BERMUDA MONETARY AUTHORITY

17th March, 2015

Dear Stakeholder:

Re: The consultation paper entitled "Economic Balance Sheet Framework" issued December 2014

The Bermuda Monetary Authority ("the Authority" or "the BMA") would like to thank you for your continued support of the development of the Bermuda insurance regulatory framework. The Authority appreciates the feedback received and is committed to working closely with its stakeholders to ensure that the regulatory regime is effective and is aligned with international standards.

On December 19th 2014 the Authority sought feedback from industry, by publishing its planned Economic Balance Sheet framework. Detailed responses were received, many of them requesting additional information in the form of guidance. The Authority will be providing that guidance during a trial run scheduled for April /May 2015.

General comments on the EBS CP

Overall the CP was well received, on the understanding that further testing of the proposals was necessary. The results of this testing will then inform the decisions on what subsequent specific changes or modifications may be needed. In responses to requests for guidance, templates to assist in the calculation of the risk margin will be provided as part of the upcoming trial run.

It was noted by several responders that some Long Term companies do not currently produce audited GAAP financial statements to form the base for the EBS. The Authority is aware of this and notes that insurers will have to start preparing audited GAAP statements in due course as noted in the Authority's notice to the market entitled "**Public Disclosures and other related matters**" published on April 4th 2014in which the Authority stated:

"One *of the proposals under the economic balance sheet framework will be that general purpose financial statements under GAAP and/or IFRS will serve as the basis for statutory accounting under Section 15 of the Insurance Act for the entire commercial insurance market for the 2016 year-end."*

For the purposes of the trial run, the Authority will endeavour to provide some additional guidance to help affected insurers in this area.

A question was raised about how the risk margin would work in the context of Variable Annuity Guarantees business, and there was a request for an option to use methods other than the cost of capital method for the risk margin. Given the push for equivalence with Solvency II, the Authority believes that the cost of capital approach is the most appropriate method to use. However, other options proposed by insurers as part of the trial run will be considered, provided they can demonstrate that they achieve a broadly similar result to the cost of capital method.

The Authority has selected several questions as a representative sample of the responses received and presents them with answers as follows:

1. In paragraph 72, the BMA proposes the cost-of-capital method. Is it the intention to mandate a specific approach for the calculation, or would different approaches be permitted?

   The Authority intends to mandate the use of the cost-of-capital method for the initial implementation of the EBS regime, but would be open to considering alternative approaches that may emerge in future.

2. If standard loads/formulas or other practices deemed "accepted" are applied for ENIDs and risk margins, would the resulting ENID and risk margin components of the technical provisions need to be certified as part of the actuarial opinion or would they be deemed appropriate by definition?

   This will be the subject of future discussion, but the current intention is that the actuarial opinion would cover the whole of the technical provisions, and thus would at least implicitly cover any loadings applied to cover ENIDs or other approximations.

3. Can you please clarify whether comparative financial statements will be required for the first filing in 2017, or whether (re)insurers will be required to provide only 2016 financial year-end results on adoption?

   The Authority will not be expecting prior year comparatives to be filed for the first EBS filing.

4. Is it correct that the Authority's intention is to eliminate the statutory financial statement audit on implementation of the EBS framework and rely solely on the GAAP audit? Does this mean that they would not require any additional communication from the auditors, and would rely solely on the existing financial statement GAAP audit opinion?

   In essence the answer is 'yes', the current statutory financial statements are intended to be replaced with the company's GAAP statements, which would be audited as usual. There would be no further audit opinion needed for the EBS.

5. There appears to be a circular reference in the guidance, which is: The Risk Margin needs the BSCR (ECR) as an input, but the BSCR will eventually use the EBS which already uses the Risk Margin and an input. Is this correct and can the Authority suggest a remedy?

   The Authority does not believe this to be the case. For P&C business, the reserve risk charge in the BSCR will be based on the best estimate outstanding claims reserves and the premium risk will continue to be based on written premiums, and similarly for Long Term business where the charge is based on reserves, this will be the best estimate reserve. The risk margin is not required as part of the BSCR calculations, and thus does not need to be split between its component parts.

6. Will a template for the risk margin calculation be made publicly available?

   Yes, templates will be provided.

