September 6, 2022

[submitted via FSRA website]

Financial Services Regulatory Authority of Ontario
25 Sheppard Avenue West, Suite 100
Toronto, ON
M2N 6S6

RE: ID 2022-008: Consultation on the proposed insurance prudential supervisory framework guidance (the "Proposed Framework")

We are pleased to provide the Financial Services, Regulatory Authority of Ontario ("FSRA") with our comments in connection with the above-noted Proposed Framework.

CAIR and reciprocal exchanges background

CAIR is an industry association for Canada's insurance reciprocals. CAIR is providing comments on behalf of its Ontario members, which include municipal governments, hospitals, educational institutions and local utility companies.

As defined in the *Insurance Act* (Ontario) (the "Act"), a reciprocal insurance exchange is a group of subscribers exchanging reciprocal contracts of indemnity or insurance with each other through the same attorney. Subscribers are the persons exchanging with each other reciprocal contracts of indemnity or insurance as provided in section 378 of the Act.

Due to their nature, reciprocal exchanges are not-for-profits. Reciprocal exchanges are often created in sectors where traditional insurance has not met the needs of an industry from a cost and/or coverage perspective. Reciprocal exchanges permit subscribers to mutually protect themselves with appropriate coverage in a more cost-efficient manner than they can with traditional insurance, with each subscriber contributing its share of claims and operational costs.

Importantly, reciprocal exchanges may undertake insurance only on behalf of their subscribers.

The Proposed Framework <u>does not</u> apply to reciprocal exchanges

The Proposed Framework, as stated on page 2 of the Proposed Framework, is intended to affect "insurers incorporated under the Act."

While reciprocal exchanges are *licensed* under the Act, they are not *incorporated* under the Act. We believe the specific language chosen by FSRA in connection with the scope of the Proposed Framework is deliberate. As such, the Proposed Framework does not apply to reciprocal exchanges.

We agree with this approach -- for the reasons noted below, the Proposed Framework simply doesn't work well for reciprocal exchanges. Historically, regulators have recognized the unique aspects of reciprocal exchanges. Specific acknowledgement of the exclusion of reciprocal exchanges from the Proposed Framework would be appreciated by our membership.

The Proposed Framework should not apply to reciprocal exchanges

In the event that FSRA is considering a similar framework for reciprocal exchanges or wishes to amend the Proposed Framework to include reciprocal exchanges in the Proposed Framework, we have set out below some of our high-level concerns in connection with the Proposed Framework in the context of reciprocal exchanges.

- **Reciprocal exchange governance.**

Each reciprocal exchange is governed by a subscribers agreement. A reciprocal exchange's subscriber agreement, among other things:

1. establishes an advisory board to be responsible for the supervision of the exchange,
2. sets out the powers and duties of the advisory board, and
3. describes how the exchange will establish standards and procedures in connection with investments.

Any change to the agreement must be approved by the regulator.

Unlike a traditional insurer, through the subscribers agreement, the reciprocal exchange has a contract with its subscribers/policyholders regarding the governance of the reciprocal exchange, including its management and oversight. Through the mandated advisory board, subscribers/policyholders are given a voice in the governance of the exchange - the advisory board is made up of the reciprocal exchange's policyholders. *As such, the interests of subscribers and reciprocal exchanges are aligned, significantly reducing market conduct risk*. The very structure of the reciprocal lowers the likelihood of imprudent or unsafe business practices and misconduct impacting policyholders, which is the rationale for the Proposed Framework.

- **Reciprocal exchanges are required to make up any deficiency.**

Section 386 of the Act requires the reciprocal exchange to maintain reserves and surplus in amounts set out in the legislation. The subscriber agreement allows premium reassessment in the unlikely event that additional premium is needed (i.e. the subscribers are required to make up any deficiency), thus improving the stability of the reciprocal exchange itself. This is different than in traditional insurance, where an insurer cannot go back to the insured to request additional premium.

