1st June 2012

Dear Insurers,

Re: Consultation Paper, Enhancements to the Regulatory and Supervisory Regime for Commercial Insurers

The Bermuda Monetary Authority (the Authority) wishes to thank stakeholders for their continued support of our key initiatives. In January 2012, the Authority published for comment a consultation paper that proposed enhancements to the regulatory and supervisory regime for Bermuda's commercial insurers (that is, Class 4, 3B and 3A general business insurers and Class E, D and C Long-Term insurers). The Authority is committed to engaging stakeholders as we strive to achieve our regulatory and supervisory objectives and appreciate the interest of stakeholders in commenting on regulatory initiatives.

The Authority's responses to the key comments that were received are outlined below.

I. Proposals related to the internal audit function

Summary of Proposal: The Authority has proposed to require commercial insurers to segregate and staff independently from the compliance function the internal audit function. It is also proposed to require the segregation of the internal audit function from the business lines for which it has oversight responsibility and from the underwriting and finance operations.

Summary of Comments: Commenters suggested that implementation of this proposal could be particularly burdensome for certain classes of insurers, particularly Class 3A insurers, and that those insurers and possibly others may need an extension of time to comply with this requirement (which would have been imposed effective January 1, 2013).

Resolution: The Authority is committed to implementing a requirement for a separate and independent internal audit function for commercial insurers but recognises that this may involve the need to undertake corporate restructuring and/or hiring of additional personnel or outsourcing. Accordingly, the Authority will allow commercial insurers an additional year to comply with this new requirement, i.e. until January 1, 2014, while strongly encouraging earlier adoption.

II. Proposals related to certain business activities not traditionally considered to be insurance

Summary of Proposal: The Authority has proposed to require commercial insurers to conduct the following activities in a separately incorporated and capitalised subsidiary or affiliate:

a) Property management, sales or leasing
b) Conducting an investment business
c) Establishing or operating an investment fund that makes investments of a nature that are not ancillary to the business of the insurer
d) Acting as a fund administrator
e) Accepting deposits
f) Underwriting debt or equity securities or otherwise engaging in investment banking
g) Engaging in commercial or industrial activities not ancillary to the conduct of an insurance business

Activities conducted as of December 31, 2011 would be allowed to continue pursuant to existing authorisation until January 1, 2017, at which time they would be required to be conducted in accordance with the Insurance Act, as amended.

Summary of Comments: Commenters stated that the scope of activities that must be conducted in a separately incorporated and capitalised subsidiary or affiliate should not encompass investments in financial derivatives, insurance-linked securities or other forms of risk transfer. There was some concern as to whether the proposal, if implemented, would have an adverse impact on innovation in the Bermuda market. It was suggested that the Authority have the power to determine the scope of permissible insurance business and ancillary business. The Authority was asked to confirm that the non-traditional activities could be conducted through a subsidiary of a regulated entity. The Authority was asked to allow new commercial insurers or those currently applying for a licence to take advantage of the grandfathering period.

Resolution: The requirement to conduct certain activities in a separately incorporated and capitalised subsidiary or affiliate will be adopted as proposed. The Authority confirms that non-traditional activities within the scope of this treatment do not include an insurer's own investments, including those in financial derivatives, insurance-linked securities or other forms of risk transfer. The Authority believes that this clarification should address concerns about adverse impact on innovation.

The Authority confirms its ability to determine the scope of permissible insurance business and ancillary business. The Authority also confirms that the non-traditional activities may be conducted through a subsidiary of a regulated entity.

The Authority is not minded to extend the grandfathering period to companies formed or in the application process subsequent to December 31, 2011 as they presumably were on notice of the proposals to restrict non-traditional insurance business. However, in appropriate cases, the Authority will give consideration to the issuance of an exemption or modification to permit the conduct of certain specified activities.

III. <u>Proposals related to the separate incorporation and capitalisation of companies directly writing long-term and general business insurance</u>

Summary of Proposal: The Authority proposed to require the separate incorporation of commercial insurers directly writing long-term and general business insurance, subject to the grandfathering of exisiting dual licences. It was further proposed to allow Long-Term insurers to write accident and disability contracts of any duration.

Summary of Comments: Commenters suggested further liberalisation of the ability of both general business and Long-Term insurers to write certain lines of business such as guaranteed investment contracts and accident and health policies regardless of contract term. It was suggested that "occasional" users of dual licences be allowed the benefits of grandfathering and that exceptions be granted for "small" business lines, run-off operations and segregated account companies (SACs). Commenters asked that the BMA eliminate the long-term business fund if dual licences are prohibited going forward (also in light of new potential restrictions on non-traditional insurance activities). The Authority was asked to confirm its power to permit an insurer to write any line of business within its licence.

