



BERMUDA MONETARY AUTHORITY

DISCUSSION PAPER

POLICYHOLDER PROTECTION

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I. EXECUTIVE SUMMARY

1. The critical role that insurance plays in the growth of both developed and emerging economies highlights the importance of creating and supporting a stable insurance market. While sound prudential regulation is a major component in ensuring that the industry operates in a sustainable and sound manner; at the heart of the development of this sector is the confidence consumers have that they will receive the benefits owed to them upon the occurrence of an insured event. Once consumer confidence is lost, its effects can reverberate throughout the financial system.
2. This Discussion Paper (“DP”) explores the importance of policyholder protection to developing and sustaining an economy and the various ways policyholder protection can be advanced. In order to support consumer confidence and be in line with international best practice, the Bermuda Monetary Authority (“the Authority”) is proposing that Bermuda adopt a formal policyholder protection mechanism for the insurance sector. Tools presented in this Paper for discussion include, tied or segregated assets, protection schemes and preferential treatment of policyholders.
3. The DP seeks comment on the Authority’s proposal for adoption of a mechanism designed to enhance the protection of policyholders of insurance entities licensed by the Authority.¹ The mechanism would involve the implementation of a prospective arrangement for the preferential payment of policyholders’ claims ahead of general creditors in the event of the liquidation or winding up of a Bermuda insurer.² This preference would apply prospectively only to contracts entered into on or after the date enabling legislation is passed, so as to preserve existing contractual rights of counterparties and investors.
4. The Authority is of the view that the approach taken in this DP is in line with international best practices in insurance regulation and policyholder protection. The Authority seeks to ensure that its approach to implementing its policyholder protection framework is appropriate for all sectors of Bermuda’s insurance industry, which includes a large wholesale market, and an important retail market.
5. The views of the insurance industry and of other interested persons on the proposals set out in this Paper are invited. Comments should be sent to the Authority, addressed to policy@bma.bm not later than **5th September 2014**.

¹ This proposal is made jointly with the Ministry of Economic Development which has consented to the issuance of this Discussion Paper.

² References in this paper to insurers are intended to apply equally to reinsurers unless noted otherwise.

II. BACKGROUND

6. Policyholder protection requires a multi-faceted approach, which includes sound prudential, regulatory and supervisory regimes, an efficient resolution structure, as well as any additional mechanisms that may be used to augment the appropriate protection needed.
7. International standard setters cite policyholder protection as one of the core objectives of an effective regulatory and supervisory infrastructure. The International Association of Insurance Supervisors (“IAIS”) issued Insurance Core Principles (“ICPs”)³ setting out the essential components that “must be present in the supervisory regime in order to promote a financially sound insurance sector and provide an adequate level of policyholder protection.”⁴
8. The ICPs serve as the basis for developing or strengthening a supervisory regime, while at the same time aiding in identifying gaps to be addressed. Under ICP 12, “Winding up and Exit from the Market”, the IAIS submits that in the event of a wind-up, “the legal framework gives priority to the protection of policyholders⁵ and aims at minimising disruption to the timely provision of benefits to policyholders.”⁶
9. Adherence to the ICPs facilitates the promotion of a stable, well-functioning insurance market, resulting in greater protection for policyholders. Usually an effective solvency sub-structure, which is embedded within the supervisory regime, ensures that appropriate assets have been set aside to match insurance liabilities so that policyholders’ obligations can be satisfied at all times. It may also include additional capital requirements and enhanced supervisory monitoring if required capital levels are breached.
10. The G20 also issued high level principles on consumer protection in financial services which affirmed that such protection “should be an integral part of the legal, regulatory and supervisory framework, and should reflect the diversity of national circumstances and global market and regulatory developments within the financial sector.”⁷
11. Regardless of how robust a jurisdiction’s supervisory and regulatory regime is, it cannot prevent all insurance failures. In the event of an insurer failure,

³ <http://www.iaisweb.org/Insurance-Core-Principles-material-adopted-in-2011-795>

⁴ IAIS Insurance Core Principles, Standards, Guidance and Assessment Methodology 1 October 2011

⁵ The term “policyholder” is used to include beneficiaries and third party claimants

⁶ Ibid

⁷ OECD G20 High-Level Principles on Financial Consumer Protection October 2011

policyholders may be disadvantaged socially and economically if the insurer is unable to satisfy its obligations. The loss of retirement earnings, disability income, funds to pay for medical needs or compensate accident victims, may also place a strain on a jurisdiction's social system and on its government's resources. Ultimately the consequences of such failures can undermine confidence in the insurance industry and potentially have adverse effects on the wider financial system.