The structure of the reciprocal means that, for the most part, only subscribers are affected by its failure. Subscribers are aware of this risk because subscriber agreements outline the financial impacts to subscribers.

- **Proportionality.**

Section 379 of the Act provides that "No person shall be deemed to be an insurer within the meaning of this Act by reason of exchanging with other persons reciprocal contracts of indemnity or insurance under this Act." As such the subscribers are not insurers. Subscribers are, however, the policyholders of the reciprocal exchange. The rights and interests of policyholders are protected by the very nature of the reciprocal exchange.

We note that the Proposed Framework references the concept of proportionality. If applied to reciprocal exchanges, any supervisory framework should make it clear that benchmarks used in the context of reciprocal exchanges are different than those used for other types of insurers and that any requirements for independence (see below for more information about independence requirements) and similar expensive oversight will be proportional to their size and take into account the nature and built-in protections of reciprocal exchanges – including that reciprocal exchange members, which are also the policyholders and subscribers of the reciprocal exchange, are represented in the form of an advisory board that oversees the underwriting practices and other operations of the reciprocal exchange.

- **Costs of the Proposed Framework.**

The Proposed Framework indicates that the level and extent of supervision under the Proposed Framework will depend on the size, complexity and risk profile of the insurer, as well as the potential consequences of an insurer's failure, including systemic impact.

Historically, reciprocal exchanges have been low-risk, stable, well-capitalized organizations. That said, most reciprocal exchanges are relatively small organizations with limited capacity to implement the additional oversight functions that seem to be required by the Proposed Framework, particularly the independence requirements. The Proposed Framework seems to require insurers to outsource oversight functions to external third parties or become subject to increased FSRA assessment procedures. This approach penalizes smaller organizations that may not have "sufficient" independence between oversight and operational management. But, as noted, reciprocal exchanges do have an advisory board that oversees operational management – that advisory board is made up of the subscribers/policyholders. The existence and function of the advisory board should be a factor when considering any supervisory framework for reciprocal exchanges. If it is not, the supervisory framework would take necessary resources away from not-for-profit sectors, like health care, which result seems to be unnecessary given the nature of reciprocal exchanges.

Another cost concern is what seems to be a requirement in the Proposed Framework for the completion of an ORSA. Unlike traditional insurers, reciprocal exchanges are not required to complete an ORSA. As such, any supervisory framework for reciprocal exchanges should not consider an ORSA to be a key indicator of resilience.

Currently, reciprocal exchanges are able to return excess surplus to subscribers. These insurance savings benefit the subscribers and the taxpayers of the province in the long run (as indicated, reciprocal

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exchanges are often hospitals, municipalities, universities, local utility companies and school boards). To the extent the Proposed Framework increases costs to the reciprocal exchange, it will reduce the ability of the reciprocal exchange to return excess surplus to subscribers.

Need for continued consultation.

In our experience, the concept of reciprocal exchanges is not well understood. The Proposed Framework properly does not apply to reciprocal exchanges. If the Proposed Framework is meant to apply to reciprocal exchanges, we strongly suggest that further direct consultation by FSRA be conducted with reciprocal exchanges. In this way, FSRA will not only understand the operational and other challenges inherent with the Proposed Framework, but it may be possible to develop a realistic way to create a framework in connection with reciprocal exchanges that would be meaningful. In our view, the Proposed Framework proposes a theoretical way to supervise insurers as if they were a homogenous group, but Ontario's insurers are not a homogenous group – reciprocal exchanges are not traditional insurers, they are the result of a group of subscribers exchanging reciprocal exchange contracts of indemnity or insurance with each other.

This letter has touched on several areas we feel warrant a deeper review. If required in connection with reciprocals, we look forward to discussing the points raised above in a more direct forum. Please contact Sandra Taylor if you have any questions.

Sincerely,

Sandra Taylor, CHAIR