



BERMUDA MONETARY AUTHORITY

CONSULTATION PAPER ON THE RECLASSIFICATION OF THE CLASS 3 SECTOR

15th May 2008

PREAMBLE

In the years following the 2003 IMF assessment of Bermuda's insurance sector supervision, there has been extensive policy development and public consultation in respect of the BMA's risk-based framework of prudential supervision. In 2005, the BMA introduced a new onsite supervisory regime for the Class 4 sector. The BMA has also recently established a new risk-based solvency capital requirement for the Class 4 sector. These initiatives have substantially strengthened and modernised the prudential requirements applying to Class 4 insurers.

In 2007 the BMA had its second detailed IMF assessment of Bermuda's commercial insurance sector supervision. The IMF remarked that the current licensing system is broadly risk-based, but that the Class 3 sector is a mix of entities with varying risk profiles. The IMF also highlighted that the BMA should continue its progressive rollout of the onsite-inspection programme to the Class 3 sector.

While developing this work for the Class 4 sector the BMA was mindful that there would need to be further application of the framework to regulated entities within the Class 3 sector. This paper examines Phase I of proposals to further stratify the insurance register, which will facilitate the full implementation of our risk-based supervisory model to the Class 3 sector. This will also provide for better comparative analysis, enable the BMA to appropriately supervise and regulate the wide range of company types in the current Class 3 category, and ensure consistency in how regulations are applied to Bermuda's entire commercial insurance sector.

As can be seen from the pages that follow, these proposals are focused on commercial insurers and special purpose business. Our clear policy goal is to leave the existing regulatory framework for captives broadly unchanged and to ensure that the transition to the new regime does not impact the captive sector.

The BMA welcomes comments on the legislative proposals outlined in this paper, which should be submitted in writing to Shelby Weldon (sweldon@bma.bm) no later than 11th June 2008.

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GLOSSARY

BMA	Bermuda Monetary Authority
BSCR	Bermuda Solvency Capital Requirement
GPW	Gross Premium Written
Insurance Act	Insurance Act 1978 and Related Regulations
Insurer	An insurer authorised under the Insurance Act to conduct insurance business (which includes reinsurance business)
IAIS	International Association of Insurance Supervisors
IMF	International Monetary Fund
NPW	Net Premium Written
RAC	Rent-A-Captive
SAC	Segregated Accounts Company
SFR	Under the Insurance Act, every Class 3 insurer is required to file annually a statutory financial return and statutory financial statements within 4 months from the insurer's financial year end (may be extended on application to 7 months). The statutory financial return includes the approved auditor's report on the statutory financial statements, a declaration of statutory ratios and an opinion from a loss reserve specialist (e.g. casualty actuary) in respect of the insurer's loss and loss expense provisions.
SPI	Special Purpose Insurer
Unrelated business	Insurance business consisting of insuring risks of persons who are not shareholders in, or affiliates of, the insurer.
Class 1	A body corporate is registrable as a Class 1 insurer where that body corporate: a. is wholly owned by one person and intends to carry on insurance business consisting only of insuring the risk of that person; or b. is an affiliate of a group and intends to carry on insurance business consisting only of insuring the

risks of any other affiliate of that group or its own shareholders.

Class 2

A body corporate is registrable as a Class 2 insurer where that body corporate is wholly owned by two or more unrelated persons and intends to carry on insurance business not less than 80% of the net premiums written in respect of which will be written for the purpose of:

- a. insuring the risk of any of those persons or of any affiliate of any of those persons; or
- b. insuring risk which, in the opinion of the BMA, arises out of the business or operations of those persons or any affiliates of any of those persons.

A body corporate is registrable as a Class 2 insurer where that body corporate would be registrable as a Class 1 insurer but for the fact that:

- a. not all of the premiums which it intends to carry on, but at least 80% of the net premiums written, will consist of business described as Class 1 business; or
- b. it intends to carry on insurance business not less than 80% of the net premiums written in respect of which will, in the opinion of the BMA, arise out of the business or operations of the person by whom it is owned or any of the affiliates of that person.

