

30th November 2010

Dear (Re) Insurers:

RE: CONSULTATION PAPER ON THE SOLVENCY FRAMEWORK FOR LONG-TERM INSURERS

The Bermuda Monetary Authority (“the Authority”) wishes to thank the stakeholders for their continued support in relation to our key initiatives. Recently, the Authority published a Consultation Paper on the Solvency Framework for Long-Term Insurers.

The Authority is cognizant of the extent of change required to adopt internationally recognised regulatory standards and appreciates the comments expressed in the feedback received to the Consultation Paper. The Authority is committed to working closely with insurers to ensure an effective and efficient transition to the new standards.

The Authority received a number of comments to the Consultation Paper and our responses are presented below. In our responses, the term “insurer” includes “reinsurer” and “insurance” includes “reinsurance”

Classification System

A number of comments expressed concern that the proposed classification system does not provide a licence class that adequately reflects the circumstances and risk characteristics of some insurers.

The proposed legislation on licence classification provides the Authority with the capacity to license an insurer in a different classification than might otherwise be required. Exercise of this discretion would recognise the circumstances, the risk characteristics and adequate protection of the ultimate policyholders of the insurer. The Authority is preparing a guidance note describing the circumstances under which it may determine a different classification is appropriate. It is the Authority’s current expectation that many reinsurers that only conduct business with their affiliated insurers will be licensed as Class C. The Authority expects to publish the guidance note on long-term classification by December 15, 2010.

Comments expressed concerns that the licence classification system only impacts the pace at which the regulatory requirements become effective, i.e. the regulatory requirements do not vary by class.

Many of the regulatory reforms in the Consultation Paper apply to Class C, Class D and Class E insurers, but not to Class A or Class B insurers. Thus there are some distinctions between the classes in the application of the proposals. Development of the classification system was not only intended to address the implementation of current regulation, but also to provide a framework appropriate for future developments. As further developments occur, they may be applied differently to each of the classes.

Since the release of the Consultation Paper, the Authority has continued to review the risk characteristics of the different classes and the reporting requirements. As a result, the Authority has refined the reporting requirements for both the capital requirements in the Bermuda Statutory Capital Requirement (BSCR) and the Commercial Insurers Solvency Assessment (CISSA) reporting for Class C insurers. These refinements are described below.

Capital Requirements

Comments have been expressed concerning the level of capital required under the proposed regulatory standards, typically with the view that they are too high.

(a) **Enhanced Capital Requirement (ECR)**

The Authority has calibrated the factors in the formula-based approach to determining the ECR at the 99% TVaR confidence level over a one year time horizon. In order to ease the complexity of the calculations, the Authority's factors do not recognise many risk management techniques that insurers may use to mitigate the impact of adverse developments. As such the factors may appear higher than expected for an insurer with strong risk management and risk mitigating processes in place.

In addition, the Authority's approach recognises the benefits of diversification as a separate element of the capital determination process through a square root of the sum of the squares formula. In other frameworks, the recognition of diversification is reflected directly in the factors. Consequently a direct comparison of capital factors from the BSCR with those from other frameworks is difficult.

Insurers that believe the formula-based BSCR process does not appropriately reflect the risks inherent in their business are encouraged to seek approval for their internal capital model to be used to determine their capital requirements.

The Authority has continued to make refinements to the BSCR template and has also recognised proportionality principles by creating a separate BSCR template for Class C insurers. The Operational Risk components have been removed from the Class C form. The updated BSCR for Class D and Class E insurers, as well as the BSCR for Class C firms, are published in conjunction with this response.

(b) **Minimum Margin of Solvency (MSM)**

The Authority has also reviewed the MSM requirements and is implementing the following revision:

MSM as Proposed in the Consultation Paper

<u>Class</u>	<u>Minimum Margin of Solvency</u>
A	Greater of \$120,000 or 2.5% of assets
B	Greater of \$250,000 or 2.5% of assets
C	Greater of \$1,000,000 or 2.5% of assets
D	Greater of \$5,000,000 or 2.5% of assets
E	Greater of \$10,000,000 or 2.5% of assets

MSM as Revised

<u>Class</u>	<u>Minimum Margin of Solvency</u>
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A	Greater of \$120,000 or 0.5% of assets*
B	Greater of \$250,000 or 1.0 of assets*
C	Greater of \$500,000 or 1.5% of assets*
D	Greater of \$4 million or (2.0% of first \$250 million of assets* plus 1.5% on excess)
E	Greater of \$8 million or (2.0% of first \$500 million of assets* plus 1.5% on excess)

*where assets equal Total Assets held on the balance sheet for the Long-Term business fund, less amounts in Long-Term segregated accounts.