Resolution: The Authority will undertake a further review of the legislative framework for general business and Long-Term insurers and the long-term business fund. At this point, however, it is intended to make only the changes on which the Authority has consulted. Accordingly, the Authority will require the separate incorporation of insurers directly writing long-term and general business insurance, subject to the grandfathering of exisiting dual licences. The Authority will also allow Long-Term insurers to write accident and disability contracts of any duration.

The Authority must review carefully any liberalisation of the ability of both general business and Long-Term insurers to write business traditionally written only by Long-Term insurers in light of risk management and actuarial concerns. The Authority understands the anomaly inherent in the historical practice of general business insurers writing workmen's compensation and health underwriting generally being a long-term business. The Authority will undertake a careful review of the important boundary issues between general business and long-term insurance and propose a comprehensive realignment in a separate consultation.

With respect to the proposals to allow "occasional" users of dual licences the benefits of grandfathering and to exempt "small" business lines, the Authority notes that insurers already have the authority to write incidental business. It is believed that this incidental authority is sufficient to address the occasional use of a dual licence and small business lines. Other situations, such as companies in run-off or SACs, can be addressed as appropriate through requests for exemptions or modifications.

IV. <u>Proposals related to licensing requirements</u>

Summary of Proposals: The Authority proposed to require the submission of additional information with respect to licensing a commercial insurer. Specifically, applicants would be required to demonstrate through the submission of *pro forma* balance sheets and income statements that the ECR would be met for five years post licensing and high-level information on corporate governance and risk management policies (including an outsourcing policy) would need to be provided.

Summary of Comments: Commenters concerns focused on the potential lengthening of the licensing application review period. Other comments included a request to shorten the period for the submission of *pro forma* financial statements from five to three years and to allow the outsourcing policy to be provided on a post-approval basis.

Resolution: The Authority is mindful of the need to maintain the jurisdiction's ability to process expeditiously applications for new licences and, indeed, the importance of balancing the need for enhancements to the commercial regime with the need for expeditious review and decision making by the Authority more generally. The five-year requirement for *pro forma* statements reflects, in the Authority's view, an appropriate business planning cycle and should be retained. With respect to outsourcing arrangements, the high-level information on governance and risk management should include information on planned reliance on outsourcing and the expected timetable for entering into outsourcing arrangements. Applicants will be encouraged, however, to provide available contracts for review during the application process in order to surface any issues at the earliest possible time and to minimise the need to review these contracts subsequently through material change filings. Outsourcing arrangements will continue to be reviewed through the supervisory process.

V. <u>Proposals related to changes in business</u>

Summary of Proposals: The Authority proposed to expand the scope of the material changes in Section 30JA(1) of the Insurance Act that are subject to the 14-day prior notification requirements of Section 30JB and the power of the Authority to object pursuant to Section 30JC. Reportable changes would include: (i) the prospective outsourcing of key functions or underwriting activities to an external unrelated vendor; (ii) the acquisition of a controlling interest in, or creation of an entity conducting material financial business operations that offer products or services to unaffiliated third parties; (iii) expansion into a material new line of insurance or reinsurance business, including material portfolio transfers (both inward and outward); and (iv) material divestitures.

Summary of Comments: Commenters requested clarification on the scope of key functions and portfolio transfers covered by the material change provisions. Further guidance on the definition of materiality was sought and the Authority was asked to confirm that it would grant deference to the reasonable judgment of management in this regard. The definition of portfolio transfer was questioned and it was suggested that "material portfolio transfers" be limited to all or substantially all of a line of business. One commenter requested clarification on the interplay between portfolio transfers and material divestitures.

Concern was raised with respect to processing times for material change notifications, especially with respect to acquisitions and new business formations; it was noted that, in some cases, the requirements of the securities laws in other jurisdictions could overlap with the requirements of the BMA for prior notice of the same transactions.

One commenter suggested that the scope of new material changes be limited to the non-traditional business activities that were the subject of another proposal in the consultation.

It was noted that insurance groups regulated by a competent authority should not be subject to prior notification but, rather, should be required to provide *post hoc* notification to the Authority within 90 days of a material change. Commenters also sought assurance that the absence of objection or request for additional information by the Authority within the 14-day period would be deemed to constitute non-objection.

Resolution: The Authority intends to adopt the proposal substantially as proposed, with certain clarifications. The key functions covered by the material change enhancements are: the internal audit, risk management, compliance and actuarial functions. The Authority would like to clarify that a material change would be deemed to occur only if the responsibility for the function or underwriting is outsourced; merely adding outsourced resources to a function or to a company's underwriting team would not be deemed material outsourcing if the ultimate responsibility for the function or the underwriting is retained in-house.

Materiality is necessarily dependent on the facts and circumstances of a particular line of business, operation or portfolio transfer; the Authority confirms that it will grant deference to the reasonable judgment of management in determining materiality. In general, if a transaction is material for purposes of the disclosure requirements of a listed company, it would be deemed material for purposes of reporting a material change to the Authority. Companies are welcome to contact the Authority for greater clarity on whether a particular change would constitute a material change.

