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1. INTRODUCTION

1. This consultation paper outlines the economic balance sheet ("EBS") framework proposed by the Bermuda Monetary Authority (the "Authority"), which is based on a flexible principles-based approach accompanied by supporting guidelines. The proposals in this paper apply to Bermuda general business insurers (Class 3A, 3B and 4), and would also include an insurance group or Bermuda group1 for which the Authority is the group supervisor.

2. For the purposes of this paper:
   
   “general business” as defined under section 1 of the Insurance Act 1978 (the “Act”);
   
   “group supervisor” as defined under section 27A of the Act;
   
   “insurance business” as defined under section 1 of the Act;
   
   “insurance group” as defined under section 1 of the Act;
   
   “insurer” includes “reinsurer” and “insurance” includes “reinsurance” and “insurer” also includes “insurance group” and Bermuda group;
   
   “international accounting standards” refers to internationally recognised standards of accounting including International Financial Reporting Standards ("IFRS") and U.S. Generally Accepted Accounting Principles ("GAAP");
   
   “long-term business” as defined under section 1 of the Act; and
   
   “principle of proportionality” or “proportionality” refers to flexibility under the supervisory framework depending on the nature, scale, and complexity of the insurer.

3. The insurance industry and other interested parties are invited to submit their views on the proposals set out in this paper. Comments should be sent to the Authority and addressed to policy@bma.bm no later than Friday, 5th October 2012.

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1 “Bermuda group” has the meaning as set forth in the Authority’s Guidance Note on Designated Insurer (May 2012) and Insurance Group Supervision Statement of Principles (May 2012).
II. BACKGROUND

4. In August 2010, the Authority issued a discussion paper (the “DP”), which considered the introduction of an EBS framework and proposed changes to regulatory reporting. The EBS framework is aimed at providing a consistent and accurate valuation basis for preparing regulatory reporting in line with proposed international standards. Revisions to the regulatory reporting framework are designed to facilitate the Authority’s review and understanding of individual insurers and the Bermuda insurance sector as a whole, and enable it to make valid comparisons between individual insurance entities. The DP set out the background to these proposed changes, elaborated on their rationale, and posed several questions concerning the implementation of an EBS framework and revised regulatory reporting scheme.

5. In light of comments received on the DP and the acknowledgement of significant differences in the approaches to an EBS framework in the general business and long-term contexts, the Authority has decided to issue separate consultations on the EBS framework for general business and Long-Term insurers.

6. A fundamental premise of the EBS framework for both general business and Long-Term insurers is an endorsement of the idea that assets and liabilities should be valued on a consistent economic basis: that this would reduce or eliminate, where possible, accounting mismatches where no underlying economic mismatches exist, thereby providing a more accurate picture of an entity’s solvency position and enhancing overall protection for policyholders. This fundamental premise can be expressed as an overarching principle guiding the Authority’s development of the EBS framework and reporting scheme for both groups of insurers.

7. Other desirable characteristics that guide the development of the EBS framework for either general business or Long-Term insurers include:

   a. Consistency with International Regulatory and Accounting Standards: to ensure Bermuda is consistent with international best practice, the EBS framework and reporting scheme should be consistent with the work of the International Association of Insurance Supervisors’ (“IAIS”). In order to reduce the burden on insurers, the EBS framework should also take into account the direction of the work being performed by accounting standard bodies, such as the

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b. **Consistency with Solvency II:** to be deemed equivalent to Solvency II, the Bermuda EBS requirements should be established in a broadly consistent manner and recognise, where appropriate, the unique characteristics of the Bermuda market.

c. **Proportionality:** the EBS framework and reporting scheme adopted should be commensurate with the nature, scale, and complexity of the risks undertaken by the insurer. In particular, calculation methods, assumptions, modelling techniques, and data requirements should be adopted in a proportional manner.

d. **Materiality:** the calculation methods, assumptions, modelling techniques, and data requirements adopted should incorporate those risks facing an insurer such that their omission or modification would influence the final EBS determination.

e. **Governance and Review:** a sound system of governance and review undertaken by suitably qualified persons should be in place to oversee and approve the processes involved in the EBS determination.

