



15th March 2017

Dear Stakeholders:

Re: Consultation Paper on Bermuda Solvency Capital Requirement Update Proposal, November 2016

The Bermuda Monetary Authority (Authority) would like to thank stakeholders for their continued support of our key initiatives. The Authority appreciates the feedback received and is committed to working closely with its stakeholders to ensure that Bermuda's regulatory regime is effective and aligned with international standards.

On 30th November 2016, the Authority issued a consultation paper on a series of potential adjustments to the Bermuda Solvency Capital Requirement (BSCR) standard formula.

Outlined below are our responses to the more significant comments:

I. Background and General Comments

I.1) Implementation Date and Field Testing Period

The majority of the stakeholders raised concerns about the timing of testing and implementation of the proposals. Aside from the timing, several stakeholders were generally supportive of the changes being proposed.

The Authority acknowledges these concerns and has decided to delay the date these proposed changes will enter into force for one year, more specifically for year-end filings for financial years beginning on or after 1st January 2017 (i.e. for year-end 2017 for most insurers) the BSCR changes will be calculated for reporting purposes (i.e. the official Enhanced Capital Requirement (ECR) ratio will be the one calculated under the current basis) and will then enter into force for financial years beginning on or after 1st January 2018 (i.e. for year-end 2018 for most insurers). This will allow more extensive field testing (two rounds rather than one) as well as providing more time for insurers to prepare to comply with new requirements.

I.2) Grade-in Provisions

Several stakeholders suggested a phased-in implementation approach to mitigate the impact of the proposed changes especially for Long-Term insurers which are more constrained in terms of their ability to reprice contracts.

The Authority agrees with this proposal and in addition to postponing the date the changes will enter into force by one year, there will be a three-year grade-in period starting in the financial year beginning on or after 1st January 2018 (i.e. for year-end 2018 for most insurers). Insurers should calculate the ECR under both the current regime (i.e. without the changes proposed herein) and the new regime and reflect:

- 33% of the difference between the two calculations in the financial year beginning on or after 1st January 2018 (i.e. for year-end 2018 for most insurers), which means that the ECR for that year will correspond to the ECR under the current regime plus the referred 33% of the difference.
- 66% of the difference between the two calculations in the financial year beginning on or after 1st January 2019 (i.e. for year-end 2019 for most insurers), which means that the ECR for that year will correspond to the ECR under the current regime plus the referred 66% of the difference.
- 100% the difference between the two calculations in the financial year beginning on or after 1st January 2020 (i.e. for year-end 2020 for most insurers), which means that the ECR for that year will correspond to the ECR under the new regime.

Some stakeholders also mentioned that other major risk based regulatory regimes are currently being revised, namely Solvency II and the draft Insurance Capital Standard (ICS) of the International Association of Insurance Supervisors (IAIS). While no major changes on issues addressed on the Consultation Paper are expected, delaying the proposed changes for one-year plus implementing the phase-in provisions will better align timelines and allow the Authority to amend certain provisions should there be significant unjustifiable divergence between our proposals and these regimes.

I.3) Grandfathering Provisions for In-force Transactions and Further BSCR Changes

Some Long-Term insurers suggested the introduction of grandfathering provisions for inforce transactions. Grandfathering provisions introduce an uneven level playing field between existing and new players, are hard to supervise and report, complicate calculations (e.g. unbundling charges and diversification benefits between inforce and new transactions) and embed legacy and cliff components into the BSCR standard formula. The Authority believes that grade-in provisions are a more equitable, effective and efficient approach to manage the impact of the new changes.

There was also a request for the Authority to share its plan for future changes in the BSCR standard formula. The Authority will engage with industry associations with this regard. The BSCR plan will be a separate document and will be published in due course.

