

Bermuda Monetary Authority

Regulatory and Supervisory Challenges in International Insurance Centres – Lesson from Bermuda

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April 4th 2008

My subject today is the challenges that regulators face. From this endless list I'll choose five topics.

Brad Kading, who is speaking next, will give an overview of the Bermuda market, and my first slide sets out some of the things that attract me to Bermuda.

We are regulating an innovative and increasingly sophisticated industry. This presents challenges to a regulator to keep abreast of and not be a roadblock to developments. In Bermuda, we think that not over-regulating is as important as not under-regulating. Unnecessary regulation is frustrating for all concerned. Our goal is to achieve the right balance of protecting the public, while enabling good business to be written.

Bermuda is now the second largest insurance market in the world, and we are working to apply international standards appropriately for our own market. However, each market has its particular nature and it's not always the case that generic standards automatically apply. For example, Bermuda is primarily a reinsurance centre, and much of the insurance is business to business. Regulating reinsurance and B2B insurance poses different challenges to regulating consumer insurance.

There are over a thousand captives in Bermuda that range from very small to very large and many well-known insurance and reinsurance companies with at least a billion dollars in capital. We have therefore adopted a risk-based approach to monitoring business activities to allocate resources efficiently. In particular, all large insurers are required to have actuarial certification of loss liabilities.

The IMF endorsed our approach earlier this year, and the Bermuda Monetary Authority is participating in international developments via our membership of bodies such as the IAIS, and our active participation on key committees of that organisation, which are doing the important work of developing and refining global regulatory standards for the insurance market. In our view, being recognised internationally as a leading financial regulator means that we must continue to apply our effective, risk-based regulations and ensure that they remain consistent with international standards, which we help to develop as well as support.

A second challenge we face derives from market convergence.

Bermuda is at the forefront of the synthesis of financial and insurance markets, which in effect gives insurers access to alternative sources of capital, and investment markets access to insurance products. Different capital providers have different expectations, levels of insurance expertise and investment horizons. For example, some hedge funds see insurance as a good option for diversifying their portfolio, but fund managers are used to quick exit options which are not always available in insurance. More and more instruments are being designed to transform insurance into an investment product, marketed internationally.

For example, after the 2005 Atlantic hurricanes, a number of investment funds wished to participate in the hardened catastrophe market. This led to the emergence of sidecars, a vehicle providing capital to reinsurers to enable them to maintain gross premium volumes, and providing investors with exposure to insurance risks and returns, without the need to set up a fully-fledged insurer. The regulatory challenge was to develop guidelines for this new beast, non-rated companies with a lifespan possibly limited to 18 months, in an industry that generally promises to endure.

How do we make certain that our national standards remain effective given such convergence? And that the standards of other markets are consistent with our own? The answer lies in dialogue with peer regulators as well as the companies, and in training programmes for our people, so that they can stay abreast of developments in the convergence and increasing standardisation of regulations across sectors, e.g. IAIS and Basel Core Principles.

A third challenge is external market developments, stuff beyond our control, outside our borders. I want to discuss the sub-prime crisis and its effect on Bermuda.

Sub-prime impacts could be on the asset or liability side of a balance sheet. We have studied and surveyed about 124 of our largest companies, and where applicable applied some stress tests. Our insurance market as a whole had limited investment portfolio exposure, except where there was direct investment in a financial guaranty insurer. A survey we prepared on this subject which demonstrated how we monitored market exposure to sub prime is assisting the IAIS to support their membership. The two potential heads of liability exposure are D&O and E&O claims, and claims against financial guaranty insurers. Early estimates put the extent of D&O and E&O losses arising from sub-prime at between \$5 and \$15 billion, which is unsettling but not too disruptive in that line of business. It's anybody's guess what the FG losses will be. FG contracts are long-term in nature, and payments on many contracts will not fall due for a number of years. It is still unclear if losses are real or arise because of the accounting requirement to hold liabilities at fair value, which in this case means determining market values for non-tradeable instruments where the market is probably irrational. The Bermuda Monetary Authority has issued guidance to the FG insurers for determining liabilities with the intent that statutory returns would reflect economic value, basically the present value of anticipated future cash flows. This represents a change from a cash to accruals basis, applying standard actuarial principles.

With challenges comes opportunities. There is now interest being expressed in setting up new FG insurers. We recognise that the capacity constraints in the financial guaranty sector pose wider financial stability concerns, and have approved a financial guaranty company sponsored by an existing market participant, designed to supply additional capacity to the market.

Another major challenge to regulators is operational capability. As the markets grow and change, how do we make sure that we have the appropriate resources, especially human resources, to keep us ahead of the curve?

The Bermuda Monetary Authority took an unprecedented step earlier this year by publishing our business plan for 2008. We have identified the work we'll be doing, and saw no reason why we should not share the information with interested parties — the public we protect, the companies we regulate, our colleagues in the regulatory community.

One dividend has been to draw the attention of those with suitable skill sets to the work we're doing.

The global supply of good regulatory staff is limited. You must spot the best and persuade them of the rightness of your cause and the intriguing nature of the work that you do. You must make regulation an attractive alternative to other opportunities, and make learning and development part of a career package. I like regulatory work because of the “psychic income” involved, the feeling that I am contributing to the system. I like working in Bermuda because of the intellectual challenge of an innovative industry.

At the Bermuda Monetary Authority, our headcount targets plan for us to grow to almost 150 people by the end of this year, which compares to 62 just a little over five years ago. We're balancing local talent with skills being brought in from external sources, which makes succession planning important in this area. We recently restructured the Authority precisely for this reason.

The final group of challenges I call “international co-operation”. Changing dynamics in both the commercial and regulatory environment have made co-operation between regulators, on a unilateral, bilateral or multilateral basis, even more critical. This is driven to some extent by cross-border financial crime, and in particular the heightened focus internationally on anti-money laundering regulation and combating the financing of terrorism.

Global expectations regarding the exchange of information place greater responsibilities on all regulators. Formalising gateways and agreements that facilitate information exchange on a global scale has become a natural consequence of this fact. The recently developed IAIS MMOU is consistent with similar initiatives that have been in place for other sectors, such as the IOSCO MMOU for the securities sector. Bermuda is a signatory to both these MOUs, and has had a long-standing commitment to meeting international standards for regulatory co-operation with foreign regulators. What has become

increasingly evident is that any jurisdiction, and any regulator, that wishes to be regarded as credible and co-operative must set aside the resources and time required to be part of such arrangements.

A regulator's role and responsibilities are under a significant level of scrutiny, and given the size and significance of the Bermuda market we welcome the very high expectations placed on us with respect to how effectively we conduct our work. The Bermuda Monetary Authority certainly recognises the significance of our role, and that of the integrity and efficiency of our operations, in maintaining Bermuda's reputation as an international financial services centre. We intend to continue building on our history of balanced, practical, risk-based regulation that contributes to the success of the Bermuda market.