With respect to portfolio transfers, the Authority confirms that it intends to require notice of only those transfers that constitute all or substantially all of a line of business. A line of business generally may be defined by reference to the BSCR; however, it may be appropriate to delineate lines of business in a more granular manner based on materiality. The reference to inward and outward transactions means portfolio acquisitions and divestitures by a company that constitute all or substantially all of a line of business. The reference to material divestitures will be deleted as superfluous.

The Authority acknowledges the need to process material change notifications in a timely manner, including requests for additional information. In this regard, companies are strongly encouraged to provide the Authority with information regarding material changes at the earliest possible time, especially with respect to mergers and acquisitions and business expansions. Information filed with a securities regulator or listing authority could be used to notify the Authority, thereby reducing burden.

The Authority is not minded to restrict the scope of material changes to non-traditional activities; this is too narrow a scope in the view of the Authority and would not allow the review of some key business changes.

The Authority confirms that insurance groups regulated by a competent authority are only required to provide *post hoc* notification to the Authority within 90 days of a material change. Moreover, the Authority confirms that the absence of objection or request for additional information by the Authority within the 14-day period constitutes non-objection.

VI. Proposals related to the Minimum Margin of Solvency (MSM) Floor, Reporting of Non-Compliance with the MSM and ECR and Disclosure Requirements

Summary of Proposal: The Authority proposed to establish a floor for the MSM equal to 25 percent of the ECR at the legal entity level. The Authority also proposed to require commercial insurers to report immediately to the Authority upon becoming aware of any non-compliance with the MSM or the ECR or having reason to believe that any such non-compliance has occurred, and to file within 14 days a capital restoration plan. Commercial insurers and insurance groups would be required to disclose publicly their compliance with the MSM and the ECR and any material breach of either requirement.

Summary of Comments: Concern was raised that the establishment of an MSM floor would give rise to the need for an audit of the BSCR; this concern was shared by both companies and auditors. Clarity was requested on whether the floor would be calculated on an annual or more frequent basis. With respect to the disclosure proposal, concern was raised about the possibility of material adverse market impact and the difference in timing between Bermuda insurers and insurers in other jurisdictions. It was suggested that a disclosure in the footnotes to the financial statements filed by companies would be an appropriate resolution of this issue. Companies also questioned how breaches of the MSM or ECR would be disclosed. Some commenters requested an extension of the 14-day period for filing a capital restoration plan and another requested greater clarification of the form and content of the required plan.

Resolution: The Authority is mindful of the additional burden and expense that would be created by subjecting the BSCR to audit and has decided to remove the MSM from the audit scope given that the inputs to the calculation of the MSM are audited (i.e. the MSM is a mechanical calculation). The Authority is amenable to a disclosure in the notes to the company's annual financial statements that the company was in compliance with the MSM and ECR during the reporting period. Modified filers may make a similar attestation.

With respect to publication of breaches of the MSM or ECR, the Authority intends to address this issue through the proposed powers outlined in the *Statement of Principles on the Use of Enforcement Powers* with respect to the publication of enforcement matters. The Authority will not automatically publish the names of companies in breach of the MSM or ECR but will consider whether publication is appropriate on a case-by-case basis. The Authority's interest with respect to publication is to balance appropriately the need for policyholders and counterparties to be aware of serious capital shortfalls in a company with the interest in not unduly provokiing negative market reaction.

With respect to extending the timeframe for filing capital restoration plans, the Authority will adhere to the 14-day timeframe, with the possibility of extensions for good cause. Failure to meet the MSM or ECR is a grave matter that needs immediate management and supervisory attention and, therefore, 14 days is considered an appropriate length of time to provide the Authority with a plan to restore capital levels.

The form and content of the plan is not prescribed in order to provide companies with the flexibility to craft a capital restoration plan that best reflects the circumstances surrounding the capital shortfall and the means available to the company to remedy the shortfall. The Authority intends to work with companies in a shortfall situation to fashion a plan that is responsive to company, supervisory and market needs. It is acknowledged that this may be an iterative process and companies will not be criticised for failing to provide in the first instance a plan that addresses all possible concerns. Companies should, however, continue to provide the Authority, at a minimum, with information in the plan that outlines the timing and any proximate cause of the capital shortfall, the company's plans for addressing the shortfall (e.g. the issuance of securities, the downstreaming of capital from a parent), the timeframe in which capital is expected to be restored. Companies should also inform the Authority of the timing and substance of any communications to the market or other supervisors and any anticipated material adverse impact on the company of such shortfall (e.g. the breach of debt covenants).

Again, the Authority would like to thank stakeholders for their comments on this Consultation Paper. The Authority remains committed to working with the industry and other interested parties to ensure that results achieved are in the best interests of the Bermuda market.

Draft legislation that is proposed to enact the changes outlined in this response will be distributed in the near future.

Yours sincerely,

The Bermuda Monetary Authority