III. POLICYHOLDER PROTECTION MECHANISMS

12. In the past, governments have had to decide whether they should support the market by stepping in to provide the requisite funding and/or guarantees to satisfy policyholder obligations in the event of an insurance company failure. It has been documented that distress in the insurance sector⁸ arising from the failure of one insurer or multiple insurers, while having a negative impact on stakeholders, is unlikely to lead to systemic risk as defined by the Financial Stability Board⁹. Nevertheless, governments cannot routinely continue to mitigate failures that may have serious social and economic implications.
13. Due in part to the recent financial crisis, various international discussions and initiatives have generally moved in the direction of supporting enhancements in policyholder protection, especially in the event of an insurer failure. The design of a policyholder protection framework must strike a balance between the benefits of providing policyholders with certainty and predictability and the costs of implementing the framework.
14. There are a number of publications on policyholder protection schemes which include the IAIS' *Issue Paper on Policyholder Protection Schemes* (October 2013) and the Organisation for Economic Co-operation and Development's ("OECD") *Policyholder Protection Schemes: Selected Considerations* (2013). These publications examine the infrastructure and operations of policyholder protection schemes within the overall insurance regulatory and supervisory frameworks. They also acknowledge that there are various other ways to achieve policyholder protection.
15. A number of jurisdictions have implemented additional policyholder protection mechanisms such as:

⁸ The reference to insurance sector is specific to those insurers writing traditional insurance products.

⁹ The Geneva Association "Insurance and Resolution in Light of the Systemic Risk Debate" February 2012

- a. Establishing policyholders as priority claimants in the event an insurer is being liquidated or wound up;
- b. Setting aside earmarked assets in either separate accounts (segregated assets) or accounts that can only be used to satisfy policyholders claims (tied assets);
- c. Utilising insurance guarantee schemes or a policyholder protection fund which “are usually collective industry-funded schemes”¹⁰;
- d. Any combination of the above.

Preferential Treatment of Policyholders in Liquidation or Winding Up

16. Some jurisdictions may grant policyholders preferential treatment when an insurer is being wound-up. Usually, this preference is legally stipulated within a jurisdiction’s resolution regime so that policyholders are afforded the right to first access the insurer’s assets as to receive benefits due to them.
17. The OECD noted in its paper that there are jurisdictions that “provide relatively strong protection to policyholders in the liquidation procedure of insurers, giving policyholders a higher priority on the assets of the failed institution.”¹¹ The paper noted that countries such as Germany, Italy and Spain grant policyholders special rights over an insurer’s assets equal to that of technical provisions. Other jurisdictions such as UK, Canada, Estonia, France and Norway, allow policyholders to exercise general claim over the insurer’s assets over and above other claims except those expressly stipulated in legislation (e.g. employees’ benefits).
18. Similar to earmarked assets, there is the risk that there may not be enough assets, and/or assets may deteriorate before or during the liquidation that may result in a shortfall to satisfy policyholders’ obligations.
19. The OECD paper also supports the position that “the low frequency of insurer insolvencies” along with a regulatory and supervisory framework can “make a policyholder protection scheme redundant.” Accordingly, legal provisions such as preferential treatment of policyholders in the liquidation process “may be perceived as providing adequate protection to policyholders.”¹²

¹⁰ IAIS Issues Paper on Policyholder Protection Schemes October 2013

¹¹ OECD (2013) “Policyholder Protection Schemes: Selected Considerations”, OECD Working Papers on Finance, Insurance and Private Pensions, No 31, OECD Publishing

¹² Ibid

Earmarked Assets

20. In jurisdictions such as Switzerland and Austria assets are specifically identified and used for the sole purpose of covering policyholder liabilities (tied assets). In the event of an insurer becoming insolvent, policyholders have first claim over these tied assets. The IAIS Issues Paper identifies some of the features of tied asset structures¹³:
- a. The insurer's potential liability (technical provision) for each policy is estimated and a corresponding amount of assets is earmarked or "tied";
 - b. The value of the assets is monitored to ensure that they always cover 100% of the liabilities;
 - c. The tied assets can only be held in certain asset classes, with limitations on concentration and counterparty risks;
 - d. If regulations are breached or if the interests of policyholders are violated, the regulator can block the tied assets, withdraw the licence of the insurer or put the insurer into bankruptcy;
 - e. In the event of a failure, the assets can be used to satisfy policyholder claims;
 - f. In the case of a portfolio transfer, the tied assets are also transferred.
21. In a similar fashion, earmarked assets can be ring-fenced and placed in separate accounts (segregated assets) to support total insurance liabilities or liabilities of a particular class of business. These segregated assets¹⁴ do not form part of the insurer's general account and are usually hypothecated through a lien or legally separated in a structure (e.g. in a trust) so that those assets cannot be used for any other purpose other than for satisfying policyholder liabilities. Where an insurer fails, these assets are effectively secured from other claimants.
22. Earmarked assets face the danger of asset deterioration (for example due to market conditions) and as such policyholders are at risk where the full asset value to support corresponding liabilities may not be realisable.

