REINSURANCE RISK MANAGEMENT GUIDELINE

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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, use 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 risks, legal risks, counterparty risks, liquidity risks and operational risks. 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 underwritten insurance risks 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,[1] 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 of insurance risks to the capital markets. Such an arrangement does not necessarily require that the financial institution resort to reinsurance. These mechanisms can take a variety of forms, such as the securitization of policy liabilities or the issuance of disaster bonds, and they can be highly complex; several of them involve the creation of dedicated entities, also referred to as "Special Purpose Entities" (SPE).[2] Given the particular nature of alternative risk transfer mechanisms, they may exacerbate certain traditional reinsurance risks.

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.[3] 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")[4] 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 *Insurers Act*,[5] the AMF is issuing this guideline to explicitly inform insurers of its expectations regarding reinsurance risk management.

This guideline sets out the principles of reinsurance risk governance and the practices for managing these risks. As for the effects of reinsurance on capital adequacy requirements, they are covered by the guidelines on capital adequacy.[6]

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1 The guideline covers both registered and unregistered reinsurance.

2 The *Securitization Risk Management Guideline* deals in greater detail with special purpose entities, their operation and the sound management of related risks.

3 The *Integrated Risk Management Guideline* provide guidance regarding sound risk management pertaining to these activities.

4 International Association of Insurance Supervisors. *Insurance Core Principles, Standards, Guidance and Assessment Methodology, ICP 13 - Reinsurance and other forms of risk transfer*, 1 October 2011 (revised October 2012).

5 *Insurers Act*, CQLR, c. A-32.1, section 463.

6 Autorité des marchés financiers. *Guideline on Capital Adequacy Requirements ("MCT"), Property and Casualty Insurance*; *Guideline on Capital Adequacy Requirements ("CAR"), Life and Health Insurance*.

Reinsurance risks

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

- residual insurance risk may arise from discrepancies between reinsurance needs and the actual coverage provided for in the contract, 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 may arise when the terms of the contract do not accurately reflect the intent of the insurer or when the contract cannot be legally enforced;
- counterparty risk 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 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;
- operational risk may result from inadequate contractual arrangements or from insufficient technological or administrative capacity to manage and collect sums owed by reinsurers.

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

1. Reinsurance risk management governance

Principle 1: Roles and responsibilities of board of directors[7] 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 adequately oversee reinsurance activities.

In light of the shared roles and responsibilities incumbent upon them under the Governance Guideline,[8] the board of directors and senior management should, in particular:

- 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 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;

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

[8] Autorité des marchés financiers. *Governance Guideline*.

- develop, approve and implement a reinsurance risk management policy;
- ensure that staff in charge of applying the reinsurance policy have the necessary skills in light of the complexity of the risk management tools used;
- clearly define limits of responsibility and monitoring for all matters involving reinsurance;

• adequately monitor reinsurance transactions, in particular, through:
  - activity management reports; and
  - internal audit reports;
• ensure that the reinsurance strategy is being applied adequately;
• 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 reinsurance transactions with affiliated legal persons or associates[9] are conducted in the same manner as those carried out at arm's length.

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, among other things:

• be within the strategic and financial planning process. This process should notably take the following into consideration:
  - anticipated reinsurance needs and the nature and adequacy 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 ;[10]
  - 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.

2. 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 contracts.

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9 *Insurers Act*, CQLR, c. A-32.1, sections 16, 17 and 18

10 Autorité des marchés financiers. *Stress Testing Guideline*.

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

- define retention limits in light of the insurer's risk appetite and its risk tolerance levels set out 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;
- provide for the possible use of intermediaries, such as reinsurance brokers. The policy could for example 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;
- provide for reliance on unregistered reinsurance. In general, the policy should discuss the choice of guarantee instruments. It should also:
  - discuss the risks and costs of these instruments as well as the optimum conditions for their use;
  - specify limits and risk management practices and procedures pertaining to collateral;
- define the types of reinsurance contracts 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 contracts, 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 contract constitutes the final or entire understanding between the parties (the contract is not subject to collateral agreements);
- provide a process for ceding insurance and putting into place alternative risk transfer mechanisms;
- establish information and a training procedure for staff affected by changes to the reinsurance program or its coverage;
- 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;
  - the availability, accuracy and adequacy of reinsurance documents to satisfy the insurer's needs;
- include a policy review and updating process.

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

- ensure the proposed contract complies with legislative requirements;
- consider the effect of the contract on insurance risk exposures and on the underwriting policy;
- ensure that all underlying material risks related to the contract have been identified and that mitigation measures have been set up to manage these risks. Such risks are usually more significant when dealing with an unregistered reinsurance agreement or when alternative risk transfer mechanisms are put into place;
- carry out a prior analysis or examination of the reinsurer's financial position and ensure that the necessary verifications have been completed;
- ensure that a legal review of the contract clauses, particularly the insolvency clause, has been carried out.

Once the contract 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 contract and its date of signing;
- forward, in a timely manner, accurate and complete documents required by the counterparties to the transaction;
- ensure that the reinsurer continues to satisfy the selection criteria set forth in the reinsurance policy when the contract is renewed or reviewed.

APPENDIX A: REGISTERED AND UNREGISTERED REINSURANCE

Registered reinsurance:

A reinsurance contract is considered to be registered (registered reinsurance) if it has been accepted by a reinsurer constituted under the laws of Québec or another province or territory of Canada, or under federal laws of Canada and, in such a case, if the reinsurer holds a licence issued by a regulator of at least one province or territory. A reinsurance contract is also considered to be registered if it has been accepted by a branch office of a foreign company that has been authorized by the federal authorities, holds a licence issued by a regulator of at least one province or one territory and maintains assets allowing it to guarantee the performance of its obligations under the contract.

An unregistered reinsurance contract which does not meet the above conditions may be considered to be registered reinsurance if all the policies reinsured under the contract have been issued outside Canada and if the subsidiary or branch of the insurer having issued the policies is subject to requirements imposed by a solvency regulator of a country that is a member of the Organisation for Economic Co-operation and Development ("OECD") with respect to reinsurance business and the reinsurance contract is recognized by that country's solvency regulator.

In this situation, the reinsurance contract would normally be expected to be recognized by the solvency regulator based on conditions similar to the AMF's, namely, that the reinsurer is regulated and subject to

meaningful solvency controls in respect of its insurance risks under the contract or that the reinsurer has fully guaranteed the contract through a guarantee instrument. A reinsurance contract that does not satisfy this condition will require prior authorization of the AMF in order to be recognized as registered reinsurance.

Unregistered reinsurance:

A reinsurance contract is considered to be unregistered if it does not satisfy the conditions set out above with respect to registered reinsurance.