Class 3

A body corporate is registrable as a Class 3 insurer where that body corporate is not registrable as a Class 1, Class 2 or Class 4 insurer.

Class 4

A body corporate is registrable as a Class 4 insurer where:

- a. it has at the time of its application for registration, or will have before it carries on insurance business, a total statutory capital and surplus of not less than \$100,000,000; and
- b. it intends to carry on insurance business including excess liability business or property catastrophe reinsurance business.

Where a body corporate is registrable as Class 4 insurer it shall not be so registered if it is also registrable as a Class 1 or Class 2 insurer.

1. INTRODUCTION

- 1.1. The prudential legislative proposals and the draft legislation outlined in this paper represent the BMA's initial view on a reclassification of the existing Class 3 sector. Comments are sought on this approach together with suggestions for alternatives where issues are raised. Subject to the outcome of the consultation process the BMA intends that new legislation, amended regulations and guidance notes reflecting the proposed regulatory enhancements and policy approach will commence on 1st April 2009. Where necessary the BMA would agree transitional arrangements with affected insurers to allow sufficient time for adjustments to be made to their business operations to fully comply with any new requirements.
- 1.2. The plan involves taking a more granular view of all licensed Class 3 companies, with a view to effectively grouping entities with similar risk profiles in defined sub-classes. This will provide for better comparative analysis, enable the BMA to appropriately supervise and regulate the wide range of type of company in the current Class 3 category and ensure consistency in how regulations are applied to Bermuda's entire commercial insurance sector.
- 1.3. As at 31st December 2007 there were 504 Class 3 companies with total capital and surplus of more than \$66.7 billion. These companies represent a significant proportion of the international insurance entities licensed in Bermuda, writing more than US\$42 billion in gross premiums, and representing approximately 34% of the total number of active insurance companies in the jurisdiction. It is our intention that all commercial insurers should be subject to enhanced regulatory standards however, our goal is to leave the regulatory requirements broadly unchanged for captives and those firms with limited commercial business. The sub-categorisation of the Class 3 sector will achieve a licensing and supervisory process which reflects the amount of commercial insurance activity a company undertakes.
- 1.4. The BMA is also proposing to introduce a Special Purpose Insurer class. In order for a company to receive consideration for registration as an SPI, it would have to meet the following criteria:
 - a. The insurer is carrying on insurance securitization or transformer type business;
 - b. The insurer is established to enter into a single transaction or a single set of transactions;
 - c. The insurer's obligations are fully collateralized, and;
 - d. Transactions are carried out with a limited number of sophisticated participants.
- 1.5. To date companies incorporated and registered to conduct special purpose transactions have been required to comply with the existing minimum capital requirements for Class 3 insurers as prescribed by the Insurance Act. This amendment will ensure that the level of regulation and supervision is reflective of the characteristics of the business and the risks inherent in their activities. For all segments of the existing Class 3 sector the BMA believes that a risk-based approach to supervision will ensure a reasonable balance

between achieving its prudential objectives and not unduly constraining commercial business conducted in Bermuda.

