OSFI GUIDANCE ON CAT BONDS: IMPLICATIONS FOR THE CANADIAN FINANCIAL SYSTEM

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CAT BONDS MOVE FURTHER INTO THE CANADIAN RISK-TRANSFER TOOLKIT

Catastrophe bonds (cat bonds) transfer defined natural-catastrophe risks from insurers and reinsurers to investors in the broader capital market. By supplementing traditional reinsurance, they can provide fully collateralized, multi-year protection while expanding the pool of capital available to absorb catastrophe losses. They are therefore understood as an additional tool that can diversify an insurer's sources of risk-bearing capacity. Global Risk Institute's (GRI) May 2025 primer, Cat Bonds: Risks and Opportunities for the Canadian Financial Sector, provides background on the instrument's uses, opportunities and risks in Canada, including the importance of alignment with evolving regulatory frameworks (Bu, 2025).

On July 20, 2026, the Office of the Superintendent of Financial Institutions (OSFI) issued a regulatory notice under Section 4.3 of the Minimum Capital Test (MCT) Guideline. The notice applies to federally regulated P&C insurers, excluding mortgage insurers. It serves as interim guidance pending incorporation of this treatment into the next version of the MCT Guideline, after which it will be rescinded. Effective immediately, OSFI will consider natural cat bonds as eligible unregistered reinsurance for capital purposes under the MCT where specified conditions are met, including that the bond uses an indemnity trigger, collateral is invested in high-quality assets and fully paid into a reinsurance security agreement, and the collateral is held in Canada.

> *"Resilience and competitiveness require risk capacity. By clarifying the use of catastrophe bonds, we are helping insurers access additional risk transfer capacity while protecting policyholders."*
>
> *— Peter Routledge, Superintendent of Financial Institutions, OSFI*

Before using a natural catastrophe bond to reduce required capital for insurance risk, insurers need to obtain OSFI's approval and submit documentation showing how the bond fits within their reinsurance program and complies with their reinsurance risk-management policy and Guideline B-3. The submission is also required to cover the transaction's key contractual and legal terms, structure and collateral arrangements, as well as related stress-testing and modelling. OSFI also requires confirmation that a default under the arrangement would not trigger cross-defaults or credit events in any other debt or derivative agreements of the sponsoring insurer. This helps prevent stress arising from the cat-bond arrangement from extending to the sponsor's broader financial obligations.

The notice also sets boundaries around which risks and structures qualify for this capital treatment. Eligible coverage is limited to natural hazards such as earthquakes, hurricanes, severe convective storms, floods, and wildfires. Bonds covering man-made or human-initiated events fall outside the definition, including terrorism, war or political violence, industrial accidents,

pollution, human-caused nuclear or radiological events, and cyberattacks. Multi-peril structures will need to be assessed against this boundary. For qualifying bonds, no margin requirement applies to the bond itself. However, the collateral remains subject to the capital requirements for unregistered reinsurance (OSFI, 2026).

Among the notice's capital-recognition conditions, the indemnity-trigger requirement may be the most consequential constraint on transaction structuring. Although indemnity triggers still dominate the market, their share has been declining as parametric and industry-loss-index structures grow (Bu, 2025). Sponsors seeking MCT capital credit will therefore have less flexibility to use these alternative structures. The requirement cuts both ways: it reduces basis risk by tying payouts to reported losses, but requires disclosure of otherwise confidential catastrophe-loss data, and can result in slower settlement than parametric alternatives. By defining these conditions for capital recognition, OSFI has more clearly established the treatment of qualifying cat bonds within Canada's regulatory framework, although their wider use will still depend on transaction economics, execution and market participation.

WHY FINANCIAL INSTITUTIONS SHOULD PAY CLOSER ATTENTION

The most immediate implications are for federally regulated property and casualty insurers, which can now assess qualifying cat bonds within a more defined MCT capital framework. For institutional investors and asset managers, greater domestic issuance could broaden opportunities to gain exposure to catastrophe risk in Canada. Banks and securities firms may support structuring and placement, while a larger market could, over time, also increase demand for specialized legal, modelling, collateral-management and custody services.

For insurers, the notice expands the range of natural catastrophe events for which qualifying cat bonds can receive regulatory capital recognition. While the existing MCT framework addresses financial resources supporting earthquake risk, including reinsurance coverage and capital-market financing (OSFI, 2025), the notice provides capital recognition for qualifying cat bonds covering other natural catastrophe events, including floods, wildfires and severe convective storms. This enables sponsors to consider cat bonds alongside traditional reinsurance across a broader range of natural perils. In assessing these alternatives, sponsors can compare the all-in cost of a cat bond—including investor spreads, structuring, legal, modelling and collateral-management expenses—with the premium and associated transaction costs of traditional reinsurance. Beyond pricing considerations, cat bonds and traditional reinsurance offer different combinations of duration, collateralization, flexibility, and counterparty characteristics, which sponsors can now assess across a broader range of natural catastrophe events.

