BERMUDA MONETARY AUTHORITY

CONSULTATION PAPER

ON IMPLEMENTATION OF BERMUDA REPORTING REGIME FOR COMMERCIAL INSURERS AND INSURANCE GROUPS

September 2015

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I. Introduction

1. The Bermuda Monetary Authority (the Authority) continues to review Bermuda's regulatory and supervisory regimes, to ensure that the jurisdiction adheres to international standards and best practices for insurance regulation and supervision. In that regard, the Authority recently instituted a number of changes to its regime for commercial[1] insurers[2] and insurance groups. In order to monitor compliance with these provisions, as well as to streamline the regulatory reporting requirements, the Authority is proposing to enhance its statutory reporting requirements for its commercial insurers.

2. In December 2014, the Authority issued a Consultation Paper on the Economic Balance Sheet (EBS) Framework which would be used as the basis to determine the insurer's Enhanced Capital Requirement (ECR). The paper stated that the EBS framework would use the "GAAP balance sheet as a starting point"[3] though insurers "would still be required to provide the statutory financial statements as currently stated under Section 15 of the [Act] until such time as the Authority revises the statutory basis of financial reporting."[4] The EBS requires that the Generally Accepted Accounting Principles (GAAP) balance sheet be prepared on a consolidated basis.

3. The Authority has embedded the EBS Framework into its legislative and regulatory regimes and is now addressing the basis in which the Statutory Financial Statements (SFS) are prepared. This paper does not seek to make any changes to the EBS framework. Currently, commercial insurers are required to prepare SFS under Section 15 of the Insurance Act 1978 (the Act), which are prescribed under the Insurance Accounts Regulation 1980 (the Accounts Regulations) as well as "additional GAAP financial statements" under Section 17A of the Act. The Authority proposes to use the financial statements prepared under Section 17A of the Act as the basis in which the SFS will now be prepared, subject to the application of certain prudential filters. These financial statements, in turn, will be used to prepare the EBS. The Authority also proposes to require that the approved auditor for commercial insurers be based in Bermuda.

4. Other miscellaneous requirements will be added to the Capital and Solvency Return, as prescribed in the various Insurance (Prudential Standards) (Solvency Requirement) Rules, to capture information about outsourcing of the chief

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[1] Commercial insurers are Class 3A, Class 3B, Class 4, Class C, Class D and Class E insurers.
[2] The terms "insurers" include both insurers and reinsurers, and "insurance" includes reinsurance.
[3] Consultation Paper on Economic Balance Sheet Framework, paragraph 13
[4] Ibid, paragraph 2

executive and senior executive roles, and the recently introduced head office provisions, as set out in Section 8C of the Act. These requirements will assist the Authority to monitor compliance with the recent head office and outsourcing amendments. Additionally, the Authority proposes to amend the SFS for Segregated Account Companies (SACs) to take account of whether the SACs have recourse to the General Account, which will consequently affect the commercial insurer's Minimum Margin of Solvency (MSM) calculation.

5. The proposed changes will be risk-based, which would allow the Authority to adopt a proportional approach given the commercial insurer's risk profile. The scope of the proposed changes is focused on commercial insurers only, with the exception of paragraph 31b, which includes insurance groups. The proposals are intended to come into operation on 1st January, 2016 and apply to financial years commencing on or after 1st January, 2016.

6. This consultation aims to update Bermuda's insurance regulatory regime in a manner that is as robust as it is suitable for the characteristics of the Bermuda insurance market, ensuring that it remains both credible and appropriate. The Authority anticipates that as these requirements are operationalised, there may be a need to conduct a review. The purpose of the review will be to determine what adjustments may be needed to ensure that objectives are met while mitigating any unintended consequences.

7. The Authority invites the views of the insurance industry and other interested persons on the proposals set out in this paper. Comments should be sent to the Authority, addressed to riskanalytics@bma.bm no later than 23rd October, 2015.

II. Amendments to the Insurance Regulatory Reporting Framework

A. GAAP Financial Statements – Section 17A of the Insurance Act (1978)

8. Section 17A of the Act requires commercial insurers to prepare financial statements according to one of the following standards:
   a. International Financial Reporting Standards ('IFRS');
   b. GAAP that apply in Bermuda, Canada, the United Kingdom or the United States of America; or
   c. such other GAAP as the Authority may recognise.