2. RECLASSIFICATION PLAN

- 2.1. There will be two phases: Phase I, a comprehensive reclassification; Phase II, development of a risk-based capital model applicable to a subset of the current Class 3 insurers.
- 2.2. Phase I of the plan will require all existing Class 3 licence holders with 50% or more of unrelated business net premium written and/or net loss and loss expense provisions, to submit an application for re-registration into one of these new sub-classes. Those companies with less than 50% unrelated business will not be required to re-register into a new sub-class as the existing Class 3 category will be redefined to accommodate those insurers whose percentage of unrelated business represents more than the 20% threshold applicable to Class 2 insurers, but less than 50% of unrelated business net premium written. This reflects our policy objective that the regulatory regime for captives should be broadly unchanged – and also that the transition to the new regime should not impact on existing captive operations.
- 2.3. In addition to the legislative amendments that will be required to affect this reclassification, the BMA will also commit to providing adequate guidance to assist applicants in determining which sub-class is appropriate for their respective structure.
- 2.4. As stated in the 2008 Business Plan, the BMA will be looking to apply its new risk-based capital regime to all high impact commercial insurers registered in Bermuda. The existing minimum solvency provisions that apply to the Class 3 sector seek to make provision for the scale and nature of risk in an insurer's business in setting the required margin. However, as was determined for Class 4's, the BMA recognizes that the existing Class 3 provisions are not sufficiently tailored for the large commercial insurers currently registered in this class. Therefore all new large commercial insurers will be asked to adhere to the requirements of a new risk-based regime.
- 2.5. Phase II of the plan will begin in the first quarter of 2009, but there has already been extensive work done in the current year to gather meaningful data to support the re-calibration of the existing BSCR model, currently in effect for the Class 4 sector, for use by a subset of Class 3 insurers. More extensive data analysis and possibly additional data calls to further assist in the calibration of the BSCR for the Class 3 sector should be expected in 2009.
- 2.6. It should be noted, by way of background, that the Class 3 sector is already extremely well capitalized and that insurers and the BMA have developed sound arrangements for monitoring, managing and mitigating the risks that are taken on by Bermuda insurers and ensuring that adequate capital is held against them. As a result, the incidence of problem situations in the Bermuda market has been low, with policyholder losses

limited. The overwhelming majority of registered insurers already operate at capital levels that are in excess of the minimum solvency margin stipulated under the Insurance Act and the Regulations. Accordingly, for the most part, in developing and introducing new risk-based solvency tests, the BMA sees no need to alter the overall relationship between aggregate capital held and risks underwritten in the Bermuda market.

3. CLASS 3 – A MIX OF ENTITIES

- 3.1. In 1995 the Registrar of Companies, the agency formerly responsible for insurance supervision, proposed amendments to the Insurance Act 1978 which introduced Bermuda's first stratified system of supervision over the insurance sector. Class 3 comprises companies with a wide range of characteristics, either writing a combination of captive and commercial business, or operating as substantial commercial insurers capitalised at lower levels than Class 4 entities. As regards Class 3 captives, depending on the extent of the commercial business written by a company, we have taken the view that it may be more prudent to reclassify such insurers into their own distinct class.
- 3.2. Latest statistics, based on only those companies actively writing insurance business, reflect that there are close to 140 companies registered as Class 3 captive insurers. Included in this list would be the more than 60 rent-a-captive facilities that exist in Bermuda. This significant captive activity is one of the drivers behind the proposal to introduce a 3-tiered Class 3 structure. The example below demonstrates how a commercial insurer categorisation for a RAC can be misleading:
 - a. ***Rent-a-captives*** - The determination as to whether to register a company as a captive or commercial insurer is made primarily on the basis of whether the ultimate insureds are related in any way to the owners of the insurer. A RAC structure relieves the unrelated cell user from the expense associated with establishing and sustaining a traditional captive insurer. The unique feature of a rent-a-captive is that each cell has assets and liabilities attributed to it, and its assets cannot be used to meet the liabilities of any other cell. The RAC will also have non-cellular (core) assets, which may be available to meet liabilities that cannot be attributed to a single cell. In most instances the RAC's core statutory capital is never at risk and therefore always available to support solvency margin maintenance. Because of these features and the fact that there is no risk of statutory insolvency a more risk weighted approach to supervision would suggest that the rules applying to commercial insurers should not apply to a RAC. In this instance Section 56 and special conditions attached to the RAC's license would have to be used to ensure appropriate risk-focused requirements are applied to the company.
- 3.3. Other types of insurers included in the Class 3 category are:
 - a. ***Pure commercial insurers*** – Insurance companies writing only unrelated business.

