

BERMUDA MONETARY AUTHORITY
INSURANCE DEPARTMENT

GUIDANCE NOTE #14

INSURANCE ACTIVITY

MARCH 2005

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Introduction

- 1 The prime responsibility for the sound and prudent management of an insurer rests with the board of the insurer. Since insurance is a risk taking activity, insurers should evaluate and manage the risks that they underwrite and have the tools to establish an adequate level of premiums. An insurer's systems and practices relating to insurance activity may differ depending on the size and complexity of the insurer and the nature of the insurer's risk exposures. This note sets out guidance on an insurer's insurance activities.
- 2 The Bermuda Monetary Authority (the "Authority") recognizes the need for clarity as to the scope and implementation of the provisions of the Insurance Act and related regulations ("the Act")¹ if the regulatory system is to command the confidence of both insurers and policyholders. It seeks, therefore, to ensure that those operating in Bermuda have a good understanding of the nature of the requirements and of the Authority's approach in implementing the Act.
- 3 While the Authority aims to provide clarity as to its approach, this guidance note cannot be exhaustive. The Authority will do its best through this and other guidance notes to set out information about its regulatory approach and expectations regarding an insurer's insurance activity.
- 4 Other guidance issued by the Authority may contain additional information on insurance activities.
- 5 The Authority's guidance is of a general application and seeks to take account of the wide diversity of institutions that may be licensed under the Act. There is likely to be a need for the guidance to be revised and developed over time. Material changes in the guidance will be published, generally through the issue of revised versions.
- 6 For references in these Guidance Notes with respect to the changes in legislation contained in the Insurance Amendment Act 2004 insurers must take immediate steps to ensure they are in compliance with the Act. In relation to other matters contained in the Guidance Notes, the Authority encourages insurers to come into compliance as soon as possible and, in any event, not later than 31st December 2005 or a later date as may be agreed with the Authority in a particular case.

¹ The insurance legislation is comprised of the Insurance Act 1978 (as amended by the Insurance Amendment Acts, 1981, 1983, 1985, 1995, 1998 and 2001) and the regulations promulgated under that Act (the "Regulations"). The Regulations are the Insurance Accounts Regulations 1980 (as amended by The Insurance Accounts Amendment Regulations 1981, 1985 and 1989) and the Insurance Returns and Solvency Regulations 1980 (as amended by The Insurance Returns and Solvency Amendment Regulations 1981, 1985 and 1989). References herein to the "Act" are to the Insurance Act 1978 (as amended) and the Regulations.

Application

- 7 This guidance applies to all insurers registered under the Act.
- 8 In seeking to ensure that the objectives of this guidance are met, having regard to the size, nature, complexity and risk profile of the business of the registered insurer, the board must exercise its judgement in determining the nature and scope of the insurer's insurance activity and the related procedures and standards. It is the responsibility of the board to determine which specific provisions of this guidance should be applied.
- 9 As part of its supervisory process, the Authority will look for indications that, overall, processes or procedures for insurance activity are in place, that they are appropriate to the individual insurer, and that they are operating effectively. The Authority will formulate its overall judgment on the effectiveness of an insurer's risk management and internal control based on a variety of indicators. The degree of applicability and weighting of individual elements in this guidance will depend on the size, nature, complexity and risk profile of each insurer as well as whether some processes have been outsourced to an affiliate or external entity. For example, the Authority recognizes that insurers which only insure or reinsure the risks of their owners and are part of the same organization may pose less risk to the public than other insurers, and that it may be appropriate for the underwriting policies and procedures for these entities to be less complex than for other insurers.²

Insurance Activities

- 10 Underwriting is the process by which an insurer determines whether and under what conditions to accept a risk. Weaknesses in the controls and systems surrounding the underwriting process can expose an insurer to the risk of unexpected losses which may threaten the capital position of the insurer.
- 11 Insurers use actuarial, statistical, or financial methods for estimating liabilities and determining premiums. If these amounts are materially underestimated, the consequences for the insurer can be significant and in some cases fatal. In particular, premiums charged could be inadequate to cover the risk and costs, insurers may pursue lines of business that are not profitable, and liabilities may be underestimated, masking the true financial state of the insurer.

² As stated in the IAIS Principles on Minimum Requirements for Supervision of Reinsurers approved in October 2002 *"where captives only insure the risks of their owners and are part of the same organization they may not pose the same risk to the financial system and separate regulations may be established recognizing this reduced risk."* This approach is also consistent with international best practices as described by the International Association of Insurance Supervisors, which recognize that the principles adopted in a jurisdiction should take into account the domestic context and industry.

Underwriting policy

- 12 Insurers manage the risks they take on through a range of techniques including pooling and diversification. Every insurer should have in place strategic underwriting policies (underwriting guidelines) approved and reviewed regularly by the board of directors.
- 13 It is important that the board of directors and management of an insurer recognize that they have the prime responsibility for the sound and prudent management of an insurer's underwriting strategy.
- 14 Insurers should evaluate the risks that they underwrite, and establish and maintain an adequate level of premiums. Insurers should also have systems in place to control their expenses related to premiums and claims, including claims handling and administration expenses. Management on an on-going basis should monitor these expenses.
- 15 Insurers should establish premiums based on reasonable assumptions to enable the insurer to meet its commitments.
- 16 Insurers may be involved in derivative activities in connection with their insurance activities or through the transformation of the exposure into a derivative.³ An insurer should ensure that all derivatives underwritten, including embedded options in life insurance products, have been properly identified and properly priced.

Reinsurance

- 17 Reinsurance management refers to the selection, monitoring, review and control of reinsurance arrangements. For this purpose, reinsurance arrangements also include financial reinsurance and alternative risk transfer products.
- 18 Insurers should have a clear strategy to mitigate and diversify risks, such as defining limits on the amount of risk retained, taking out appropriate reinsurance cover or using other risk transfer arrangements consistent with its nature, business and capital position. This strategy is an integral part of the insurer's overall underwriting policy and must be approved and regularly monitored and reviewed by the board of directors.
- 19 The reinsurance program should be appropriate for the size, business mix and complexity of operations of the insurer and provide coverage appropriate to the level of capital of the insurer and the profile of the risks it underwrites.

³ Insurers are also involved in derivatives in connection with their investment activities. The Authority has issued a separate guidance note on an insurer's investment activities.

- 20 The reinsurance program should, among other matters, address how the reinsurance is to be purchased, how reinsurers will be selected, including how to assess their security, and what collateral, if any, is required at any given time.
- 21 If requested, an insurer's reinsurance arrangements should be available for review by the Authority.

End of guidance note.

If you have questions on this or other guidance from the Insurance Department please email info@bma.bm . Please put "Insurance Guidance" in the title of your email.