9. These financial statements are audited by an approved auditor and published by the Authority in accordance with Section 17A(6) of the Act. In order to use these financial statements as the starting point for both the EBS and SFS, these statements need to be prepared on a consolidated basis. Where a commercial insurer is a private company, versus a publicly-traded company, the insurer should be guided by those rules applicable to it.

10. For those smaller commercial insurers, specifically Class 3A, Class C and Class D insurers, the Authority proposes to provide those insurers with the option to produce consolidated GAAP financial statements with abbreviated notes to the financial statements (condensed consolidated GAAP financial statements). While the Authority encourages these insurers to produce the consolidated GAAP financial statements, the option is intended to mitigate the costs incurred to meet the requirements of Section 17A for insurers who do not currently prepare GAAP financials. The Authority will prescribe the format and rules governing the condensed consolidated GAAP financial statements in Schedule VIII and Schedule IX of the proposed Insurance Account Rules. The Authority proposes to amend Section 17A of the Act to allow Class 3A, Class C and Class D insurers the option to produce condensed consolidated GAAP financial statements. These statements must be audited by the insurer's approved auditor.

B. Revised Statutory Financial Statements

i. Consolidated Statutory Financial Statements

11. As noted earlier, commercial insurers are required to produce SFS as required under Section 15 of the Act and as prescribed by the Accounts Regulations. Prior to the development of the EBS regime, the SFS was used as the basis to calculate the insurer's ECR. The EBS regime, which will determine the insurer's ECR, uses the consolidated GAAP financial statements subject to certain prudential filters and EBS valuation rules. The Authority proposes to utilise the SFS as the basis to produce the EBS by amending the SFS to reflect the consolidated or condensed consolidated GAAP financial statements values, subject to certain prudential filters (consolidated SFS) that are consistent with the EBS framework.

12. The Authority proposes that Section 6A of the Act be amended to enable the Authority to make prudential rules which will prescribe the format and rules pertaining to the SFS. These proposals do not seek to make any changes to the EBS framework. The proposed Insurance Accounts Rules will contain the reporting forms for the balance sheets, income statements, statements of capital and surplus and notes to the financial statements. These reporting forms will be similar to those contained in the Accounts Regulations. To avoid duplication, the Authority will only prescribe additional notes to the financial statements that are not already contained in the consolidated GAAP financial statements. Concurrently, the Authority proposes to amend the Account Regulations to remove the requirements pertaining to commercial insurers and transfer these requirements to the Insurance Accounts Rules. The Authority proposes amending Section 53 of the Act to provide clarity that anything that is permitted or required to be prescribed under this section may be prescribed in regulations by the Minister; other than those matters prescribed by prudential rules made by the Authority under section 6A.

13. The Insurance Accounts Rules will contain the prudential filters, in preparation for EBS, and valuation rules that insurers need to apply to the GAAP financial statements in order to derive the SFS. Prudential filters refer to:
    a. adjustments to eliminate non-admitted assets including goodwill and other similar intangible assets, not considered admissible for solvency purposes; and
    b. adjustments to include certain assets and liabilities that are generally off-balance sheet under general purpose reporting. These include items such as guarantees and other instruments that do not relate to the insurer's own insurance contracts.

14. The Authority proposes to apply the following in order to develop the SFS:
    a. **General Business Loss and Loss expense provision**
        i. Insurers will be required to set aside an adequate amount of loss and loss expense provisions for general insurance business to meet

estimated unpaid losses in respect of events occurring before the last day of the relevant year and to meet expected loss adjustment expenses. The provisions and reserves will therefore, include adequate amounts in respect of losses reported and losses incurred but not reported to the insurer before the last day of the relevant year.

ii. The Authority will apply a floor whereby the Loss and Loss expense provision should not be less than the net insurance reserves calculated using values in the insurer's audited consolidated GAAP financial statements.

b. Long-Term Business Insurance Reserves

i. *Reserves for reported claims:* insurers will be required to carry in their SFS an adequate amount to meet claims unpaid at the end of the relevant year and made under contracts of insurance and reinsurance in respect of incidents occurring and reported to the insurer before the end of that year.