Policyholder Protection Schemes ("PPS")

23. Preferential treatment of policyholders in the event of liquidation or winding up, as well as earmarking assets, do not necessarily guarantee that policyholders will receive their benefits in an expeditious manner. Policyholders may find themselves waiting a long time before receiving compensation, and as such may experience undue hardship or difficulties. Consequently, this can impair confidence in the

¹³ Ibid

¹⁴ Ibid – Guernsey and Canada have segregated asset structures.

market and depending on the outcome of the liquidation, can have negative social and economic implications.

24. The establishment of a PPS may expedite policyholders' benefits pay-outs, especially where the process for an insurer's liquidation or portfolio transfer of insurance policies to ensure continuity of cover is lengthy. PPSs usually operate within established supervisory and regulatory frameworks and depending on its mandate should work cohesively with any rehabilitation or resolution programme. PPSs are usually the option of last resort when all other remedial measures have failed.
25. Given that "(t)he establishment of a policyholder protection scheme reflects a judgement to provide guaranteed levels of protection for policyholders in the event of insurer insolvency and spread the costs of such guarantees through the insurance system"¹⁵, a jurisdiction's overall regulatory framework and the nature of its insurance market would aid in determining if a PPS should be established, and if so, what should be the mandate and parameters of the scheme.
26. PPSs should work in close collaboration with the insurance regulatory authority and, contingent on its structure, can function across a spectrum of activities. The IAIS Issues Paper on Policyholder Protection highlights a number of roles a PPS can assume:
 - a. PPS *can guarantee payments* on insurance contracts (either in full or up to a specified limit) upon the failure of an insurer. Usually these payments occur after the policyholder receives payments from the insurer's assets and the PPS will cover the difference up to a certain limit (if present). The PPS' position within the resolution framework must be clearly delineated including, claims handling, subrogation rights etc.
 - b. PPS *can act as a bridge institution*¹⁶ which manages the insurance portfolio until the insurer is rehabilitated or the portfolio can be transferred to another insurer. This function facilitates the continuity of contracts, which can be regarded as important especially for certain insurance products.
 - c. PPS *can provide financial support* to a distressed insurer where it has been deemed that rehabilitation is less costly and disruptive than liquidation. Financial assistance may occur in a number of ways including loans, guarantees, assumption of liabilities or even purchasing the insurer's shares or assets. This financial support can be extended to the insurer who is purchasing the insurance portfolio.

¹⁵ Ibid

¹⁶ IAIS Issues Paper on Policyholder Protection Schemes October 2013

27. The scope of policyholder protection coverage needs to address:
- a. The type of policyholders to which coverage is extended (e.g. retail or wholesale);
 - b. Whether coverage (and the same type and extent of coverage) extends to both resident and non-resident policyholders;
 - c. The contracts to which policyholder protection extends (e.g. General Business, Long-Term, reinsurance contracts); and
 - d. The amount of policyholder protection and any limits on coverage (e.g. caps).
28. Some PPSs may be designed to cover solely retail consumers. This approach is in line with the view that wholesale purchasers of insurance (which may include the purchasers of reinsurance protection) have a level of sophistication that allows them to assess the viability and financial condition of the insurers with which they contract and therefore do not require cover by a PPS. There are other schemes that are designed to cover policyholders more broadly to include commercial policyholders, reinsurance cedants and other wholesale purchasers of (re)insurance that may in fact not have the relevant information to ascertain a (re)insurer's financial health. These schemes recognise that the ultimate beneficiary of a wholesale policy or reinsurance contract generally is not in a position to decide or influence the choice of (re)insurer and may not be a sophisticated party. For example, the policyholder may be a sophisticated pension fund and the ultimate beneficiary may be a potentially unsophisticated pensioner. Therefore, these PPSs seek to protect the ultimate beneficiaries and policyholders who are affected by the failure of the (re)insurer.
29. The scope of coverage of a PPS also needs to address cross-border insurance activity. Failure to cover cross-border activity may subject a non-resident policyholder with a contract identical to a resident policyholder with a lower-level of coverage or no coverage. Discriminatory coverage may raise issues of fairness, expose the jurisdiction to reputational risk and result in diminished business opportunities for the jurisdiction's insurers.
30. The types of insurance contracts subject to the PPS must also be considered. Some schemes cover only Long-Term insurance contracts when replacement cover may not be readily available due to advancing age or deteriorating health of the insured, whereas replacement cover for General Business insurance contracts usually is readily available. Other schemes cover all or certain types (e.g. mandatory contracts) of both General Business and Long-Term business insurance contracts.

