

Guideline

Sound Reinsurance Practices and Procedures

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TABLE OF CONTENTS

INTRODUCTION	1
REINSURANCE RISK MANAGEMENT POLICY	2
Managing Risks Through Reinsurance	2
Managing Risks Arising from the Use of Reinsurance	2
Other Information to be Included in the RRMP	3
Senior Management Oversight of the RRMP	3
DUE DILIGENCE	3
Conducting Due Diligence Evaluations	4
Updating Evaluations	4
Unregistered Reinsurers	4
REINSURANCE CONTRACTS	5
INSOLVENCY CLAUSES	6
Other Terms and Conditions Affecting the Ceding Insurance Company	6
Funds Withheld Arrangements	6
Reinsurance Contracts Subject to Relevant Laws and Courts	7
GUIDELINE ADMINISTRATION	7
OTHER GUIDANCE	7

INTRODUCTION

This Guideline provides a BCFSa version of a guideline published by the Office of the Superintendent of Financial Instruments (“OSFI”) titled B-3 Sound Reinsurance Practices and Procedures. The BCFSa version follows OSFI’s closely, with appropriate adjustments to ensure it is suitable for the B.C. jurisdiction. This Guideline sets out expectations for effective reinsurance practices and procedures. It is applicable to all B.C. incorporated insurance companies (“insurance companies”) that are party to reinsurance cessions, retrocessions, and, where applicable, to assumption reinsurance transactions.

Reinsurance is an important risk management tool that can be used by an insurance company to reduce insurance risks and the volatility of financial results, stabilize solvency, make more efficient use of capital,

better withstand catastrophic events, increase underwriting capacity, and to draw on reinsurers' expertise. However, reinsurance exposes an insurer to operational, legal, counterparty, and liquidity risks, among other risks. The combination of these risks can make reinsurance complex and challenging to implement effectively. Inadequate reinsurance risk management practices and procedures can materially affect an insurance company's financial soundness and reputation and can ultimately contribute to its failure.

Insurance companies should adhere to the following reinsurance principles when developing risk management frameworks for managing their reinsurance risks. BCFSa will assess an insurance company's reinsurance risk management framework against these principles.

REINSURANCE RISK MANAGEMENT POLICY

Principle 1: An insurance company should have a sound and comprehensive Reinsurance Risk Management Policy ("RRMP") that is overseen by senior management.

BCFSa expects that an insurance company's RRMP will form an integral component of its overall enterprise-wide risk management framework. The RRMP should reflect the scale, nature and complexity of an insurance company's business, and consider its risk appetite. BCFSa expects the RRMP to document the significant elements of the insurance company's approach to managing risks through reinsurance, and arising from the use of reinsurance, including:

- The purpose and objectives for seeking reinsurance;
- Ceding limits;
- Counterparty risk; and
- Concentration limits.

Managing Risks Through Reinsurance

Reinsurance can be a key tool for mitigating and managing insurance risks. When an insurance company uses reinsurance to reduce its insurance risks, capital guidelines recognize this benefit of reinsurance if certain conditions are met. Under the *Life Insurance Capital Adequacy Test* ("LICAT") and the *Minimum Capital Test* ("MCT"), an insurance company may reduce its required capital for insurance risk ceded.

An insurance company may use reinsurance to mitigate its exposures to large and catastrophic losses. In this case, the company must regularly assess the adequacy and effectiveness of its reinsurance arrangements. This may involve conducting appropriate stress testing to determine if the reinsurance arrangements adequately mitigate losses to acceptable levels, in accordance with the insurance company's risk appetite.

Reinsurance may be used for purposes not directly linked to the mitigation of an insurance company's insurance risks. Under such circumstances, BCFSa will evaluate the reinsurance arrangements, including the appropriateness of capital credit for such arrangements, based on the risk impact to the insurance company.

Managing Risks Arising from the Use of Reinsurance

The RRMP should identify risks to an insurance company arising from its use of reinsurance and its approach to managing these risks.

The RRMP should establish appropriate ceding limits. An insurance company's ceding limits should be set for its overall book of business, and may also be established by line of business, as appropriate. While reinsurance is an important risk management tool, an insurance company should not, in the normal course

of its business, cede 100 per cent, or substantially all,¹ of its insurance risks.² When setting ceding limits, an insurance company should consider counterparty risks, as described below.