ii. *Reserves for unreported claims:* insurers will be required to carry an amount set aside by the insurer to meet claims under contracts of insurance and reinsurance in respect of incidents occurring, but not reported to the insurer, before the end of the relevant year.

iii. *Policy reserves—life:* The Authority proposes that this be an amount, actuarially computed, which is considered adequate to provide future guaranteed benefits as they become payable under the provisions of life insurance policies in force. Amounts applicable to other life contract benefits (such as disability waiver of premium, disability income benefits and additional accidental death benefits) and to annuities and supplemental contracts with life contingencies, may also be included. The said amount shall not include reserves in respect of accident and health policies.

iv. *Policy reserves—accident & health:* These reserves will be an amount, actuarially computed, which are considered adequate, and consist of an active life reserve, that is to say, that portion of due and collected premiums which has been set aside to be recognised as earned in the future consisting of:

- the unearned portion of the current premium;
- additional reserves, that is to say, the reserves applicable to policies which provide for the payment of uniform rate premiums in respect of a risk, the cost of which increases with the age of the insured;
- reserves for rate credits;

- a claims reserve, that is to say, the present value of amounts not yet due on claims provision for future contingent benefits being included in both cases.

v. *Policyholders' funds on deposit:* These funds will consist of premiums paid in advance of the due date, whether or not interest is paid for early payment. These liabilities shall be valued at the amounts received by the insurer, plus any interest credited.

vi. *Liability for future policy-holders' dividends:* This will be the amount of dividends payable, as declared by the directors, on participating life policies which qualify for such dividends, and shall be recorded at the amount declared.

vii. *Other insurance reserves—Long-Term business:* These consist of any other reserves required by the terms of life or accident and health contracts or as a result of special riders or options attaching to any such contracts, not being reserves provided for in the items above. These must be actuarially determined and be considered adequate.

viii. Similar to the general insurance business, the Authority will apply a floor whereby the insurer's net Long-Term insurance reserves will not be less than the net Long-Term insurance reserves calculated using values in the insurer's audited consolidated GAAP financial statements.

ix. The Authority proposes including a note to Line 27 of the proposed statutory balance sheet for Class C, Class D and Class E insurers disclosing the movements in the Long-Term business insurance reserves. The reserves shall be split between reserves relating to insurance contracts and reserves relating to investments contracts as per Schedule II of the Insurance Account Rules.

c. Prudential Filters

i. *Goodwill and intangibles:* Goodwill is to be valued at nil in the consolidated SFS. Other intangible assets can be recognised and measured at a value other than zero only if they can be sold separately and the expected future economic benefits will flow to the insurer and the value of the assets can be reliably measured. These assets must be separable and there should be evidence of exchange transactions for the same or similar assets indicating that they are saleable in the market place. If the value assessment of an intangible asset cannot be reliably measured, then such asset should be valued at nil.

ii. *Prepaids and deferred expenses:* There is no existing market value option for prepaid assets and deferred expenses. In this regard and since prepaids cannot generally be utilised to pay policyholders, they should be valued at nil in the consolidated SFS.

iii. *Deferred Acquisition Costs (DAC):* Insurers will be allowed to carry DAC on the statutory balance sheet. The amount of DAC carried shall be valued consistently with the generally accepted accounted standards adopted by the insurer.

iv. *Contingent Liabilities:* The Authority proposes that contingent liabilities other than the insurer’s own insurance contracts related guarantees be recognised as liabilities in the consolidated SFS and valued based on the expected present value of future cash-flows required to settle the contingent liability over the lifetime of that contingent liability, using the basic risk-free interest rate. Where the present value of the contingent liability cannot be determined because the timing of likely scenarios cannot be reliably estimated, the amount of the liability should be recorded at its undiscounted value. In coming up with the expected values, insurers should take into account both a profit element and risk premium required by market participants. For cases in which the contingent liability has asymmetrical outcomes, the valuation of the contingent liability should take account of a range of possible outcomes. This may be accomplished through option pricing models or models that consider multiple outcomes.