8. Delays in the roll out of Solvency II and the work on convergence of standards of FASB and IASB, present some practical challenges to the implementation of the EBS framework for both general business and Long-Term insurers. The Authority does not propose waiting for the finalisation and possible alignment of international standards, but instead proposes developing a flexible principles-based approach supported by guidelines. It is anticipated that insurers preparing financial statements under the Solvency II rules, future IFRS, or U.S. GAAP will be able to comply with the EBS reporting requirements (subject, in the latter cases, to the application of certain prudential filters). It is acknowledged that, subsequent to finalisation, some future revisions may be needed to the guidelines to appropriately reflect developments in international and regulatory standards.

9. In developing an EBS framework for general business, the following areas have been identified as significant in warranting additional consideration:

   **a. Valuation of technical provisions**

   In the valuation of general business liabilities, the following issues are addressed in the development of the framework proposals in section III of this paper:

   i. **Discount rate:** selection of an appropriate discount rate;
ii. **Contract boundaries**: there are currently varied definitions of the contract boundary in the different regulatory and financial reporting regimes. In determining the definition for the Bermuda market, consideration needs to be given to the extent to which future premiums are recognised and to the extent the risk assumed can be reassessed and re-priced; and

iii. **Risk margin**: the calculation of a risk margin, i.e. the compensation required by the insurer to bear the risk that ultimate cash flows exceed those expected.

### b. Valuation of assets and other liabilities

The major focus for general business will be on the technical provisions for the liability side of the balance sheet. Considerations in the valuation of assets and other liabilities should be broadly consistent across the general and long-term business sectors.
III. PRINCIPLES AND GUIDANCE

10. The following set of principles, developed by the Authority, underlies the development of the EBS framework. This is an integral part of the modernisation of the regulatory regime for insurers.

11. In developing these principles, the Authority has taken into account the latest regulatory and accounting developments, as well as the IAIS Insurance Core Principles and principles underlying the Solvency II insurance contracts project.

12. The Authority does not expect the principles in this paper to change over time, however, it is intended that the guidance will be further refined as accounting and international best practice develop and converge.

OVERARCHING PRINCIPLES

1. The valuation of assets and liabilities should be on a consistent economic basis.

   1.1 Accounting mismatches in the absence of real underlying economic mismatches within the business should be avoided.

   1.2 The economic value should reflect a prospective valuation of the future cash flows of the assets and liabilities, allowing for the riskiness of the cash flows and the time value of money.

   1.3 It is recognised that in certain cases insurers are long-term investors in assets and can avoid potential mark-to-market volatility of assets. The valuation of assets and liabilities should take this into account.

2. The valuation of the EBS should take into account proportionality and materiality.

   2.1 The insurer should take a proportionate approach to economic valuation, whereby the insurer’s greatest focus should be on those risks, parameters, and assumptions that are most material for the valuation.

   2.2 Parameters and assumptions should be considered as material if their omission or misstatement could influence the decision-making or the judgment of the users of the EBS, including those of the supervisor.

DATA

3. The data used to support the development of the EBS should be relevant, complete, and reliable.
3.1 Data includes both policyholder data used in actuarial models and other data (e.g. experience analyses, market information) used to set the assumptions and parameters for the valuation.

3.2 The insurer is responsible for ensuring that:

a. relevant data is not excluded from the valuation process without justification;
b. the data used is free from material errors;
c. data used from different time periods for the same estimation are consistent;
d. the data used is up-to-date and consistent with the assumptions underlying the actuarial and statistical techniques that are applied to them in the calculation of the liabilities;
e. the data is available at a sufficient level of granularity and includes sufficient historical information to identify trends and assess the characteristics of the underlying risk;
f. the data is credible for its intended use, for example in assumption setting, and the insurer understands the sources and any limitations to the use of the data;
g. the data appropriately reflects the risks to which the insurer is exposed with regard to its obligations; and
h. where external data is used, the insurer understands the sources and any limitations within the data, and can justify why external data is considered more suitable than internal data.