31. Whether or not long-term coverage extends to pension schemes may vary as some jurisdictions have separate pension benefit guarantee schemes. There are also variations in the coverage of the investment or savings components of Long-Term insurance contracts. The substantial savings or investment component of some Long-Term insurance contracts may be seriously compromised by insurer failure. However, arguments have been made that alternatives are available to guarantee payment of these funds (e.g. the funds could be deposited in an insured depository institution).
32. Some schemes offer unlimited protection, whereas others have an element of co-insurance, reflecting cost and moral hazard considerations. Different levels of protection may be offered for pure insurance products versus the investment or savings component of Long-Term insurance products, which compete with banking products. In the latter case, comparability to Deposit Insurance Schemes may be advisable to avoid competitive imbalances or distortions. It is possible to provide for different levels of coverage for different products, although this does involve additional complexity in both design and administration.

IV. POLICYHOLDER PROTECTION FRAMEWORK FOR BERMUDA INSURANCE MARKET

33. The Authority proposes that a policyholder protection framework involving a simple priority in the payment of claims for policyholders of both Long-Term and General Business insurance and reinsurance contracts may be the most appropriate modification of the jurisdiction's regime. This approach is deemed appropriate given the relatively rare occurrence of insurer failure in Bermuda and the longer time horizon for the payment of insurance liabilities compared to other financial services firms (e.g. banks). Also the requirement to hold sufficient capital assets under the Insurance Act and rules and regulations, along with detailed capital requirements and the robust system of insurance supervision in Bermuda are additional factors supporting this approach.
34. Presently the winding up process for any company, including insurers is governed by the Companies Act 1981 ("the Companies Act"). Section 236 of the Companies Act provides that certain payments should stand ahead of payments to general creditors in the event of liquidation or winding up. It sets out the payment priority as first for the payment of taxes, second for the payment of wages and salary and accrued holiday remuneration and third for contributions to pension and workers' compensation schemes.

35. Under Section 34 of the Insurance Act, Bermuda insurers conducting General insurance business may be wound-up voluntarily under the Companies Act upon a petition to the Supreme Court of Bermuda (“the Court”) of 10 or more policyholders owning policies of an aggregate value of not less than \$50,000. Under Section 36(1) of the Insurance Act, a Bermuda insurer conducting Long-Term business may not be wound up voluntarily.
36. Under Section 35 of the Insurance Act, the Authority may present to the Court an involuntary petition for the winding up of a Bermuda insurer on the grounds that: (i) the insurer is unable to pay its debts within the meaning of Sections 161 and 162 of the Companies Act; (ii) the insurer has failed to satisfy an obligation under the Insurance Act; (iii) the insurer has failed to satisfy the obligation under Section 15 of the Insurance Act as to the preparation of accounts or to produce or file Statutory Financial Statements in accordance with Section 17 of the Insurance Act and the Authority is unable to ascertain the insurer’s financial position; or (iv) the Authority has determined that it is in the public interest to wind-up the insurer and the Court has concluded that the winding up is just and equitable.
37. If immediately before the winding up the insurer was carrying on or entitled to carry on a Long-Term business, the assets in the insurer’s Long-Term insurance business fund are available first to meet the insurer’s liabilities attributable to its Long-Term insurance business. The insurer’s assets are only available to meet other liabilities if and to the extent a surplus exists after meeting its Long-Term liabilities (Section 36(2), (3) of the Insurance Act).
38. The Authority is considering the addition of a category of preference in the event of a Bermuda licensed insurer’s liquidation or winding up for the payment of policyholders’ claims ahead of the claims of general creditors. This preference would apply only prospectively to contracts entered into on or after the date enabling legislation is passed, so as to preserve existing contractual rights of counterparties and investors. The proposed preferential ranking would also give regard to funds legally established for certain insurance products, such as the Long-Term business fund under Section 24 of the Insurance Act, which could only be used to satisfy the insurance obligations for those policies that are part of the fund. If adopted as proposed, the Companies Act would need to be amended accordingly to further clarify which funds are segregated. The Ministry of Economic Development, which is responsible for administration of the Companies Act, has expressed its willingness to consider such amendments and advance the proposal for public comment.