v. *Taxes:* The Authority proposes that current tax liabilities or assets be measured at the amount expected to be paid to or recovered from the taxation authorities, using the tax rates that have been enacted or substantively enacted by the end of the reporting period. Insurers shall recognise and value deferred tax assets and liabilities in relation to all assets and liabilities in conformity with the GAAP principles adopted by the insurer. Notwithstanding the above, insurers shall value deferred taxes, other than deferred tax assets arising from the carry-forward of unused tax credits and the carry-forward of unused tax losses, on the basis of the difference between the values ascribed to assets and liabilities recognised and valued in accordance with SFS prudential rules, and the values ascribed to assets and liabilities as recognised and valued for tax purposes.

vi. Insurers should only ascribe a positive value to deferred tax assets where it is probable that future taxable profit will be available against which the deferred tax asset can be utilised, taking into account any legal or regulatory requirements on the time limits relating to the carry-forward of unused tax losses or the carry-forward of unused tax credits.

ii. Unconsolidated SFS

15. The Authority had set out to replace the current SFS with GAAP financial statements subject to prudential filters as discussed above. However, for insurers that have subsidiaries which are consolidated in their GAAP financial statements, the Authority still needed information on an unconsolidated basis. This relates to information necessary to assess the insurer's liquidity position, MSM and class of registration to prevent a migration up in MSM and class which could have arisen from the consolidation approach, and also to assess liquidity applicable to Bermuda policyholders. The Authority considered requesting this information separately, but after considering the extent of the information required, it was determined that it would be more practical to include unconsolidated statutory financial statements in the SFS. The basis of the unconsolidated balance sheet and income statement would be the legal entity's unconsolidated balance sheet and income statements on a GAAP basis adjusted for prudential filters and reserves as discussed above. However, to increase efficiency, the Authority is proposing amending existing unconsolidated statutory accounting valuation standards to make them consistent with GAAP accounting valuation standards so that these statements can be used in the construction of the consolidated GAAP and consolidated statutory financial statements, e.g. allowance of deferred acquisition costs and deposit accounting. Accordingly, insurers are therefore, able to base the unconsolidated amounts on legal entity information that is used for GAAP consolidation purposes.

16. The Authority proposes to require commercial insurers to file a statutory balance sheet, statutory income statement and statutory statement of capital and surplus on an unconsolidated basis (unconsolidated SFS) reflecting the legal entity's unconsolidated financial position. The format and the rules governing the unconsolidated SFS will be prescribed in the Insurance Account Rules. The information contained in the unconsolidated SFS will be used as one of the basis for computation of the MSM with the other consideration being 25% of ECR which is computed from the EBS. The information will also be the basis for computation of the insurer's liquidity ratio, determination of the insurer's class of registration and to generate market statistics that are published on the Authority's website and Annual Report.

iii. Treatment of Investments in Affiliates For Consolidated SFS

17. Where they have control, the Authority proposes that commercial insurers consolidate their investments in affiliates in the consolidated SFS. Insurers will apply the adopted GAAP principles to value and determine whether it controls or has significant influence over an affiliate. The insurer will also apply the aforementioned prudential filters, where relevant, as it consolidates these investments in the financial statements.

18. Where the insurer has significant influence but no control over the subsidiary, the value of these investments (with the applied prudential filters) will be included in Line 4 of the SFS balance sheet.

19. When an amalgamation occurs during the year between two insurers, the combined entity should report for the entire fiscal period regardless of when the amalgamation took place. The insurer will not be required to restate comparatives of the combined entity in the amalgamation.

iv. Insurance Risk Transfer and Schedule of Deposit Accounting

20. In situations where the GAAP principles adopted by the insurer require insurance contracts that do not transfer significant insurance risk, to apply deposit accounting in deriving the GAAP financial statements, insurers will be required to apply the same approach for the consolidated and unconsolidated SFS. The deposit assets and liabilities shall be included in Lines 13 (e) and 36 (c) respectively of the balance sheet.

v. Segregated Accounts Companies (SACs)

21. For commercial insurers which are SACs: (i) that have no recourse to the General Account, i.e. where each segregated account's assets are ring-fenced from the General Account, have no additional funding from the General Account, and/or creditors cannot access the funds in the General Account; and (ii) where each segregated accounts assets are ring fenced from other segregated accounts (e.g. no financial transactions among segregated accounts such as reinsurance, loans, guarantees, etc.), the Authority proposes that the consolidated and unconsolidated SFS reflect the following:
    a. The General Account should be reported as a separate line item on balance sheet and income statement.

b. Segregated account assets and liabilities will be reported in aggregate on the statutory balance sheet lines 13(b)-(d) (segregated assets and segregated liabilities will be reported on the statutory balance sheet line 36(b).
c. The insurer's license class will be determined based on the insurer's risk profile taking into account the assets in the General Account.
d. The insurer's MSM will be calculated using the General Account assets only, excluding the segregated assets line.

