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Dear Class 4 and Class 3B (re)insurer

Re: Discussion Paper on Implementing Group-wide Supervision (“the Discussion Paper”)

The Bermuda Monetary Authority (“the Authority”) issued its recent publication, Discussion Paper on Implementing Group-wide Supervision. We have received a number of comments and the Authority’s responses are outlined below.

General Comments

The Authority has embarked upon its programme towards achieving mutual recognition and supervisory equivalence with key jurisdictions that are strategic to Bermuda and its stakeholders. We recently issued our Bermuda’s Insurance Solvency Framework Roadmap to Mutual Recognition (“Roadmap”) which provides the Authority’s proposed approach to enhancing the regulatory regime. We are committed to engaging our stakeholders so that we achieve our supervisory outcomes, as well as retain Bermuda’s role as a key player in the international fora.

In implementing a group-wide supervision regime, we recognise the complexities presented by groups, especially internationally active groups; therefore, in order to understand and regulate these risk exposures, additional regulatory and reporting requirements are necessary. The role of the Group-wide Supervisor may be undertaken by the Authority or another regulator from an equivalent jurisdiction. Hence the appointed Group-wide Supervisor may request additional information from both the group and/or the supervisors of the group’s entities in order to supervise the group effectively.

The Authority is currently active within the International Association of Insurance Supervisors (“IAIS”), participating in a number of regulatory and supervisory workstreams. Accordingly, in our

interaction with other supervisors, it is notable that the general trend is to extend heightened scrutiny beyond the globally systemic groups to those that are considered to be of high impact at the jurisdictional level. In this regard, we have taken care to make proposals that both reflect proportionality, while being consistent with evolving international standards to increase our chances of achieving our equivalence goals.

Group-Wide Supervisor

Comments were expressed regarding the determination of the Group-wide Supervisor. The Authority was asked to elaborate on its criteria to determine ‘mind and management’. Also, there may be a number of supervisors that may qualify to become the Group-wide Supervisor of a group so what mechanism is there to resolve this issue.

1. Presently, there are no defined criteria to determine the Group-wide Supervisor’s appointment. Gleaning from past determination of home-host supervisors, the predominant factor was either place of incorporation or where the mind and management of the entity’s board occurs.¹ The IAIS, in its guidance paper on the role and responsibilities of the Group-wide Supervisor, identified a number of principles in determining the Group-wide Supervisor:
 - a. The supervisor where the group is based and the supervisor has statutory responsibility to supervise the head of the group;
 - b. The location of the group’s head office, which is where the group’s board and senior management would likely meet;
 - c. Where the registered head office is not the operational head, the location where:
 - i. The main business activities of the group are undertaken;
 - ii. The main business decisions are taken;
 - iii. The main risks are underwritten and/or
 - iv. The group has its largest balance sheet total

¹ **Home jurisdiction:** a home jurisdiction is one in which the parent insurer is incorporated, or in which the head office of a branch is incorporated. Host jurisdictions / supervisors must be aware of the distinctions between immediate and higher level home jurisdictions / supervisors, taking account of the hierarchical corporate structures of many international insurers and insurance groups. – IAIS Glossary

2. The Authority is interested in where the group's board deliberate on matters² such as :
 - a. setting strategic direction;
 - b. determining the insurer's risk appetite;
 - c. choice of corporate structure including mergers, acquisitions and strategic alliances;
 - d. choice of new lines of business, new products, marketplace positioning; and
 - e. assessing solvency needs.

3. The Authority must determine **where** (location/jurisdiction) the mind and management takes place that fulfils the aforementioned responsibilities. Additionally, we may consider other factors such as access to the group's senior management and where the group's control functions reside. In formulating its "test" of where the mind and management occurs, the Authority will be monitoring discussions and drafting guidance on this area. We intend to adopt a principles-based approach in deciding where the group's mind and management occurs which would certainly engender greater dialogue with the market and other regulators.