39. The Authority is considering this proposal for both General Business and Long-Term insurance contracts (including pension contracts and the savings or investment component of Long-Term contracts) for ease of administration. However, for companies that underwrite both General Business insurance and Long-Term insurance contracts, Long-Term policyholders would receive payment ahead of General Business claimants. This reflects the generally higher cost and lower availability of comparable cover, particularly for policyholders who have held Long-Term policies for a number of years and may be faced with the need to find replacement coverage at an advanced age or in declining health, and the possibility that Long-Term policyholders may have suffered investment losses on the savings or investment component of their policies. For pension contracts, this reflects the significant dependence of pensioners on pension payments for normal living expenses. The preference of Long-Term business insurance over general insurance business would be for those insurance policies that are not secured, for whatever reason.
40. The priority of payments would also place policyholders with outstanding insurance claims ahead of policyholders seeking to recover prepaid premiums. This recognises that unpaid claimants (e.g. the homeowner or small business owner needing insurance payments to rebuild a damaged property) may suffer economic loss far in excess of policyholders seeking to recoup premium payments.
41. Consistent with existing law, the claims of the Bermuda Government for taxes, and the employees' claims for payment of wages, salary and accrued holidays, and contributions to pension and workers' compensation schemes,¹⁷ would have precedence over the policyholders' claims as well as general creditors. This is consistent with international practice.
42. The Authority suggests that Section 236 of the Companies Act be amended to reflect the proposed "waterfall" of payment priorities as follows:
- a. The claims of employees under Section 33(3) of the Employment Act 2000.
 - b. The claims of the Bermuda Government for taxes.
 - c. The claims of employees for contributions to pension and workers' compensation schemes.
 - d. The claims of Long-Term policyholders (including pension contracts and the savings or investment component of long-term contracts).

¹⁷ Consideration could be given to the disallowance of a preference for claims for wages, salaries and pension contributions from members of executive management with culpability for the failure of the insurer. Claims for wages and salary would not extend to claims for board of directors fees.

- e. The claims of policyholders with respect to outstanding claims on General Business contracts.
 - f. The claims of policyholders with respect to prepaid premiums.
 - g. The claims of general creditors.
43. As mentioned earlier, the Authority is of the view that, given the limited number of insurer failures, the proposed priority for creditors maybe sufficient. The Authority sees the establishment of a PPS for policyholders' payment upon the failure of a Bermuda insurer maybe unduly burdensome to the industry. However, the Authority is considering the appropriateness of adopting limited forms of protection for policyholders who may require additional protection.

V. DISCUSSION POINTS

Specific Questions for Commenters on the Policyholder Protection Framework

Comments are sought on all aspects of the policyholder protection mechanisms outlined in this Discussion Paper. In particular, commenters are asked for their views on the following questions:

1. Is the term "policyholder" as referenced in paragraph 8 of the Paper adequate in the context of persons who should be covered in the priority of payments in the event of liquidation?
2. Is a prospective policyholder protection scheme consisting of a simple priority in claims payments appropriate for Bermuda (re)insurers and their policyholders? Does it achieve the proper balance between the costs of the scheme and concerns about moral hazard and providing policyholders with certainty and predictability?
3. Should the Authority consider a proposal to require earmarking or establishing tied asset pools and, if so, should the proposal include a trustee arrangement or limitations on the use or investment of the earmarked or tied assets?
4. Should the Authority consider a proposal that encompasses guaranteed payments from an industry-funded pool? If yes, what would be the scope to be covered?
5. Should there be a different approach for insurers that operate branches in Bermuda?
6. Is the change in approach to a more clearly defined segregation of the long-term fund assets sufficient to protect those assets from other creditors?
7. Should pension funds be treated differently?
8. Should the policyholder protection scheme cover both General Business and Long-Term contracts of (re)insurance or should it be more limited? In particular,

are there certain lines of General Business insurance for which policyholder protection may not be necessary or appropriate?

9. Is the waterfall outlined in this DP an appropriate ranking of claims? Is the prioritisation of Long-Term claims over General Business claims appropriate?
10. Should policyholders' claims be considered over claims of the Bermuda Government for taxes?