22. For commercial insurers which are SACs that: (i) have recourse to the General Account, i.e. where the contractual risk arrangements of one segregated account are not legally segregated from the General Account; the segregated account(s) can access additional funding from the General Account, and/or where creditors for the segregated account can claim against the General Account; and (ii) where contractual arrangements of one segregated accounts are not legally segregated from other segregated accounts (e.g. loans, guarantees, reinsurance arrangements), the Authority proposes that the consolidated and unconsolidated SFS reflect the following:
    a. The information in the segregated accounts and the General Account be viewed as one, therefore, the insurer should prepare the unconsolidated SFS aggregating the segregated accounts and General Account balances.
    b. The insurer's license class will be determined based on the aggregated General Account and segregated accounts net premiums or total assets.
    c. The insurer's MSM will be calculated using the aggregated General Account and segregated accounts' assets.

C. Revised Statutory Financial Return

23. Section 18 of the Act requires all insurers to file a Statutory Financial Return (SFR) with the Authority. For commercial insurers, the Authority proposes to amend the Insurance Account Regulations and Insurance Return and Solvency Regulations to remove any references to commercial insurers, and place these requirements in the Insurance Accounts Rules, subject to modifications as noted below.

24. The SFR for commercial insurers will not include the solvency certificate as each commercial insurer will be required to prepare a Declaration of Compliance certificate, which will be published in accordance with Section 17A(6) of the Act. The Cover Sheet will be renamed the Insurer Information Sheet (IIS), and will include the calculations for the MSM and liquidity ratios (refer to paragraphs 11 to 13 of the Insurance Accounts Rules.)

25. The MSM calculation will be amended to include information on SACs, depending on whether or not the SAC has recourse to the General Account (see paragraphs 21 and 22). The liquidity ratio computation will include line 36 of the unconsolidated SFS pertaining to "Sundry Liabilities" as a relevant liability for the purposes of the calculation.

26. The Authority proposes that the SFR be signed by the insurer's principal representative and two directors attesting that it was prepared in accordance with the Insurance Accounts Rules.

D. Approved Auditors

27. Section 16 of the Act requires every insurer to appoint an auditor approved by the Authority and that the approved auditor is required to audit the SFS. Given the proposed changes to the commercial insurance regulatory reporting framework, the Authority proposes the following:
    a. The approved auditor will only audit the consolidated GAAP or consolidated condensed GAAP financial statements as will be required under Section 17A of the Act.
    b. The approved auditor will provide audit assurance that the consolidated SFS was derived from the GAAP financial statements, and that the prudential filters and adjustments were applied appropriately.
    c. The approved auditor will provide audit assurance that the unconsolidated SFS was derived from the consolidated SFS, and that the prudential filters and adjustments were applied.
    d. The approved auditor for commercial insurers will be Bermuda-based. The Authority proposes to amend the Act to make this requirement. The audit working papers and related documents must be maintained in Bermuda. These requirements are intended to allow the Authority easy access to the audit working papers as well as to conduct interviews with the auditor as necessary.

28. The Authority proposes to amend Section 16A of the Act by revoking subsection 16A(1)(A), which allows the Minister to make regulations prescribing facts or matters which are likely to be of the material significance for the discharge of the Authority's functions, and replace it with a new subsection that expressly states those conditions or situations which are of material significance. The conditions

or situations will be consistent with the principles currently found in the guidance note "Role of the Approved Auditor". These include:

a. identification of a material misstatement in the insurer's statutory financial statements or group financial statements resulting from fraud, error or illegal acts or the consequences of them;
b. conclusion that there is substantial doubt as to the ability of the insurer or group to continue as a going concern for a period of one year from the balance sheet date;
c. identification of adjustments to the group financial statements, which individually or in aggregate, indicates to him/her that the previous year's audited annual financial statements, prepared according to GAAP, were materially misstated;
d. identification of adjustments to the insurer's financial statements, which individually or in aggregate, indicates to him/her that the previous year's audited annual financial statements, were materially misstated;
e. identification of a material weakness in internal control during the conduct of normal audit procedures;
f. identification of a material conflict of interest during the conduct of normal audit procedures; or
g. unresolved disagreements with management pertaining to the application of GAAP or statutory reporting.