Supervisory Colleges

Comments were expressed regarding the statutory requirements for supervisory colleges and what the Authority would require from the industry.

1. The Authority wishes to reserve the right to host a supervisory college on a "need-to-basis" and would prefer to remain flexible on the frequency and format of these colleges. In keeping with the tone of the Discussion Paper, a principles-based group-wide supervisory regime allows the Authority to approach supervisory colleges in the same manner.

2. The Authority presently has powers under sections 29A and 29B of the Insurance Act 1978 to request additional information as is reasonable for the Authority to perform its functions. The information requested from insurers may vary depending on the issue being discussed

² IAIS & OECD - Draft Issues Paper on Corporate Governance – 3 June 2009

and as such, we prefer not to be prescriptive in what information is needed for the supervisory college. In order to avoid duplication and unnecessary burdens on insurers where possible, the Authority may utilise information we have in-house, and from other supervisors.

3. The Authority may issue further guidance on supervisory colleges for the Bermuda market in due course taking into account guidance provided by various international bodies including the IAIS.

Equivalence

Comments were expressed regarding the Authority's assessment of other jurisdictions for supervisory equivalence.

1. The Discussion Paper proposed that the Authority may employ a principles-based approach to ascertain broad equivalence against the Authority's regulatory and supervisory frameworks. In order to conduct these assessments, the Authority may take into account work conducted by the IMF or the EU; however, where jurisdictions have not been subject to such assessments, the Authority may need to develop its own equivalence assessment.
2. It should be noted that the IAIS' Insurance Groups and Cross-sectoral Subcommittee ("IGCS") has begun a supervisory equivalence workstream for insurance groups, and there is a proposal to include this as a future ICP. We see this as an important component to facilitate the process internationally.

Impact of equivalence on a group's corporate structure

Comments were expressed regarding requesting the group to establish a locally incorporated parent. The Authority proposed this option where the appointed Group-wide Supervisor may not be from an equivalent jurisdiction.

1. The Authority does not intend to arbitrarily impose such a requirement; however, this may be necessary if the Authority does not consider the Group-wide Supervisor as equivalent

and the Bermuda entities contribute significantly to the group's overall business activities and/or they conduct significant business activities within Bermuda. The Authority will be concerned if the group is not being supervised effectively, which in turn, may have adverse implications on the Bermuda entities and the jurisdiction as a whole. Therefore, the Authority may need to do what is absolutely necessary to safeguard the Bermuda entities and Bermuda's financial sector.

2. Where the intermediate parent of the Bermuda entities may be from an equivalent jurisdiction, the Authority may recognise the regulator of that jurisdiction as the Group-wide Supervisor. Further, we would need to be satisfied that particular regulator has the ability to assess and take corrective measure where the risks presented by the entire group may affect the sub-group. The Group-wide Supervisor must also demonstrate that they can execute the role effectively and efficiently and they must demonstrate, inter alia, competency, adequacy of resources and possess the requisite regulatory and supervisory powers to act in this role.
3. Recently, the Authority has received a few requests concerning branch regulation for significant insurance operations. The Authority is presently reviewing its position on branch regulation, especially in light of its objective to achieve mutual recognition and supervisory equivalence.

3.1 In the context of a group-wide supervisory regime where the Group-wide Supervisor is deemed equivalent by the Authority, the Authority may consider recognising the work of that Group-wide Supervisor; however, the branch entity would need to comply with certain statutory obligations such as, inter alia, filing requirements and the Authority's impending Code of Conduct for insurers.

The Authority may consider the following options in assessing branch operations located in Bermuda:

- a. Where the parent of the branch operations belongs to a jurisdiction that is deemed equivalent, the Authority may not require assets equal to policyholder liabilities to be placed locally;
- b. Where the parent of the branch operations belongs to a jurisdiction that is not deemed equivalent; however, the main business activities emanate from the branch:
 - the Authority may require the branch to become a Bermuda-based subsidiary; or
 - the Authority may require the branch to establish local assets at least equal to 50% of policyholder liabilities. We will consider this ring-fencing provision in light of the extent to which such policyholder liabilities are already collateralised in other jurisdictions;
- c. Where the parent of the branch operations belongs to a jurisdiction that is not deemed equivalent; and, the main business activities do not emanate from the branch, then the Authority may consider waiving the requirement for the ring-fenced assets to be localised. Rather, they may be held in another jurisdiction in an appropriate manner.