POTENTIAL EFFECTS ON THE BROADER FINANCIAL SYSTEM

The global market remains heavily influenced by U.S. hurricane and other U.S. catastrophe exposures (Artemis, 2026). TD's two issuances contribute a more geographically differentiated Canadian peril profile, with the second extending coverage to include named storms, winter storms and wildfires (TD Bank Group, 2026). If issuance expands beyond a single repeat sponsor, Canadian

risks could gradually diversify the catastrophe exposures available to global ILS investors while providing domestic insurers with an additional source of risk-bearing capacity. For investors, the strength of that diversification benefit will depend on factors such as issue size, repeat issuance, model confidence, and transparent transaction structures.

A larger Canadian cat-bond market could also affect competition for catastrophe risk. A clearer route to capital recognition may make capital-market protection a more credible option when insurers compare capacity, duration and price. This could create an additional pricing reference and give sponsors more flexibility in negotiating their overall reinsurance arrangements. Traditional reinsurers would remain central to the market, but they could respond to greater cat-bond participation by adjusting pricing, offering additional or more flexible capacity, expanding multi-year and collateralized solutions, or partnering more closely with ILS managers and capital-market investors. These competitive responses could be as important as the direct growth of cat bonds themselves.

At the financial-system level in Canada, broader use of cat bonds could also change how catastrophe risk is distributed. A larger share of losses could be transferred from insurers' and reinsurers' balance sheets to a broader investor base, diversifying catastrophe-risk-bearing capacity beyond the insurance sector. At the same time, this would increase the importance of understanding where catastrophe risk ultimately sits within the financial system and how investors respond following major loss events, including availability and pricing of capital thereafter.

WHAT CANADA CAN LEARN FROM MORE ESTABLISHED INSURANCE-LINKED SECURITIES (ILS) MARKETS

More established ILS markets suggest that regulatory recognition is only one component of successful market development. These jurisdictions have generally complemented prudential recognition with legal, tax and market-development measures that reduce execution uncertainty and support repeat issuance. The UK established a dedicated regulatory and tax framework for ILS, including an authorization regime for insurance special purpose vehicles (ISPVs) and specific tax treatment for qualifying structures (Bank of England, 2025). Singapore paired its regulatory framework for special purpose reinsurance vehicles (SPRVs) with an ILS grant scheme that offsets eligible issuance costs, alongside industry-development initiatives intended to build expertise and attract transactions (Yong & Tiwari, 2026). In each case, regulatory recognition was supported by measures intended to make transactions easier to structure and repeat.

For Canada, OSFI's notice addresses an important source of prudential uncertainty. Market development will now depend more on whether transactions can be executed efficiently and remain commercially competitive with traditional reinsurance than on regulatory recognition itself. A clear example is the requirement that collateral be in Canada and fully paid in under a reinsurance security agreement. As ILS transactions commonly use offshore special purpose vehicles that hold collateral in trust outside the sponsor’s home jurisdiction, this

requirement may necessitate Canadian-based collateral and related custody arrangements. TD's structures, which invest proceeds in Canadian dollar-denominated notes, illustrate one approach to meeting these requirements; for first-time sponsors, however, the associated arrangements may still entail additional structuring and cost considerations.

Experience in other jurisdictions suggests that clear approval processes, practical legal and collateral arrangements and access to specialist modelling and structuring expertise can reduce execution uncertainty and support market participation. Canada's notice has so far focused on the prudential and capital-treatment aspects of ILS market development. This focus differs from the broader frameworks in the United Kingdom, which include a dedicated ISPV authorization regime and tax treatment, and Singapore, which complements its regulatory framework with an ILS grant scheme for eligible issuance costs. Accordingly, the notice alone is unlikely to align the all-in cost of a Canadian issuance with that in these more established markets. Tax treatment or cost-support measures, if introduced, would be separate from and subsequent to the prudential clarification provided by the notice.

CONCLUSION

OSFI's notice marks an important step in clarifying the prudential treatment of natural cat bonds in Canada. Looking ahead, a key question is whether greater regulatory certainty translates into broader sponsor participation and repeat Canadian issuance. Such a development would provide stronger evidence that cat bonds are becoming an established part of Canada's catastrophe-risk financing market rather than remaining limited to occasional transactions. Investor appetite and supporting market infrastructure will also shape their longer-term development. For sponsors, part of the benefit of this clarification may show up as improved traditional reinsurance terms rather than as cat bond issuance itself.

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