E. Capital and Solvency Return – Regulatory Disclosures

29. The proposals to commercial insurer's regulatory reporting noted above, will facilitate enhanced financial analysis of the insurer. To be able to benefit, the Authority will require supplementary information that will be considered in its prudential reviews.

30. The Authority proposes to amend the Capital and Solvency Return (CSR) in the prudential standards for insurers to provide the supplementary information. The amendments are proposed as follows:

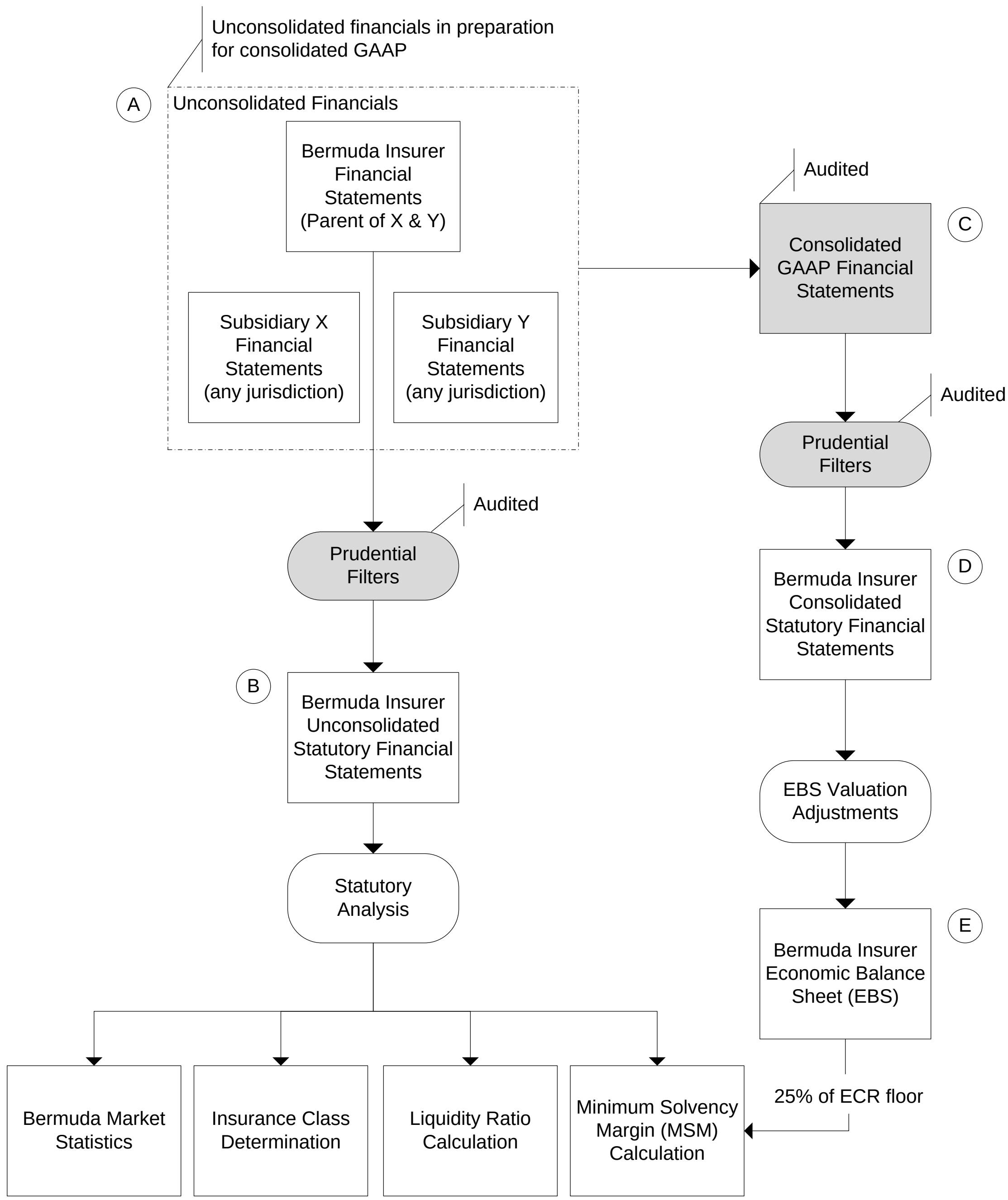
    a. A new Schedule XVI which captures information on regulated non-insurance financial operating entities where the insurer does not hold a majority interest. The schedule will include details confirming the affiliate's domicile, nature of its operations, ownership, total assets, investment amount (equity method) and regulatory capital level. The format, structure and methodology to compute the capital charge for this risk will be consistent with the capital calculation used in the CSR for insurance groups.