An insurance company should monitor and manage the multiple factors that affect counterparty risk. When assessing counterparty risk, an insurance company should consider all elements of risk associated with counterparties, including the implications of the legal and insolvency framework of a counterparty's home jurisdiction, and the terms and conditions of reinsurance contracts. Counterparty risk should be considered at an aggregate level (e.g., group of affiliated counterparties) for stress testing. BCFSA expects an insurance company to assess counterparty risk from the perspectives of both going-concern and gone-concern scenarios of its reinsurers. An insurance company's process for assessing counterparty risk should be consistent across all counterparties (i.e., affiliates and non-affiliates).

An insurance company should also consider its total exposure to a counterparty as part of its assessment of counterparty risks. The RRMP should establish appropriate counterparty concentration limits both to individual counterparties and also to groups of affiliated counterparties. The limits should reflect the counterparty risks described above, as well as the risks to be ceded.

Where an insurance company's reinsurance program exposes it to liquidity risk, the RRMP should set out processes for measuring, monitoring and adequately controlling this risk.

Other Information to be Included in the RRMP

The RRMP should detail:

- The roles and responsibilities for those charged with implementing the RRMP, including the controls and oversight for the reinsurance program;
- The process for ensuring that the RRMP is updated to reflect changing market conditions; and
- The insurance company's policy on the use of registered and unregistered reinsurance.

BCFSA expects the level of controls and oversight to be commensurate with the significance of the insurance risk to which the reinsurance program is applied.

Senior Management Oversight of the RRMP

BCFSA expects senior management to oversee the development, implementation and operationalization of the RRMP.

Senior management is also responsible for ensuring that appropriate policies, procedures, and internal controls exist to monitor the effectiveness of, and compliance with, the RRMP on an ongoing basis. At a minimum, senior management should review the RRMP annually.

Please refer to OSFI's Corporate Governance Guideline for expectations of insurance company boards of directors in regard to operational, business, risk and crisis management policies.

DUE DILIGENCE

Principle 2: An insurance company should conduct due diligence on its reinsurance counterparties on an ongoing basis sufficient to ensure that the insurance company is aware of its counterparty risk and is able to assess and manage such risk.

¹ For the purposes of this Guideline, BCFSA generally applies the concept of "substantially all" in a manner consistent with that used in the context of assumption reinsurance and asset sale transaction approvals.

² Such an arrangement could potentially increase risks to the insurance company, e.g., by weakening the underwriting standards and discipline at the ceding insurance company.

An insurance company should evaluate the ability of all current and prospective reinsurance counterparties to meet their liabilities under severe but plausible adverse events on an ongoing basis. The level of an insurance company's due diligence on any reinsurance counterparty should be commensurate with its level of exposure to that counterparty. The level of due diligence should not be any less thorough if the counterparty is an affiliate of the insurance company.

Conducting Due Diligence Evaluations

An insurance company's evaluation of its current and prospective reinsurance counterparties should not rely solely on third parties, including rating agency assessments or broker analysis and recommendations.³ Prudent practice dictates that the insurance company should, to an extent proportional to the importance of such counterparty, conduct its own due diligence on the financial strength and capabilities of reinsurance counterparties.

When performing its due diligence, an insurance company should consider, among other things, the reinsurance counterparty's:

- Claims payment record;
- Expected future claims obligations;
- Balance sheet strength;
- Funding sources, including its level and access to capital, and form, amount, and sources of liquidity;
- Management, including the quality of its governance practices and procedures; and
- Retrocession arrangements and the direct or indirect impact they may have on the insurance company's own arrangements with the reinsurer.⁴

Similarly, an insurance company that is a reinsurer should, commensurate with its level of exposure to the cedant, conduct its own due diligence on the risk management and risk assessment criteria of the cedant.

Updating Evaluations

The evaluation of each of an insurance company's reinsurance counterparties should be updated throughout the life of the reinsurance contract. In cases where there may be material exposures to incurred but not reported losses, management should ensure that the evaluation continues beyond the expiration date of the contract. This is to ensure that the insurance company assesses potential reinsurance recoverables from expected future claims.

Unregistered Reinsurers

BCFSA expects a higher level of due diligence by an insurance company in respect of any current or prospective reinsurance arrangement with an unregistered reinsurer⁵ or with a cedant that is not regulated by BCFSA. When assessing counterparty risk, an insurance company should consider the home jurisdiction of the unregistered reinsurer. This would include the robustness of the regulatory and supervisory regime, as well as the legal and insolvency frameworks.