(c) Phase In to New Capital Standards

The Authority recognises that the proposed solvency framework is a major departure from the current regulatory requirements. To ease the process of transitioning for insurers, allow time to raise capital where needed and also allow opportunity for the Authority to refine the calibration of the formula-based capital requirements where warranted, the Authority will phase in the new standards over a three-year period. As the new standards become effective, insurers will be required to meet 50% of the ultimate capital requirement in the first year, 75% in the second year and 100% in the third year and onwards. This phase in approach will apply to both the ECR and MSM requirements.

Questions have been expressed concerning the capital requirements for dual licensed insurers, and whether such insurers can use the group BSCR or an internal capital model (ICM) on a group basis to determine the ECR.

The Authority agrees that a dual licensed insurer can use the group BSCR template or an ICM for their combined general and Long-Term business to determine the ECR.

The capital requirements for certain assets require segregation according to the most conservative rating. Where three or more ratings exist, the middle rating has been recommended.

The Authority appreciates this recommendation, but will proceed with the use of the most conservative rating. This approach maintains consistency with the current practice in place for general business and eases complexities where the group BSCR is used for determining the ECR.

Internal Models

Comments have been expressed concerning the Authority's plans for reviewing and approving internal capital models.

Beginning with the *Survey of Economic Capital Modeling Practices in the Bermuda Insurance Market*, which was published in December 2008, and continuing with the *Standards and Application Framework for the Use of Internal Capital Models for Regulatory Capital Purposes*, which was

published in June of 2009, the Authority has begun to develop a process for reviewing an insurer's internal capital model (ICM) for use in calculating regulatory capital.

This process has been further enhanced through the execution of pilot reviews in 2010, leading to a planned revision of the ICM standards guidance in 2011, which will reflect the lessons learned from the pilot reviews and further developments in international standards and best practice. Of note, the Authority's ICM pre-application process will be further enhanced and the fee structure for reviews will be revised. Fees relating to an ICM review will be included in a broader consultation on fees with the industry planned for 2011. However, the principles relating to ICM approval will remain roughly the same, namely that a model is used appropriately, adequate governance and controls exist, all material risks are sufficiently modelled and the structure, theory and assumptions employed in the model are in line with leading practice.

While the pilot reviews and papers published to this point have dealt mainly with Class 4 insurers, the Authority plans to broaden the scope of ICM approval to other classes of insurers, including the Long-Term business sector, in the near future. Accordingly, the Authority is planning to conduct more pilot exercises to inform the standards that are to be applied to the different classes of insurers in 2011, and further develop plans for hiring and/or outsourcing ICM review related tasks to ensure appropriate resources are dedicated to this important initiative.

Given the current stage of legislative developments and ICM review planning related to the Long-Term business sector, the Authority does not anticipate approving a Long-Term business ICM before the end of 2011.

The Authority will be conducting a trial run of the proposed regulatory framework in the spring of 2011 with those companies expected to become Class E insurers. During this process, we will work with these insurers to assess their BSCR submission. If areas are identified where the standard model may not appropriately reflect the insurer's risks, the Authority may exercise its capacity to apply a capital adjustment to the BSCR requirement. If an insurer has an ICM, information gleaned from it could be a contributing factor to the Authority's determination.

Questions were asked concerning whether the Authority would accept an internal capital model for use on a specific segment or segments of a long-term insurer's business.

The Authority agrees that an ICM may be used to determine the capital requirement for a segment or segments of an insurer's business.

CISSA

Comments have been expressed concerning the prescriptive nature of the CISSA reporting form and the extent of information required.

The Authority's intention with CISSA is to obtain information on each insurer's internal approach to managing risk. Subsequent to the release of the Consultation Paper, the Authority has consolidated the CISSA reporting form to three worksheets. The repetitive queries for each risk have been removed. Insurers now complete the template based on their approach to managing risk, and append documentation as appropriate. In responding to the CISSA queries, each insurer will consider how it views and addresses risk and respond accordingly.

In addition, the Authority has created a separate CISSA template for Class C insurers that is tailored to the risk characteristics of this class and makes provision for more simplified reporting requirements. The revised CISSA for Class D and Class E insurers as well as the CISSA for Class C are published in

conjunction with this response.

Questions have been expressed concerning the CISSA requirements for dual licensed insurers and whether such insurers can use the group CISSA to report their risk management practices.

The Authority agrees that a dual licensed insurer can use the group CISSA template to report its risk management practices.

Economic Balance Sheet

Comments have been expressed concerning the timing and costs of implementation regarding the Authority's proposals on economic balance sheets.

The Authority is of the view that there is some urgency to implement a globally recognised financial reporting basis for Bermuda insurance entities that measures assets and liabilities on a consistent basis. This is an important foundation for the Authority's solvency framework. The Authority is also mindful of the international developments on this front and intends to harmonise its implementation process with these initiatives.

