31st October 2013

Dear (Re)insurers:

RE: Consultation Paper on Refinements to the Bermuda Solvency Capital Requirement and Other Legislative Amendments Issued for Comment on 1st July 2013

The Bermuda Monetary Authority (the Authority) wishes to thank stakeholders for their continued support in furthering the development of the Bermuda regulatory framework for insurance. The refinements identified in the recent Consultation Paper on Solvency Capital Requirements are the result of extensive dialogue with industry representatives over the past year. The Authority appreciates the feedback received and is committed to working closely with insurers to ensure an effective and efficient transition to the new standards.

The Authority will be responding separately to each submission, but outlined below are our responses to the more significant comments received to identify where changes are being made, and to provide further clarity on the proposals.

I. COMMENCEMENT DATE

The commencement date for the Bermuda Solvency Capital Requirement (BSCR) rule changes and the other legislative amendments that formed part of the consultation package is 1st January 2014. The scope of the amendments largely concerns insurance returns to be submitted to the Authority. The Authority's interpretation of this is that all filings submitted on or after 1st January 2014 should comply with the new requirements, and thus they apply to the year-end 2013 filings.

In practice, apart from the BSCR amendments, most of the other changes proposed are relatively minor in effect, and should not represent a significant change from current practice for most companies. Where an individual company feels they have particular difficulties with the revised requirements, they should discuss their concerns with their usual contact at the Authority as soon as possible.

II. INVESTMENT RISKS

The Authority developed BSCR rating class 0 for sovereign government debt. To qualify, the debt must be issued in its own currency and the country should be rated AA- or better (i.e. BSCR Rating Class 2 or better). Other bonds that are explicitly guaranteed by a sovereign government meeting these requirements also qualify. Several comments enquired whether GNMA (Ginnie Mae), FNMA (Fannie Mae) and/or FHLMC (Freddie Mac) qualify.

GNMA, FNMA and FHLMC instruments are to be reported under Mortgage-Backed Securities (MBS) and are not eligible for the sovereign bond classification. While the Authority acknowledges that an explicit government guarantee applies to the credit risk for GNMA-insured mortgages (although this is not the case for FNMA and FHLMC), uncertainty remains with the timing of the mortgage loan repayments. Consequently, we have not extended the sovereign debt treatment to MBS.

The Consultation Paper proposed a capital factor of 35% for all other mortgages (e.g. restructured, 90 day overdue or in process of foreclosure). Comments received proposed that a 25% charge would be more appropriate in this instance.

The Authority agrees and has amended the capital charge for All Other Mortgages to 25%.

III. CREDIT RISKS

There were various questions about the detail of the offsets (in addition to collateral) that could be used to reduce reinsurance exposures, including comments about the content of the various line items within the balance sheet.

The Authority would like to confirm that premiums receivables should typically be captured under Line 10 of the balance sheet and not Line 11. Reinsurance receivables are typically those recoverables that have now been crystallised – hence both reinsurance receivables and recoverables are assessed together from a credit risk perspective.

Additionally, the Authority confirms that the Line 33 offset against reinsurance balances should only apply to the extent that they are attributable to a specific reinsurer.

Under funds withheld arrangements the assets may be of better risk quality than the credit risk of the cedant. Can the credit risk of the assets be used to reduce the credit risk of the cedant?

Schedule IIA provides a mechanism for recording funds withheld where those assets are segregated or held in trust. In completing Schedule IIA, the asset capital requirements apply rather than the credit risk capital charges of the cedant.

Confirmation was requested that BSCR credit ratings are based on financial strength ratings, which are distinct from the issuer credit ratings that the investment risks are based on.

The Authority confirms that Credit Risk ratings for reinsurance exposures should be based on the financial strength ratings of the company. Additionally, the Authority confirms that the same BSCR rating classes apply to reinsurance exposures as for investment risks, and this will be clarified in the Rules.

For the Catastrophic Risk Charge, does the offset recognise recoverable arrangements on Special Purpose Insurers (SPIs) and catastrophe (cat) bonds only, or does it include collateral we would expect to recover?