³ Any significant outsourcing of this due diligence function to a third party must be in accordance with BCFSA's Third-Party Risk Management Guideline.

⁴ If an insurance company is aware that a reinsurance counterparty relies significantly on retrocessions, the insurance company should seek greater visibility of the identities and financial standing of the retrocessionaires.

⁵ Generally, an "unregistered reinsurer" is a reinsurer that is not reinsuring in Canada risks in accordance with OSFI Advisory 2007-01-R1: Insurance in Canada of Risks, and, as such, is not regulated and supervised by BCFSA. For complete definitions of "unregistered reinsurer", see OSFI's Guideline A - Life Insurance Capital Adequacy Test and the Minimum Capital Test for property and casualty insurance companies.

REINSURANCE CONTRACTS

Principle 3: The terms and conditions of the reinsurance contract should provide clarity and certainty on reinsurance coverage.

An insurance company should have processes and procedures in place to ensure that a comprehensive, written, and binding reinsurance contract is executed prior to the effective date of reinsurance coverage. To achieve clarity and certainty on reinsurance coverage, a reinsurance contract should be unambiguous, and there should be complete and final agreement of all material terms and conditions of the contract, documented in writing, by all parties prior to the contract's effective date.

BCFSA recognizes that there may be situations where a comprehensive reinsurance contract is only duly executed by all parties after the effective date. In such circumstances, historical practice has been that the reinsurance coverage during this interim period is usually set out in a less formal document (e.g., slip, cover note, letter of proposal, binding letter of intent, hereinafter referred to as the "summary document"). If an event were to occur within this interim period, lack of certainty relating to the terms and conditions of the reinsurance coverage in the summary document could result in actual operational and reputational risks for both the cedant and the reinsurer.

In an effort to mitigate these risks, BCFSA expects insurance companies to:

- Obtain contractually binding summary documents prior to the effective date of the reinsurance coverage, including, but not limited to electronic copies, or original hard copies, of signed documents that set out:
 - The premium/consideration paid by the cedant;
 - The percentage of risk assumed by each reinsurer;
 - The risk(s) reinsured;
 - The duration of the coverage;
 - Exclusions to terms of coverage, where applicable; and
 - Standard clauses that are relied upon or incorporated by reference into the reinsurance contract;
- Address, within the summary document, material issues most likely to arise, includes including all variable or unique agreement terms; and
- Ensure that all final comprehensive reinsurance contracts, including amendments thereto, bear the duly authorized signature of both ceding company and reinsurer(s)⁶ within a relatively short timeframe having regard for the nature, complexity, and materiality of the agreement (e.g., within 120 days of execution).

A reinsurance contract should stand on its own, providing the necessary clarity and legal certainty on reinsurance coverage. BCFSA acknowledges, however, that there may be situations where it is necessary and appropriate for an insurance company to enter into a supplemental or subordinated reinsurance contract, a side letter, or other types of arrangements that are ancillary to, and form part of, the main reinsurance contract. In addition to ensuring that these arrangements meet the requirements of this guideline, the insurance company should inform stakeholders about these arrangements, ensure that such amendments are appropriately reflected in its financial statements,

⁶ BCFSA would generally not consider an agreement bearing the signature of the reinsurance intermediary as acceptable unless the intermediary can support a finding that it has the authority to act for, or on behalf of, the cedant or reinsurer, as the case may be.

and ensure that they do not adversely change the terms or conditions of the original contract to the detriment of policyholders.

INSOLVENCY CLAUSES

Principle 4: The terms and conditions of a reinsurance contract should not adversely affect the ceding insurance company.

The terms and conditions of a binding reinsurance agreement should provide that funds will be available to cover policyholder⁷ claims in the event of either the cedant's or reinsurer's insolvency. To this end, reinsurance contracts should include an insolvency clause. An insurance company should pay particular attention to the appropriate use⁸ of off-set or cut-through clauses, the structure of funds withheld arrangements⁹ and other such types of terms or conditions that may frustrate the scheme of priorities under the federal *Winding-Up and Restructuring Act* ("WURA").

Ceding insurance companies should ensure that all reinsurance contracts contain an insolvency clause clarifying that the reinsurer must continue to make full payments to an insolvent cedant without any reduction resulting solely from the cedant's insolvency. Such a clause provides greater certainty that reinsurance receivables remain within the overall general estate of the insolvent ceding company rather than being allocated toward the payment of specific claims of creditors or policyholders.