Another consultation paper with additional changes is expected to be produced in the second half of 2017 with the ultimate goal of further increasing the risk sensitivity of the BSCR standard formula and better reflect how insurers manage risks. It will be field tested as part of the year-end 2017 filing and will enter into force for year-end 2018. Likely areas to be included in this upcoming consultation paper are: interest rate risk, risk mitigation techniques, use of management actions and use of look-through for equity risk charge. Notwithstanding the BSCR plan, no significant changes are envisaged in the medium term, unless there are material international regulatory developments that prompt the need for the Authority to revise our approach to continue to be perceived as a leading jurisdiction that is aligned with best practices in terms of solvency regimes.

II. Equity Risk

The Authority has received a fairly large and diversified number of comments on equity risk which were duly taken into account on the basis of their technical robustness, risk sensitivity and benchmarking to other leading risk-based regulatory regimes. Ultimately, the Authority has decided to perform the following changes:

- Apply instantaneous equity shocks (which will remain largely unchanged from the previous proposal) to both sides of the balance sheet (assets and technical provisions and segregated account companies), typically to the so called Net Asset Value (NAV).
- Revise the definition for ring fenced asset and liabilities.
- Add to the 35% equity shock (previously applied solely to equity listed in OECD and Bermuda markets) exposures listed in the European Economic Area (EEA), Hong-Kong and Singapore markets as well as in other developed markets to be published in the Authority's Guidance and also equity exposures to selected mutual funds.
- Ignore short equity exposures (other than those embedded in the technical provisions and segregated account companies) for the purposes of the calculation. This provision will be reassessed as part of the upcoming consultation paper, once risk mitigation acceptance criteria are proposed.
- Assign a null equity risk charge for the shocks in which the NAV is negative.

III. Premium Risk

Very few comments were received on premium risk. Overall there is no clear preference for the options being tested, although some stakeholders mentioned preference towards option 1 for consistency with the Solvency II approach. The Authority has decided to implement a slightly modified version of option 1 where the base exposure will be the maximum between the estimate of the net premiums to be earned by the insurer during the next 12 months' accounting period and the net premium written at year end.

Some stakeholders requested more clarity on what falls under the scope of multi-year exposure. As already explained in the consultation paper, in order to determine what contracts fall under multi-year exposure, insurers should take into account whether the contracts fall within the contract boundaries for in-force and next year business exposure. Contract boundaries are defined in paragraph 122 of the Authority's Guidance Notes for Commercial Insurers and Insurance Groups' Statutory Reporting Regime, of 30th November 2016: the cash flow projections used in the calculation of the best estimate should take account of all future cash in- and out-flows required to settle the insurance obligations attributable to the lifetime of the policy. This is defined to continue up to the point at which:

- a) the insurer is no longer required to provide coverage;
- b) the insurer has the right or the practical ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk;
- c) the insurer has the right or the practical ability to reassess the risk of the portfolio that contains the contract and, as a result, can set a price that fully reflects the risk of that portfolio.

For example, multi-year contracts with "getaway clauses", such as annual renewal of cancellation provisions may be treated as one-year contracts and thus excluded from multi-year exposure.

IV. Credit Risk

Very few comments were received on credit risk; they were duly taken into account on the basis of their technical robustness and proportionality. Ultimately, the Authority has decided not to change the proposed approaches and calibration factors for future premium receivables and receivables on securities sold. As for the insurance credit risk charge associated with future claims, the new proposed approach may not work well for insurers that are on contraction or run-off phase, therefore we propose that the capital charge to be the maximum between the current approach and the new approach.

V. Other Insurance Risk Long-Term Insurance

Several Long-Term stakeholders proposed to split this charge between:

- Lapse-sensitive mortality products, with the charge applied to the best estimate liabilities for lapse sensitive mortality products, including lapse-supported products.
- Mortality products with no or low lapse sensitivity, with the charge applied to the best estimate liabilities for non-lapse sensitive mortality products.

The Authority agrees with this approach but further study is needed on the calibration of the associated factors. As such, changes to this capital charge will be postponed to the referred consultation paper with additional changes which is expected to be produced in the second half of 2017.