3.3 Documentation sufficient to demonstrate that the data quality standards of 3.2 are met should be maintained for supervisory review. A directory of all data used in the calculations of the technical provisions should be maintained and specify the source, characteristics, and usage of the data used in those calculations.

**VALUATION OF ASSETS**

4. **Financial assets should be reported on an economic basis.**

4.1 A key objective is to avoid creating artificial mismatches; so the asset valuation must be considered in the context of the liability valuation, as described below.

4.2 Assets should be valued consistently with international accounting standards.

a. Market values should be based on quoted market prices in active markets, where possible. Other valuation methods, such as mark-to-model, should make maximum use of relevant market inputs.

b. Goodwill should be recorded at zero value.

c. Deferred Acquisition Cost (“DAC”) is eliminated (with a corresponding adjustment to liabilities).
d. Future expected instalments of premiums should not be included as part of premiums receivable, but included as part of the premium provisions.

e. Intangible assets should be recognised only if it is probable that the expected future economic benefits will flow to the insurer and that the cost of the assets can be measured reliably. The assets must be separable, and there should be evidence of exchange transactions for the same or similar assets indicating it is saleable in the marketplace. Intangible assets should be recognised at fair value. If a fair value measurement of an intangible asset is not possible, then such an asset should be valued at nil.

f. Deferred tax assets should be recorded based on international accounting standards and adjusted for changes required to determine the EBS. Amounts expected to be recovered in more than one year should be discounted using risk-free rates.

g. Fixed maturity investments, equity investments, investment property, and short-term investments should be recorded at fair value.

h. Investments in non-controlled affiliates should be recorded at fair value or the equity method of accounting subject to prudential filters (e.g. the elimination of goodwill and other non-admitted assets) and impairment testing.

i. Funds withheld should be recorded based on the consideration received or expected to be received.

j. Other assets should be recorded at fair value if they have a “readily realisable value.”

4.3 Typically market prices are expected to be used although an amortised cost method may be appropriate in certain circumstances if it could be demonstrated that the insurer has the intent and ability to hold the assets to maturity.

a. The ability of the insurer to hold assets to maturity would depend, in part, on the stability of the underlying liability cash flows.

b. Assets valued on an amortised cost basis should be evaluated for adequacy, at least annually, taking into account any significant impairment to the assets.

c. The valuation of assets and liabilities should be on a consistent economic basis (i.e. if the amortised cost method is used then this would be reflected in the discount rate used for the valuation of liabilities).

VALUATION OF TECHNICAL PROVISIONS

5. Technical provisions should be valued at economic value using best-estimate, probability-weighted cash flows with an additional risk margin.

5.1 For the valuation, unbiased current assumptions should be used. These should be based on a combination of relevant, credible experience, as well as expert judgment as to potential future trends and developments e.g. mortality trends.
5.2 The assumptions are used to derive a probability associated with each future cash flow. The intention is not to deliberately overstate or understate the expected value for the best-estimate.

5.3 At each valuation date, the insurer should consider whether the assumptions used are still appropriate and be able to justify any changes (or non-changes) in assumptions.

5.4 Separate amounts should be shown for outstanding claims provisions (in respect of claims incurred whether reported or not) and premium provisions (in respect of future claims events). An additional risk margin would not be expected to be split between the two components.

6. The cash flow projection used in the calculation of the best-estimate should take account of all future cash in- and out-flows required to settle the insurance obligations attributable to the lifetime of the policy.

6.1 The lifetime of the policy is defined to continue up to the point at which:

a. the insurer is no longer required to provide coverage;

b. the insurer has the right or the practical ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk;

c. the insurer has the right or the practical ability to reassess the risk of the portfolio that contains the contract and, as a result, can set a price that fully reflects that risk of that portfolio.

6.2 The cash flows expected to be taken into account in the valuation should be based on unbiased current estimates and would include:

a. future best-estimate premium payments;

b. benefit payments to cedants, policyholders, and beneficiaries, including an allowance for any discretionary benefits, e.g. certain contracts are designed with the right to participate in the performance of a specified pool of assets;

c. expenses, including any payments to intermediaries, claim costs, servicing costs, and investment costs;

d. payments to and from reinsurers or other providers of risk mitigation, including reinstatement premiums; and

e. other cash flow items which are expected to be charged to policyholders or required to settle the obligations.