Group Corporate Governance and Risk Management

Comments were expressed regarding what the Authority meant by “sound business manner” particularly relating to the possibility of exercising any enforcement or supervisory actions where the group may not be conducting its operations suitably.

The Authority will be issuing a consultation paper on its Code of Conduct in Q3 2009. We will elaborate further on what “sound manner” means in that consultation paper. The Code of Conduct is being drafted to focus solely on the solo level given that a group supervisory regime does not yet exist; however, we propose that the term “sound business manner” will be consistently applied to both solo and group entities when the group’s regime is implemented.

Group Solvency Framework

Comments were expressed regarding how the hybrid approach advocated in the Discussion Paper would work in practical terms.

The Discussion Paper is predicated on the theory that the Authority is the Group-wide Supervisor when it proposes methods the calculation of group solvency . The hybrid approach examines certain risk exposures, such as those presented by unregulated entities and intra-group transactions, to ensure that they are reflected in the final group solvency calculation. The hybrid approach may warrant additional capital treatment to determine the group's Enhanced Capital Requirement ("ECR") or it may generate a capital add-on. The group solvency calculation, required by the Authority, does not negate what other jurisdictions may require for their own solvency requirements. The Authority will be issuing its consultation paper on group-wide supervision, and will provide further details on our proposed group solvency regime.

Comments were expressed regarding the Authority's assessment of intra-group transactions, and specifically, how would we determine if these are being managed properly.

The Authority's proposed treatment of intra-group transactions allows the group to present a modelled assessment of the transaction for our consideration. The Authority proposes to review the modelled assessment of the intra-group transaction and take into account the risk management structure surrounding the transaction. The additional disclosures on intra-group transactions will assist the Authority in its review; therefore the Authority will be issuing an information request on the list of material intra-group transactions to begin our thematic studies in this area. These thematic studies will be used to engage in further discussion on the matter. If the intra-group transaction presents an exposure that is not adequately reflected in its solvency calculations, the Authority may impose a capital add-on.

Comments were expressed regarding the definition of a material intra-group transaction.

1. The Authority will be issuing an information request for insurers to provide “an inventory of material intra-group transactions, to start the process of disclosure of these instruments”³.
2. In issuing its Level 2 Consultation Paper on “Supervision of Risk Concentration and Intra-Group Transactions” CEIOPS borrowed the principle of materiality⁴ from the International Accounting Standards Board, which is meant to guide supervisors in prescribing a materiality threshold for intra-group transactions. As a regulator, the Authority is concerned where the effects of an intra-group transaction may have a material impact on an insurer’s statutory capital and surplus. The materiality threshold would be established based on the Authority’s view of what may trigger a supervisory review once an insurer’s statutory capital and surplus has been affected by an intra-group transaction.
3. Based on the above, the Authority proposes the following criteria in determining a material intra-group transaction:
 - a. Intra-group transaction whose impact can cause a reduction in the insurer’s statutory capital and surplus by 5% or more;
 - b. A series of linked intra-group transactions that can cumulatively reduce an insurer’s capital and surplus by 10% or more.

Comments were expressed regarding where the Authority may impose a capital add-on: at the legal entity level or the group level?