7. Will companies be allowed to use their own yield curves provided that they are constructed under similar principles and do not deviate significantly from the Authority's prescribed curves?

   Companies will need to adopt this approach in respect of currencies for which the Authority does not supply discount curves – otherwise companies would generally be required to use the discount curves supplied by the Authority.

8. How does the cost of capital base (for the risk margin) differ from the company's full BSCR (it appears most risks are included)?

   It essentially covers all risks that cannot effectively be hedged away by the insurer. It therefore covers insurance risk, reinsurance credit risk, operational risk and 'unavoidable' market risk, on the assumption that most market and interest rate risks can be eliminated with appropriate adjustments to the investment portfolio. The Authority is still considering the full details of the extent of coverage required, and further details will be included in the guidance for the trial run.

9. What is the meaning of the phrase "market risks in respect of assets, sufficient to cover the best estimate that are classified as 'held' to maturity or otherwise held to qualify for adjustments to the risk free discount rate"? Does this mean, if the scenario approach is chosen, market risks for the assets used here need to be considered in the Risk Margin calculation?

   The Authority is still considering the precise details of the makeup of any market risk charge component of the risk margin, and further guidance will be provided for the trial run.

10. Can you clarify if it is correct that for Class C and D entities, starting in 2016, audited GAAP financial statements will also have to be provided and that these may be published by the BMA where appropriate (subject to s.56 exemptions).

    That is the current intention.

11. Can you clarify under what circumstances a stochastic version of the Standard or Scenario-based approach would be appropriate?

    The Authority's trial run guidance material will address this issue.

12. Can you clarify how the BMA will include variable annuities in the EBS?

    The Authority's trial run guidance material will address this issue.

Other areas of concern included:

- The treatment of foreign exchange fluctuation in the calculation of the best estimate.
- Mention of Canadian standards (CALM and CIFRS). At this stage these do not appear to be equivalent economic approaches to the Authority's proposals, and so would not be accepted as technical provisions under EBS.
- Concerns were raised over the allowance for reinsurer default as part of the best estimate provisions. The Authority will provide further guidance for the trial run.
- Various questions were raised about expenses to be included in technical provisions. Further guidance will be provided on expenses as part of the trial run.

Trial run

The Authority expects to provide a specification for the trial run by Thursday 2nd April together with a spreadsheet for completion. The full details are still being developed, but it is expected that this will take the form of the updated BSCR spreadsheet containing the EBS Schedule XIV and the additional information to be requested. It will also contain the discount curves for the currencies mentioned in the consultation paper (CP), along with a specification to assist insurers in determining curves for other currencies.

Insurers will only be required to complete the parts of the CISSA/GSSA and risk management information that are needed to produce a BSCR amount, making use of the current filing information where relevant. There will be no need to provide management attestations or Loss Reserve/Actuarial Opinions, and results should be provided on a 'best efforts' basis.

The Authority may request additional information using different assumptions in an effort to test alternative approaches in some areas, and the spreadsheet will provide the opportunity for further comments and suggestions gained from experiences with the trial run.

The specification will be set out at a level similar to that in the CP, but further guidance on individual line items will be provided which may eventually form part of the BSCR Instruction Handbook. The Authority is expecting to add to the guidance information that it will provide on an ongoing basis as part of the Q&A process that will be run as part of the trial run.

As part of the trial run, the Authority will also be testing some proposed changes to the BSCR. These are required in order to address caveats identified by EIOPA in its January 2015 report on their assessment of the Bermuda regime (EIOPA-CP-14/042), titled “Equivalence assessment of the Bermudian supervisory system in relation to articles 172, 227 and 260 of the Solvency II Directive” and issued on 19 December 2014. These will cover additional modules for currency risk and asset concentration risk, modifications to the ‘cash at bank’ charge, and the introduction of geographical diversification for P&C business. Full details of the proposed changes will be set out in a consultation paper to be issued at the same time as the trial run is launched.

To further assist with the trial run, the Authority will be holding a series of meetings with our industry partners on a sectoral basis to discuss both the EBS concepts and the BSCR changes proposed, and to answer specific questions that are raised. These will be held during April and the first half of May, on an as-needed basis, depending on demand.

The deadline for completed trial run submissions is Friday 29th May 2015. All insurers are strongly encouraged to participate, given that this will be the most effective method of resolving any remaining issues.