6.3 Separate totals should be shown for gross and net of reinsurance outstanding claims provisions and premium provisions. The risk margin needs to be shown on a net of reinsurance basis.

6.4 Note that it may be possible for the premium provision component of the technical provisions to be negative, if future expected premium receipts exceed expected claims and expenses.
7. The valuation should take into account potential management actions and potential changes in policyholder behaviour.

7.1 The size of the technical provisions could be influenced by the policyholder’s decision to exercise options open to him as well as management’s ability to exercise its discretion.

7.2 Management actions should be reflected in the valuation of the technical provisions provided that the management actions:
   a. are clearly documented;
   b. have been approved by senior management;
   c. are consistent with representations made to policyholders;
   d. reflect the time and cost required to implement; and
   e. are consistent with past evidence of similar actions in similar circumstances.

7.3 Policyholder behaviour should reflect:
   a. analysis of previous data on policyholder actions, if available;
   b. analysis of the degree to which it would be in the policyholder’s interest to exercise the available option;
   c. changes in the operating environment e.g. if the level of guarantees is increasing in the market then policyholders are more likely to lapse and purchase a new product (and vice versa); and
   d. potential interaction with management actions.

7.4 It is intended that the analysis of policyholder behaviour (which includes the possibility of recaptures for reinsurance transactions) should be prospective; thereby requiring some degree of expert judgment.

8. In the calculation of technical provisions, estimated future cash flows should be adjusted for the time value of money. The discount rate should be based on the risk-free curve and may be adjusted to reflect risk characteristics of the liabilities.

8.1 The starting point for the risk-free curve should be the swap yield curve appropriate to the currency of the cash flows at the valuation date.

8.2 If the swap yield curve is not of an adequate duration, then other reference points, such as government bond yields, should be used.

8.3 Extrapolation and interpolation of the yield curve is possible, but the insurer would need to justify the approach as reasonable.
8.4 No adjustment to take account of the insurer’s own credit standing should be made in the valuation of technical provisions.

9. Technical provisions should include a risk margin to reflect the uncertainty associated with probability-weighted cash flows. The risk margin should, generally, be the compensation the insurer requires to bear the risk that the ultimate cash flows could exceed those expected.

9.1 For the risk margin the following characteristics are expected:
   a. the greater the uncertainty associated with the cash flow, the larger the risk margin;
   b. risks which are more material, all else being equal, will result in a larger risk margin;
   c. risks that persist for longer, all else being equal, will result in a larger risk margin; and
   d. similar risks should give rise to similar risk margins.

9.2 For the risk margin, the cost of capital approach should be used.
   a. The risks to be taken into account are non-hedgeable risks, such as insurance risk, credit risk, operational risk, and market risk associated with assets held to maturity.
   b. The cost of capital rate to be used is 6%.
   c. The calculation should be based on the regulatory capital requirement calculated under the BSCR or an approved model.
   d. The risk margin can be calculated at an aggregate level; the insurer may, where necessary, make reasonable allowance for the effects of the diversification of regulatory capital requirements within the insurance entity when calculating the risk margin.

9.3 As noted in paragraph 5.4, it is not necessary for general business to calculate the risk margin separately for outstanding claims and premium provisions.

9.4 The risk margin should be calculated on a net of reinsurance basis.

10. When calculating best-estimate technical provisions, the undertaking should identify and take into account all material guarantees and contractual options included in the insurance policies.

10.1 The value of options and guarantees would be influenced by the prevailing economic conditions and the likelihood of the policyholder to exercise the option.

10.2 In order to properly value financial options, the insurer would typically need to examine a number of different scenarios.

10.3 For the simpler and less material options, the analysis may be based on simplified methods, such as closed form solutions or the analysis of selected scenarios. However, for more complex and material options, a range of stochastic scenarios may be required.
10.4 For valuation purposes, the stochastic scenarios used are typically calibrated to market prices.

LIABILITIES OTHER THAN TECHNICAL PROVISIONS

11. Liabilities other than technical provisions should be valued on an economic basis, consistent with international accounting standards.