The Authority may impose capital add-ons where it believes the risk exposures presented by the group are not adequately captured in its solvency calculations. The question as to where the

³ BMA’s Discussion Paper on Implementing Group-wide Supervision

⁴ Information is material if its omission or misstatement could influence the economic decision of users taken on the basis of financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being primary qualitative characteristic which information must have if it is to be useful.

capital add-on will be imposed would depend on where the risk exposure presents itself. The Authority may explore the following options:

- a. If the risk exposure emanates from an entity within the Authority's supervisory control, then the capital add-on may be applied at that level;
- b. If the risk exposure emanates from an entity from another jurisdiction, then the Authority may contact the relevant supervisor who may impose the capital add-on at that level. If the supervisor does not have the authority to do so, then the capital add-on may be imposed at the group level; or
- c. If the risk exposure emanates from the group and/or an unregulated entity/activity, then the capital add-on may be imposed at the group level.

The capital add-on process will be subject to the appeals process that is presently in place.

Comments were expressed regarding the Authority's proposed approach to deduct the value of the investment in an unregulated entity from the group's regulatory capital.

The Discussion Paper presented the Authority's proposed solvency approach using either the consolidation or aggregation method, which is supplemented by introducing elements of the legal entity approach to calculate the group's solvency requirement. The mechanics of how this may work can be seen in the simple example provided in Appendix I. The Authority would provide further details in its upcoming consultation paper on group-wide supervision.

Calibration

Comments were expressed regarding whether the Authority would consider allowing insurers to use 99.5% VaR confidence level in its internal model to determine the ECR.

We recently issued our guidance note on Standards and Application Framework for the Use of Internal Capital Models for Regulatory Capital Purposes ("Internal Models Framework"). The section titled "Calibration Test" states that "where practicable, the ICM should be calibrated such that the regulatory capital requirement is determined using the TVaR metric subject to a confidence level of 99.0% over a one year period with a complete run-off to extinction of all

liabilities.” The Authority may consider approving an internal model that uses 99.5% VaR calibration as long as the insurer demonstrates that this metric is at least as effective as a 99.0% TVaR over a one year time horizon in determining the regulatory capital requirement.

Internal Models

Comments were expressed regarding whether the Authority would accept reviews and validations of internal models from third parties such as rating agencies, other regulators etc.

In approving an insurer’s internal model, the Authority may consider the reviews and validations from rating agencies, actuarial consulting firms or any third party to the extent that it is practicable. If the model approval arose from another regulator, then the Authority may consider accepting the approval if the jurisdiction is deemed equivalent. Paragraph 33 of the Internal Models Framework states that the “degree of reliance placed upon these reviews will be guided by the extent to which their approach is comparable to that of the Authority’s, the sufficiency of documentation available, and any other factors that the Authority may consider appropriate.”

Unregulated (or “non-regulated”) Entities

Comments were expressed regarding the Authority’s proposed approach to supervise unregulated entities, such as holding companies. Further clarification of the Authority’s position was requested.

1. Currently, many jurisdictions, including Bermuda, do not have direct regulatory or supervisory oversight over unregulated entities, including holding companies. As noted in our Discussion Paper, it is the IAIS’ view that the supervisor should exercise appropriate power over the head of the group, even if the head of the group is an unregulated entity, such as a holding company⁵. This can be accomplished through direct means where the supervisor has express powers to supervise the holding company, or through the follow-up

⁵ IAIS Principles on group-wide supervision October 2008

approach, where the supervisor can exercise its powers over the regulated insurer to gain information from the holding company.

2. The IAIS acknowledged that the follow-up approach “may have limitations regarding the effectiveness of group supervision in practice, and granting express powers in relation to the holding company to the supervisors would provide a better legal basis.”⁶ The Solvency II Directive provides for regulatory and supervisory oversight over holding company operations. Further, CEIOPS’ advice on facilitating effective supervision of groups refers to attaining appropriate oversight over holding companies as to achieve effective group supervision⁷. International discussions have increased over the issue of regulating non-regulated entities, at least minimally, the holding company; therefore, it is not an issue that the Authority can ignore. Our present position, as stated in the Discussion Paper, is to have limited supervisory oversight over non-regulated entities. As we continue in the development of our group-wide supervisory regime, we will be observing international developments in this area.