Formulation of an appropriate economic balance sheet reporting standard involves considerable technical expertise and the Authority anticipates working closely with industry in the development process. The comments received will be considered further as the Authority develops a consultation paper on the topic.

Disclosures and Transparency

Comments have been expressed concerning the content of the public disclosures proposed by the Authority and whether waivers would be granted in certain circumstances.

The Authority published its "Consultation Paper on Disclosures and Transparency" in June of this year. As noted in the Consultation Paper, the Authority proposes to introduce provisions to largely waive *legal entity public* disclosures and require only group disclosures in rare circumstances, which may include:

- Where the associated group disclosures do not materially differ from that which would be disclosed for the legal entity; or
- Where legal entity disclosures, on account of financial accounting conventions, do not in the Authority's opinion appropriately reflect the economic characteristics of the Bermuda insurer. An example could arise in business combinations where statutory and general purpose accounting use different criteria to establish the acquirer, resulting in the economic characteristics of an insurer *appearing materially dissimilar* from its statutory position when reported on a general purpose accounting basis.

In the above cases, the waiver would generally be accompanied by Authority issued directions; an insurer should expect that some aspects of its legal entity information (partial disclosures) would be required to be made public to give stakeholders a sense of the scale of the legal entity and maintain transparency.

The Authority will consider applications on a case by case basis. Notwithstanding, insurers should not fail in their obligations to develop systems, processes and/or measures that are in proportion to their risk profile.

Examples of the public disclosures of Class 4 general business insurers can be viewed on the Authority's website at http://www.bma.bm/insurance/public-filings_Full.asp

The Authority has been reviewing the Disclosure and Transparency requirements annually. An update Consultation Paper is anticipated in the second quarter of 2011.

Group Wide Supervision

Comments have been expressed seeking clarification on the group-wide supervision framework particularly with respect to the rules or factors that would govern the Authority's determination of whether it would be the Group Wide Supervisor and how it would operate as Group Wide Supervisor.

The Authority published its "Consultation Paper: Insurance Groups Regulatory Framework" in February this year describing the proposed framework. Group wide supervision is an emerging area of regulation and the Authority is intent on aligning its group-wide supervision framework with international developments. The Authority is continuing to refine its rules and procedures with the intention to publish a guidance note in the near future.

Eligible Capital

Comments have been expressed concerning the eligible capital rules for assets held in trust accounts.

Collateral requirements are common in the insurance industry; and are designed to protect a specific group of policyholders against their insurer's credit risk. The collateralised assets are not available to all policyholders until the obligations to the underlying collateralised policyholders have been satisfied. As indicated in the Authority's "Consultation on Eligible Capital" published in September 2009, assets held in trust accounts as collateral for the policy obligations of a reinsurer remain eligible for Tier 1 treatment up to the amount of such respective policyholder's obligations as recorded in the statutory balance sheet of the reinsurer.

However, in some reinsurance arrangements, reinsurers commit additional assets into the trust accounts in excess of their recorded policyholder obligations. In such cases, the eligible capital must be adjusted to recognise the limited accessibility of these assets. It is proposed that this adjustment be calculated as the difference between the encumbered assets and the respective policyholder's obligations as reported in the statutory balance sheet and the difference be transferred to Tier 3 basic capital. In special situations, upon application, the Authority will consider the merits of treating such excess collateral as Tier 1 or Tier 2 capital. Consideration on the appropriate eligible capital treatment will be on a case by case basis with due regard to the excess assets availability to meet the reinsurer's obligations to the ceding insurer(s) and any limitations on its fungibility.

Questions have been expressed concerning the eligible capital rules for letters of credit, guarantees and other commitments.

Paragraph 41 of the Eligible Capital Consultation Paper addresses letters of credit and similar instruments. As indicated in the Paper, "The Authority considers off balance sheet instruments (e.g. letters of credit, contingent capital, etc.) as potential sources of capital as they may be called upon to absorb losses, albeit under limited circumstances. In order to determine the eligibility of such instruments, each must receive approval from the Authority before inclusion as ancillary capital.

The Authority has been working on draft legislation for the Eligible Capital rules and expects to publish these for comment by December 3, 2010.

Other Questions Raised

Will existing accounting policies remain in effect?

The existing accounting policies will remain in effect, including directions under Section 56 of the Insurance Act, 1978, until such time as the underlying statutory framework is changed (i.e. moved to general purpose). The transition from the existing statutory framework to general purpose financial statements will negate existing s. 56 directions for the primary statutory financial statements as these will be governed by generally accepted accounting principles as opposed to statutory guidance / directions. The application of prudential filters and other adjustments to move from general purpose financial statements to an economic balance sheet may, however, allow for the application of s. 56 directions. The Authority's expectation would be that in many cases, the reasons for issuing a s. 56 direction under the existing statutory accounting framework would mirror those that might apply for prudential filters and that accordingly many of these s. 56 directions would continue to be relevant as part of the prudential filters / adjustments. This would be assessed on a case by case basis.