BCFSA expects reinsurance contracts with third-party reinsurers (i.e., entities that are not in the same corporate group as the insurance company-cedant) to contain an insolvency clause stipulating that, in the event of the insolvency of the insurance company-cedant, all reinsurance receivables are to be paid directly to an insurance company-cedant in Canada, or to a person acting for, or on behalf of, the insurance company-cedant in Canada.

BCFSA expects reinsurance contracts with affiliated reinsurers (i.e., entities within the same corporate group as the insurance company-cedant) to contain a clause stipulating that all reinsurance receivables are to be paid directly to an insurance company-cedant in Canada, or to a person acting for, or on behalf of, the insurance company-cedant in Canada.

Other Terms and Conditions Affecting the Ceding Insurance Company

Reinsurance contracts should not contain other types of terms or conditions that may limit a troubled or insolvent cedant's ability to enforce the contractual obligations of a reinsurer, or that may adversely affect the treatment of any claims in respect of the cedant's policyholders. Off-set and cut-through clauses may allow certain creditors or policyholders to have preferential treatment over other claims, contrary to the scheme of distribution in the WURA.

Funds Withheld Arrangements

If a reinsurance contract provides for a funds withheld arrangement, the contract must clearly provide that, in the event of the cedant's or reinsurer's insolvency, the funds withheld, less any surplus due back to the reinsurer, must form part of the property of the cedant's general estate or part of the assets in Canada of a foreign insurance company, as defined under the WURA and the *Insurance Companies Act* ("ICA").

⁷ No policyholder in the (re)insurance chain should be adversely affected, including the cedant and its policyholders.

⁸ BCFSA recognizes that there may be situations where the interests of a cedant insurance company and its policyholders may be better served by the use of off-set and cut-through clauses. BCFSA does not intend to restrict the use of such terms or conditions where they do not give preferential treatment over other claims under the scheme of distribution in the *Winding-Up and Restructuring Act*.

⁹ Under funds withheld arrangements, assets (generally the premium) that would normally be paid over to a reinsurer as consideration under the reinsurance agreement are withheld and retained by the ceding company as a form of security enabling a capital credit for unregistered reinsurance.

Reinsurance Contracts Subject to Relevant Laws and Courts

BCFSA expects reinsurance contracts, and any disputes arising from such contracts, to be subject to the laws and courts of B.C. or another equivalent legal jurisdiction. Accordingly, all contracts related to reinsurance coverage should stipulate a choice of forum, a choice of law, and the appointment of agents for service of legal processes in a manner consistent with this expectation.

GUIDELINE ADMINISTRATION

An insurance company should maintain (and provide to BCFSA upon request):

- Its RRMP;
- A complete description of all its reinsurance arrangements;
- The due diligence performed on reinsurance counterparties; and
- The stress testing performed on the reinsurance program.

Insurance companies should regularly report to senior management to confirm that their reinsurance risk management practices and procedures meet, except as otherwise disclosed, the principles set out in this Guideline. The reporting should include assurances that the insurance company's reinsurance arrangements effect a risk transfer and that they have been accounted for in an appropriate manner.

An insurance company should promptly inform BCFSA if it becomes aware of any reinsurance issues that could materially impact its financial condition. An insurance company should also document and disclose any deviations from the principles set out in this Guideline to senior management and to BCFSA. The disclosure should address the nature and extent of the deviation, and the measures taken or proposed to correct or mitigate any associated risks.

A reinsurance program or reinsurance contract that does not adhere to the principles and expectations set out in this Guideline may not provide the intended protection to the ceding company and could compromise the availability of balances that may have been otherwise recoverable. BCFSA may not grant a capital credit for the reinsurance arrangement or may adjust the insurance company's capital requirements or target solvency ratios in such circumstances.

OTHER GUIDANCE

This Guideline is complementary to, and should be read in conjunction with, other guidance that directly or indirectly addresses various elements of reinsurance or governance, including:

- BCFSA's Third-Party Risk Management Guideline, if an insurance company uses the services of a reinsurance intermediary to facilitate its reinsurance RRMP;
- OSFI's Guideline A - Life Insurance Capital Adequacy Test for life insurers and societies; Minimum Capital Test for property and casualty insurers; and
- OSFI's Corporate Governance guideline, which provides information to Boards and management about OSFI's expectations on corporate governance.