11.1 In practice this means fair value will be used.

   a. Current and deferred tax liabilities should be recorded based on international accounting standards adjusted for changes required to determine the EBS. Amounts expected to be paid in more than one year should be discounted using risk-free rates.

   b. Reinsurance balances payable should be recorded at amount due. Amounts due in over one year would be subject to discounting using risk-free rates.

   c. Financial liabilities and embedded derivatives should be recorded at fair value excluding an insurer’s own credit spread to its own debt.

GOVERNANCE

12. Insurers shall have effective systems and controls to ensure that valuation estimates of their assets and liabilities are appropriate and reliable.

12.1 Insurers shall establish, implement, and maintain clearly defined policies and procedures for the process of valuation, including:

   a. the description and definition of roles and responsibilities of the personnel involved with the valuation;

   b. the collection, analysis, and use of data, along with the steps taken to ensure that the data is relevant, complete, and accurate;

   c. a validation between the extract data (e.g. policyholder or asset extracts) and the results of the valuation process. For example, confirmation that the premiums, face amounts, and fund values from the policy extracts are consistent with the output of the actuarial models and other sources of information such as public accounts;

   d. the actuarial and statistical methodologies for the calculation of the technical provisions;

   e. determination of the assumptions including the derivation of the yield curve used;

   f. parameterising and running of the model;

   g. quality controls; and

   h. documentation.
12.2 Certain aspects of the valuation process will depend on the expertise of persons with relevant knowledge, experience, and understanding of the risks inherent in the insurance business and involve expert judgment. In such cases, the insurer should document the use of expert judgment and indicate the steps used to validate the conclusions based on such judgment.

12.3 Insurers shall validate the calculation of technical provisions, at least once a year, or when there are indications that the data, assumptions, or methods used in the calculation or the level of the technical provisions are no longer appropriate. The technical provisions included in the EBS would, when fully operational, be subject to certification by the insurer’s loss reserve specialist.

12.4 Insurers shall ensure that the persons overseeing the validation process are sufficiently qualified with regard to their knowledge and experience to carry out the validation process.
IV. TIMETABLE FOR THE MOVE TOWARD AN ECONOMIC BALANCE SHEET

13. In late 2012, the Authority proposes to conduct a test run of the revised reporting method on a preselected “test group” of Class 3B and 4 insurers on a voluntary basis, based on the reporting period ending 31st December 2011. This will be followed by trial runs of revised reporting in 2013 and 2014, for the reporting years 2012 and 2013, respectively.

14. The reporting framework will then be more formally applied to the Class 3B and 4 general business insurers, with a soft launch of revised statutory reporting in 2015, for reporting periods ending 31st December 2014. A soft launch means that insurers may comply on a “best-efforts” basis and need not provide management or board attestation/certification. The soft launch will serve as a “dry run” of the new statutory reporting framework, in the year just prior to the formal migration to EBS statutory reporting.

15. A full formal adoption is proposed for the reporting period ending 31st December 2015 (to be submitted in 2016); at which point reporting under the previous statutory rules would cease.

16. The framework will be extended to Class 3A general business insurers, using the same implementation strategy, one year later than the timetable for the Class 3B and 4 insurers (see Table 1 - General Business Reporting Timetable on the following page). It is recognised that the nature, scale, and complexity of Class 3A insurers varies greatly and individual insurers are invited to discuss with the Authority, at their earliest opportunity, any proposals for applying proportionality (as outlined in paragraph 7c of this paper) in the adoption of the EBS framework, where appropriate.

17. It should be noted that the above proposals mean that there will be a period of dual reporting, where insurers will participate in the trial run and soft launch phases and continue to report under the existing statutory requirements. This period of “parallel reporting” will provide insurers and the Authority with the necessary time to gain experience and comfort with the new reporting standards, prior to the migration to formal regulatory reporting.

18. In the trial run and soft launch phases of implementation, insurers will be expected to aim for an economic valuation on a best-efforts basis, in which case the Authority recognises that some reliance will need to be placed on approximations. A full economic valuation should be the goal of insurers when formally introduced to statutory reporting, but this will, of course, be subject to the principle of
proportionality and materiality. The Authority will retain the power to modify reporting requirements in exceptional cases.