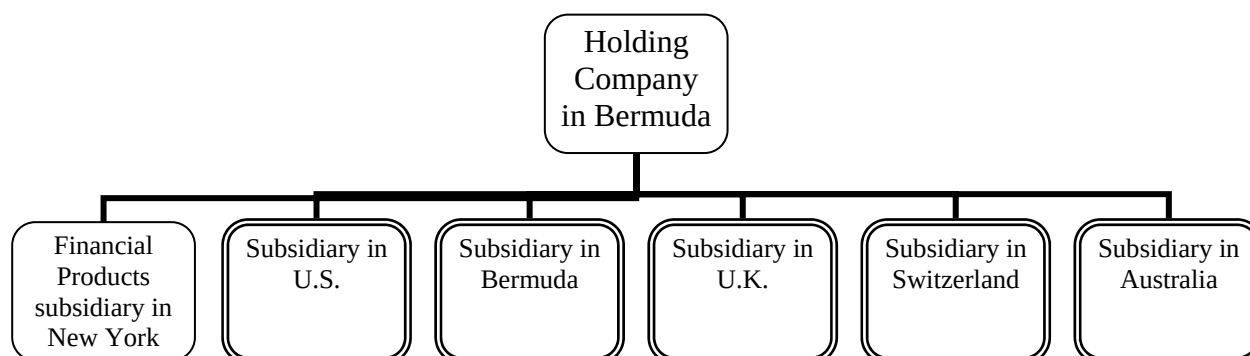
Please feel free to contact us if you have any questions and again, we look forward to working with our stakeholders to ensure mutually beneficial outcomes are achieved.

Yours sincerely,

⁶ IAIS Issues Paper on Group-wide Solvency Assessment and Supervision 5 March 2009

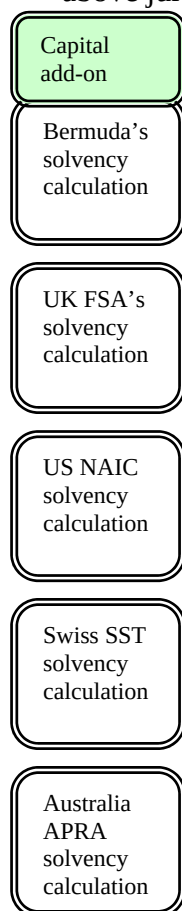
⁷ Advice to the European Commission on aspects of the Framework Directive Proposal related to Insurance Groups Measures to facilitate the effective supervision of groups May 2008

APPENDIX I



Regulated Entities with Solo Capital Requirements determined by the respective jurisdiction's solvency rules.

The group above is required to calculate its group solvency capital requirement. We assume the above jurisdictions are deemed equivalent.



Aggregation method: The sum total of the solo calculations would be the group solvency requirement (“Group ECR”). The Bermuda subsidiary may have investments in the financial products unit. The Authority’s default position is to treat the investment as a non-admitted asset (deducted from Line 4 of the SFR) to come up with the group’s statutory capital and surplus amount. The group may provide a modelled assessment for our consideration.

A modelled assessment of the risk exposure presented by the financial products unit may warrant a capital add-on which can be assessed on the Bermuda legal entity. As stated in the comments earlier on the application of capital add-ons, if the risk exposure is in a subsidiary outside Bermuda, then the capital add-on may be

Aggregation Method: Σ (solo entities’ solvency calculations) = Group Solvency calculation

**Capital add-on
due to exposure
in FP unit**

Group ECR
calculated using
the consolidation
method, group
BSCR or an
approved
internal model

Consolidation method: The Group ECR would be determined from the group's consolidated data. The group's investment in the financial products unit may be deducted from Line 4 of the SFR (non-admitted asset) to come up with the group's statutory capital and surplus amount. The group may provide a modelled assessment for our consideration.

A modelled assessment of the risk exposure presented by the financial products unit may even suggest that the risk exposure is greater than the value of the investment and may require a further deduction or it may generate a capital add-on, which may be assessed at the group level.