b. A new Schedule XVII which captures the MSM for insurance subsidiaries that have been consolidated in the consolidated SFS. The schedule will include details confirming the subsidiary's domicile, ownership percentage, net premium, assets, net assets and the regulatory capital requirements.
c. Schedule V(k), the Schedule of Deposit Accounting, will be amended to provide both qualitative information for the purpose of the Authority's risk analysis and quantitative information to allow the Authority to assess the exposure and produce relevant underwriting statistics.
d. Schedule V(l) will be amended to include information on SACs, specifically on:
    i. the number of segregated accounts;
    ii. the nature of risk and exposure in each segregated account;
    iii. the assets, liabilities, capital & surplus cash & investments, net loss reserves, reinsurance recoverables, gross premium written, and net premium written in each segregated account;
    iv. whether or not the segregated account has recourse to the General Account or other segregated accounts, as well as the circumstances arising where such recourse can be exercised; and
    v. other relevant information such as statutory lines of business written and the original currency reported.

31. The Authority recently issued its Consultation Paper on Enhancements to Bermuda's Insurance Regulatory Regime for Commercial Insurers and Insurance Groups where the Authority made proposals concerning outsourcing arrangements governing senior management and head office requirements. The Authority subsequently made changes to its legislative and regulatory frameworks to address these issues.
    a. Outsourcing Arrangements – Section 30JA of the Act was amended to require insurers to notify the Authority prior to outsourcing the senior management roles. The Insurance Code of Conduct was also amended so that commercial insurers will not be allowed to outsource the CEO and senior executive roles to an insurance manager. In order to monitor insurers' outsourcing arrangements and ensure that they remain appropriate based on the insurer's risk profile, the Authority will amend Schedule V(a) of the CSR to include additional information, specifically , description of chief and senior executive management's responsibilities:

    b. Head Office – Section 8C of the Act was recently amended to require all commercial insurers, except branch operations, to establish and maintain their head office in Bermuda, i.e. be managed and directed in Bermuda. This requirement is also one of the considerations in determining whether it is appropriate for the Authority to be Group Supervisor of a Bermuda Group, under Section 27B of the Act. In order to monitor compliance with these requirements, the Authority proposes to amend Schedule V(a) of the commercial insurers and insurance group's CSR to include a list of head office requirements, including residence of its directors and chief and senior executives. This information will assist the Authority in determining whether or not the insurer has in fact established its head office in Bermuda, and whether the Authority is still the appropriate supervisor for the insurance group. In considering these factors, regard is given to whether there is there sufficient presence in Bermuda for the Authority to appropriately regulate and supervise the insurer or insurance group, and also establish that the insurer or insurance group is managed and directed from Bermuda given its nature, scale and complexity.

Reporting Regime Illustrative Workflow



Notes

1. Items B, C, D, and E are to be filed with the Authority. Items B and D are included in the Statutory Financial Return (SFR). Item E is included in the Capital and Solvency Return (CSR).
2. Item C will be published on the Authority's website.
3. Audited components:
   (i) Consolidated GAAP
   (ii) Unconsolidated statutory prudential filters and that these statements, excluding filters, were used to produce the consolidated GAAP
   (iii) Consolidated statutory prudential filters.
4. Loss reserve specialist opinion and actuarial reports have been moved to the Economic Balance Sheet (EBS) and are under the prudential standards.