19. The Authority realises that for some insurers, the move to the EBS may involve additional effort and is likely to iteratively develop over time. Insurers are encouraged to discuss their plans for the development of the EBS with the Authority.

20. As part of the transitional arrangements in preparing the EBS, insurers would be permitted to leverage existing systems, processes, and capabilities to meet current reporting requirements to the extent reasonable and practicable. Some possible transitional simplifications are suggested in section V of this paper.

21. For the test and trial runs, it has been proposed that the Authority provide a standard risk-free rate curve of adequate duration for the discounting of cash flows, and the Authority will provide rates for the following major currencies: U.S. Dollar, Euro, Japanese Yen, British Pound, and Canadian Dollar. If circumstances necessitate, the scope of currency coverage will be widened. Insurers may use alternative rates, as long as the insurer can provide a rationale for such an approach and evidence that this is consistent with the principles.

22. The 2012 test run will provide the Authority with input on the practical issues faced by the move to an EBS, and help ensure that insurers are provided with the appropriate options, simplifications, and transitional arrangements where necessary.

23. It is the Authority’s expectation that, even where an insurer does not participate in the voluntary testing process, work would begin internally to prepare for the introduction of an EBS. Where challenges with implementation or other concerns arise as a consequence of such internal work, the Authority would anticipate that insurers would, at the earliest opportunity, share this information with the Authority in an effort to assist in the development of the EBS framework.

24. For the purposes of the test run and the first year of the trial run, there is no expectation that a corresponding income statement should be prepared given that the primary regulatory focus of the EBS is one of solvency. Based on the analysis of test and first year trial run results and industry consultation, proposals will be made in the future as to the form of other primary financial statements for regulatory reporting purposes, with a view to the reporting of an income statement in the second year of the trial run.
### TABLE 1: GENERAL BUSINESS REPORTING TIMETABLE

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Note: For insurance or Bermuda groups, the timetable for the application of EBS reporting remains under consideration by the Authority and will be communicated in due course.
V. TRANSITIONAL MEASURES

25. In order to support the industry in its move toward an EBS, the Authority is considering a range of possible arrangements to help insurers leverage existing systems, processes, and capabilities; the natural starting point would be the use of existing GAAP or IFRS numbers as reported to the Authority. These are meant to support insurers in the early stages of the transition to an EBS, although it is clearly acceptable if insurers wish to move forward faster in their efforts to comply with the stated principles and guidance.

26. The Authority requested assistance from the Association of Bermuda Insurers and Reinsurers’ (“ABIR”) Economic Balance Sheet Working Group (“Working Group”), which is comprised of ABIR members (18 of the 22 member insurers), to draft recommendations on an EBS framework that would be consistent with IAIS standards and be appropriate for the Bermuda market. The Working Group produced a paper that has been submitted to the Authority, entitled *Proposed Template Economic Balance Sheet – Liabilities*, dated 31st May 2012.

27. ABIR has discussed a transitional arrangement for the technical provisions and the risk margin with the Authority. This consists of a simplified approach for determining outstanding claims provisions based on applying discounting techniques to current undiscounted reserves (adjusted to remove any prudential margins as needed).

28. For premium provisions, the approach would be based on taking the existing unearned premium reserve (plus any premium deficiency reserve), and adjusting for existing DAC, as well as allowing for expected future premium (and reinstatement premium) payments. Note that this approach for premium provisions will result in an overestimation. The transitional arrangements also include a simplification for the risk margin calculation.

29. While the Authority would encourage insurers to produce accurate assessments for their technical provisions that are as robust as possible, for the purposes of the transitional arrangements, the Authority is generally content for insurers to adopt simplified approaches based on this template.

30. General observations on the use of GAAP as a starting point for the EBS include:

   a. DAC assets and unearned revenue items need to be eliminated;

   b. GAAP expenses typically exclude overhead which needs to be reflected in the EBS technical provisions; and

   c. The use of these transition measures does not exempt insurers from the governance and documentation requirements stated in the principles.