Do the proposed standards apply to Class A or Class B insurers?

Class A and B insurers are required to comply with the Minimum Margin of Solvency, but are not subject to the other requirements address in the Consultation Paper.

Do the proposed standards apply to business within Segregated Accounts?

The regulatory framework applies to the general funds of Segregated Account Companies, but does not apply to business administered within Segregated Accounts.

Does the Code of Conduct apply to long-term insurers?

The Insurance Code of Conduct ("the Code") was published in February 2010 and became effective July 1, 2010; however, the Authority is committed to working with insurers to assist them in meeting the standards in the Code by 31st December 2010. The requirements of the Code apply to insurers conducting long-term business.

How does the Authority anticipate determining which companies will be required to participate in the trial run process in 2011?

The Authority will distribute an application for long-term license reclassification by February 1, 2011. Long-term insurers expected to have more than \$500 million in assets (Total assets less segregated accounts) at December 31, 2010 will be invited to submit their application for reclassification by March 31, 2011. Those long-term insurers reclassified by the Authority as Class A, Class B, Class C or Class D will be exempt from the requirement to complete the trial run. All other long-term insurers with more that \$500 million in assets will be required to complete the trial run filings by June 30, 2011.

Schedule of Filing Dates for Long-Term Insurers

2011 Filing Dates

Insurers with \$500 million or more in assets

Description

Filing Date

2010 Financial Statements

April 30, 2011

2010 Year End Trial Run (unless exempt by the Authority as described above)

June 30, 2011

- BSCR-LT (and optionally BSCR group for dual licensed insurers)
- CISSA-LT (and optionally CISSA group for dual licensed insurers)
- Underwriting Performance Review
 - o Qualitative description of underwriting strategy
 - o Details of the projected annual net premiums, by product type and the projected net income or loss
- Investments
 - o Description of the process for calculating the effective duration for both investment assets and insurance obligations and key assumptions
 - o Description of the Investment Policy
- Group Wide Supervision
 - o Inventory of material intra-group transactions
- Product Information
 - o Features, classification and risk associated – overview only
- Eligible Capital
 - o Schedule of capital instruments eligible for ECR
 - o Schedule of capital instruments eligible for MSM
- Risk Register
 - o Risk register including material risk identified, impact assessment or categorization (e.g. low, medium, high or other rating metric), related controls, a rating of the effectiveness of these controls, and risk owner.

Reclassification application (if not submitted previously)

September 30, 2011

Insurers with less than \$500 million in assets

Description

Filing Date

2010 Financial Statements

April 30, 2011

Reclassification application

September 30, 2011

2012 Filing Dates

Class E Insurers

Description

Filing Date

2011 Year End Statements

April 30, 2012

- Financial Statements
- BSCR
- CISSA
- Underwriting Performance
- Investments and Derivatives
- Group Exposure Where the Authority is not the Group Wide Supervisor
- Product Information
- Eligible Capital
- Economic Balance Sheet
- Public Disclosures
- Risk Register

Class C and Class D Insurers

Description

Filing Date

2011 Financial Statements

April 30, 2012

2011 Year End Trial Run

June 30, 2012

- BSCR-LT (and optionally BSCR group for dual licensed insurers)
- CISSA-LT (and optionally CISSA group for dual licensed insurers)
- Underwriting Performance Review
 - Qualitative description of underwriting strategy
 - Details of the projected annual net premiums, by product type and the projected net income or loss
- Investments
 - Description of the process for calculating the effective duration for both investment assets and insurance obligations and key assumptions
 - Description of the Investment Policy
- Group Wide Supervision
 - Inventory of material intra-group transactions
- Product Information
 - Features, classification and risk associated – overview only
- Eligible Capital
 - Schedule of capital instruments eligible for ECR
 - Schedule of capital instruments eligible for MSM
- Risk Register
 - Risk register including material risk indentified, impact assessment or categorization (e.g. low, medium, high or other rating metric), related controls, a rating of the effectiveness of these controls, and risk owner.

2012 Filing Dates

Long-term Insurance Groups (insurers not already subject to group supervision under Class 3B or Class 4 group requirements)

Description

Filing Date

2011 Year End Trial Run

June 30, 2012

- Financial Reports
 - o Consolidated Financial Statements
 - o Business Projections
- Corporate Governance
 - o List of major shareholders
 - o Organisational Structure
- Risk Management
 - o Risk Management Strategy
- Solvency
 - o Group Capital and Solvency
 - o Intra-group transactions
 - o Schedule of Capital Instruments eligible for the Group MSM
 - o Schedule of Capital Instruments eligible for the Group ECR