legal risks, counterparty risks and liquidity risks;
- carry out a prior assessment of the reinsurer's financial position and expertise;
- carry out a proper legal review of the agreement clauses, particularly the insolvency clause.

Once the agreement has been entered into, the insurer should:

- follow a proper signing procedure that usually provides for an acceptable lag time between the coming into effect of the agreement and its date of signing;
- forward accurate and complete documents to the reinsurer in a timely manner;
- ensure that the reinsurer continues to satisfy the selection criteria set forth in the reinsurance policy when the agreement is being renewed.

Supervision of sound and prudent management practices

In fostering the establishment of sound and prudent management practices within financial institutions, the AMF, as part of its supervisory activities, intends to assess the degree of compliance with the principles set forth in this guideline in light of the specific attributes of each insurer. Similarly, it will examine the effectiveness and relevance of the strategies, policies and procedures adopted by insurers as well as the quality of supervision and control exercised by their boards of directors and senior management.