The offset potentially applies to all types of arrangements, but only to the extent that collateral arrangements actually exist at the balance sheet date and are not contingent on future events. As Letters of Credit are not offset against the exposure, but potentially enhance the rating of the exposure, they will not currently have any impact on the charge as the relevant factor (10%) does not currently vary by rating class. This is an area that may be subject to further refinement in future.

In respect of Bermuda-based cat bonds – as the potential recovery from the reinsurer is fully collateralised, the actual rating of the reinsurer is immaterial, and the charge that applies is the residual 2% market risk charge on the collateral itself.

IV. MISCELLANEOUS ITEMS

Funds withheld assets are not recognised in the Interest Rate and Liquidity Risk capital requirements. It would be more prudent and drive more appropriate Asset Liability Management (ALM) if the funds withheld assets are included.

The Authority agrees and anticipates addressing this as part of a more comprehensive review of the Interest Rate and Liquidity Risk capital requirements at a future date.

Some companies may have difficulty sourcing the requisite information for the refined BSCR models. How will the Authority handle these situations?

The Authority expects companies to prepare all aspects of the revised filings on a 'best effort' basis. Where information is not readily available, reasonable approximations may be used. Such circumstances should be noted in the filings.

Some companies expressed concerns about the effort required to produce prior year comparatives for items which have changed.

The Authority is sympathetic to such concerns for the year-end 2013 filings. Prior year comparatives for items which have been subject to changes can be provided on a 'best effort' or estimated basis, and it would be helpful if companies could identify where this has occurred.

V. OTHER LEGISLATIVE CHANGES

a. Insurance (Eligible Capital) Rules 2012
b. Insurance (Group Supervision) Rules 2011
c. Insurance Returns and Solvency Regulations 1980
d. Insurance Accounts Regulations 1980

Various comments and concerns were received in regards to the Eligible Capital Rules. In response the Authority has made minor updates to the section relating to disclosure of insurance contracts reflecting the associated policyholder obligations and corresponding encumbered assets, where applicable; this is just a change in presentation and not a change in the underlying policy. The Authority has also accepted the proposal to offset the capital requirement associated with the policyholder obligations in calculating the amount of encumbered assets to be transferred from Tier 1 to Tier 2. The Authority will consider forming a working group with industry to develop further guidance on Eligible Capital Rules.

There were very few comments received on the proposed changes on other aspects of the above rules and regulations, and so they will be adopted as proposed.

VI. MINIMUM MARGIN OF SOLVENCY (MMS)

As a result of the introduction of the floor to the MMS of 25% of the Enhanced Capital Requirement (ECR), and in response to comments made at the time the proposals were first consulted on, the Authority is removing the MMS from the scope of the audit requirement for those insurers affected (i.e. for Classes 3A, 3B, 4, C, D and E).

This is being achieved by removing statements relating to the MMS from the general business and Long-Term business solvency certificates for those classes. The amount of the MMS will still be filed with the Authority as part of the Solvency and Capital Return filings (the BSCR Summary Sheet). In due course the Authority will update the Solvency and Capital Return to contain the same declarations as were previously contained in the solvency certificates.

In respect of dual licensed entities, the Authority can confirm that, as proposed in the 20 September 2012 Consultation Paper on Minimum Margin of Solvency, the MMS floor will be effective for Long-Term business effective from 1st January 2017.

VII. FUTURE CHANGES TO THE BSCR

In various places in the proposals the Authority has indicated that elements of the BSCR will be subject to further enhancement. At this time, the Authority does not anticipate making further changes to the BSCR in 2014 and instead intends using the next year or so to thoughtfully develop possible refinements and assess their impact before proceeding to implementation. By doing so, we hope to establish a period of stability. During this time, we welcome a continuation of our collaborative discussions with the industry to effectively develop workable approaches.

VIII. MODEL ISSUES

The Authority is grateful to those who have identified issues in the draft models put out for consultation. The identified errors are being corrected as appropriate, along with others that have been identified internally.

The Authority is working towards having the revised BSCR models available by the end of November 2013. The market will be advised accordingly should this timing change.

Yours sincerely,

Bermuda Monetary Authority