VI. Dependencies

Stakeholders highlighted that changes to the dependency framework is likely to be the change with the most material impact on the solvency position of insurers. The Authority concurs with this assessment. Some Long-Term stakeholders requested a more granular approach to directly model correlations that fall within different risk modules and that are, in the stakeholders' opinion, overstated. Conversely, several stakeholders supported the Authority's proposed approach.

The current standard in terms of leading risk based supervisory regimes (e.g. Solvency II or the ICS) is to have a modular approach to capital requirements with multi-levels of aggregation and with capital charges being aggregated using tail correlations matrixes, firstly within the risks of the same risk module and secondly across risk modules. We believe that an appropriate selection of tail correlations matrixes strikes an adequate balance between tractability, robustness and risk sensitivity. Last but not least, the current set of correlation matrixes both in terms of structure and parameterisation are consistent and comparable to peer risk based regimes. All in all, the Authority has decided to keep the methodology unchanged.

VII. Operational Risk

Long-Term stakeholders requested a delayed or staggered implementation of the proposed operational risk changes such that insurers may be afforded time to augment their operational risk management programmes. This request is being addressed through delaying the date that the proposed changes will enter into force and also through the implementation of grade-in provisions as explained on point I of this response.

VIII. Other Adjustments

There was wide support from the stakeholder community with the proposed approach. Some stakeholders suggested focused changes to some aspects of the approach, namely the use of the risk margin as a proxy for the insurer's future income. Although interesting from a theoretical perspective these suggestions would increase the complexity of the calculation and make the calculation less "auditable". All things considered, the Authority has decided keep the proposed approach unchanged.

IX. Run-off Insurers

The Authority has received rather mixed feedback on the proposal to use entity specific parameters for reserve risk calibrated to an ultimate basis both in terms technical consistency, level playing field and cherry picking potential. The Authority acknowledges these concerns and has decided to request all run-off insurers to calculate annually the ECR using the BSCR standard formula and apply the standard BSCR factors for all risks. For loss portfolio transfers, insurers should apply for a BSCR modification to avoid potential double counting of exposure in premium and reserve risks.

Additionally, as part of the annual filing to the Authority, run-off insurers will have to include on the actuarial and run-off annual report, comments and supporting analysis on the adequacy of the standard BSCR reserve risk factors, taking into account the adverse loss reserve development potential of the carried reserves.

For avoidance of doubt run-off insurers in this context means “pure”/“traditional” run-off insurers and those insurers whose business model consists primarily of acquiring run-off books of business, namely through loss portfolio transfers and excludes insurers that operate on a going concern basis that may have a few legacy portfolios that were put into run-off.

Additionally, the Authority wishes to clarify and emphasise that having capital in excess of the 120% ECR ratio is not in itself sufficient reason for the Authority to approve dividend requests. The BSCR reserve risk charge may not appropriately reflect the risk profile of certain run-off reinsurers (e.g. for insurers with material asbestos, medical malpractice, long term care and other highly volatile and/or long tailed lines of business). Where this is the case, the Authority may impose capital add-ons.

In addition to providing the BSCR as part of the dividend request, run-off insurers will have to include actuarial and run-off supporting analysis to assess the adequacy of the standard BSCR reserve risk factors, taking into account the adverse loss reserve development and IBNR potential of the carried reserves and also to assess that the remaining capital is sufficient to ensure the complete run-off of the liabilities and all related expenses with high probability. Connected with these two points, run-off insurers should also provide details about their capital management strategy and how the implementation of this strategy is monitored.

X. Additional changes on currency risk

Certain pegged currencies, will qualify for a reduced currency shock to be set in the Authority’s Guidance, if they comply with criteria also to be set in the Guidance.

The Authority would like to thank stakeholders for their comments on the consultation paper on Bermuda Solvency Capital Requirement Update Proposal, November 2016, and we remain committed to working with industry and other interested parties to ensure that results achieved are in the best interest of the Bermuda market.

Yours sincerely,

Bermuda Monetary Authority