- b. ***Affiliated insurers*** – Insurance companies that write affiliated reinsurance business where the ultimate insureds are unrelated to the owners of the business.
- c. ***Sidecars*** – Unaffiliated reinsurers writing 100% of their business from a single cedent.
- d. ***Special Purpose Insurers*** - Insurers carrying on insurance securitization or transformer type business.
- e. ***Segregated Account Company*** - A single company consisting of a core and an indefinite number of cells, which are kept legally separate from each other. Each cell has assets and liabilities attributed to it, and its assets cannot be used to meet the liabilities of any other cell. The company will also have non-cellular (core) assets, which may be available to meet liabilities that cannot be attributed to a single cell.
- f. ***Captive writing unrelated business*** -
 - i. Insurance companies registrable as a Class 1 or 2 insurer, but for the fact that more than 20% of their net premiums written arises from risks which are unrelated to the business of their owners and/or affiliates.
 - ii. Insurers that were licensed to write captive business, but may also have intended in the future to conduct commercial insurance business in excess of the 20% threshold allowed for Class 2 insurers. In many instances this further development of the business plan never materialized and the only business written by the insurer was captive business.
 - iii. Insurers that wrote some captive business and a significant element of commercial business over and above the Class 2 20% threshold, but have subsequently run-off or significantly reduced the commercial portfolio of business written.

4. **PROPOSED THREE-TIERED CLASS 3 STRUCTURE**

- 4.1. ***Class 3 - Captive Insurers writing unrelated business*** - This would include those insurers whose percentage of unrelated business represents more than the 20% threshold applicable to Class 2 insurers, but less than 50% of unrelated business net premiums written.

Of the 504 companies currently registered as Class 3 insurers, there are more than 140 that currently write significant portions of captive business. This would include the 60 rent-a-captives and other closed cell segregated account companies where the cell participant's risks are fully-funded.

4.2. ***Class 3A – Small Commercial Insurers***

- a. This would include those insurers whose percentage of unrelated business does or is expected to exceed 50% of net premiums written and/or net loss and loss expense provisions, and
- b. Where the unrelated business net premiums do not or are not projected to exceed \$50,000,000.

The predominant portion of existing Class 3 insurers are expected to be reclassified into the small commercial category. To address concerns about an unprojected increase in premiums that may take a Class 3A insurer above the \$50,000,000 threshold, the BMA will introduce provisions which will require insurers to provide notice to the BMA under Section 8A and file a written report containing:

- i. particulars of the circumstances leading to the excessive level of unrelated business net premiums written in that year;
- ii. unaudited interim statutory financial statements covering such period as the BMA may require; and
- iii. a general business solvency certificate in respect of those statements.

To make application under Section 56 for a waiver of that condition in a given year, if it can be demonstrated that the extent of the business written in that year was not representative of a change from the company's original business plan.

We believe this provides a flexible mechanism to address the situation without requiring an entity that has not altered its business strategy for the long-term to reregister as a Class 3B insurer.

4.3 ***Class 3B – Large Commercial Insurers***

- a. This would include those insurers whose percentage of unrelated business does or is projected to exceed 50% of net premiums written and/or net loss and loss expense provisions; and
- b. Where the unrelated business net premiums do or are projected to exceed \$50,000,000.

Based on 2006 statutory financial information filed with the BMA, there were 32 Class 3 commercial insurers writing more than \$50,000,000 in total net premium. The total premiums written by this group represented approximately 40% of the total net premiums for the whole of the Class 3 sector.

5. SUPERVISION OF CLASS 3 INSURERS

Existing Level of Supervisory Oversight

- 5.1 The BMA's risk-based framework seeks to allocate supervisory resources to those entities that pose the greatest threat to its supervisory objectives. Given the diversity of risks within the full scope of the Class 3 grouping, the order of priority for more enhanced

supervisory monitoring has been based largely on size, nature of insurance business written and complexity of organisational structure. Commercial Class 3 insurers have generally been supervised as Medium-High Impact companies, subject to Enhanced Monitoring.

- 5.2 A preliminary assessment of the company is carried out which would entail a detailed file review, including any issues surrounding the company or its parent and affiliates, the complexity of insurance programme(s), market-related issues and other pertinent information in the public domain such as media reports, rating agencies' assessments and other industry reports. Financial analysis includes analysis of the company's SFR and, where possible, common size financials are prepared to gauge trends. Performance ratios are reviewed and, in particular, a reasonable explanation is sought to determine why the ratios are outside normal parameters. Once an initial conclusion has been reached and the review has been completed, it would be submitted for consideration on the onsite schedule.
- 5.3 During 2007 the Authority expanded its on-site programme to include high impact Class 3 commercial insurers. The on-site programme was also expanded further during the year to include insurance managers and newly registered commercial insurers.
- 5.4 The on-site assists the Authority in obtaining a more complete understanding of an insurer's business, and a fuller assessment of the effectiveness of the systems and management controls. Through efficient risk assessment, potential problems can be detected at an early stage and regulatory action taken on a timely basis, ensuring that in the event of problems, insurers can be restored to compliance promptly, or that their exit from the market can be managed efficiently.

Additional Supervisory Requirements Being Proposed

- 5.5 The BMA proposes to modify the filing requirements of the SFR such that all Class 3A and Class 3B insurers would be required to submit a Schedule of Ceded Reinsurance in accordance with Regulation 14A of the Insurance Returns and Solvency Regulations 1980.
- 5.6 As noted above, in due course the BMA proposes that enhanced solvency capital requirements will be implemented for Class 3B firms. Additional disclosure requirements may also be required, subject to consultation.
- 5.7 There are no additional reporting requirements or new solvency or disclosure requirements being imposed on the new Class 3 captives writing some unrelated business.

6. SPECIAL PURPOSE INSURERS (“SPI”)

- 6.1. With the continued growth in special purpose insurance transactions, the BMA is now proposing to amend the Insurance Act 1978 to introduce a third category of insurer.
- 6.2. In a “typical” insurance securitization transaction, an SPI is established for the purpose of entering into a single insurance contract. In order to fund its obligations under the contract, the SPI will often issue notes (“the Notes”) to investors in an amount equal to the company’s maximum liability under the insurance contract. The Notes will be limited recourse notes and provide that the company’s obligation to pay interest and principal to the note holders diminishes by an amount equal to the amount the company pays under the insurance contract.
- 6.3. Single transaction insurance companies have also been used for other financing transactions. In asset-backed securitization transactions a single transaction insurance company may be established to allow that transaction to access the reinsurance markets. Alternatively, a single transaction insurance company might be established to participate in a credit transformation, whereby the insurance company issues a single financial guarantee insurance policy and fully secures that contract by purchasing a matching credit default swap contract.
- 6.4. The afore-mentioned examples have a number of factors in common (i) in each case the SPI is established to enter into a single transaction or a single set of transactions which are usually all entered into simultaneously at the commencement of the company’s business (ii) the insurance companies’ obligations are fully collateralized either through the issue of limited recourse notes, a derivative contract or some other financial instrument which would need to be approved by the BMA and (iii) the transactions are carried out with a limited number of sophisticated participants. It is proposed to only register an insurer as an SPI if that insurer satisfies the three criteria described above.
- 6.5. Definition: The principal features of an SPI are proposed as follows:
 - a. The share capital for an SPI will be \$1.00;
 - b. The margin of solvency requirement for an SPI will require that the assets of the SPI exceed its liabilities at all times;
 - c. An SPI will only be permitted to write “special purpose business”; and
 - d. The SPI will be restricted from entering into any other business save for ancillary agreements such as interest rate swaps on guaranteed investment contracts that ensure the interest on the Notes can be paid.
- 6.6. Required level of supervision: Generally SPI’s will be subjected to all other relevant aspects of the Insurance Act 1978 unless otherwise expressly exempted by the attached draft legislation and/or by specific approval granted by the BMA.