



BERMUDA MONETARY AUTHORITY
CONSULTATION PAPER ON CAPITAL ADD-ON AND REDUCTION POLICY
JUNE 18, 2008

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0. Introduction

This paper outlines the Bermuda Monetary Authority’s (“the Authority”) proposals to introduce capital add-on and reduction charges for both the Bermuda Solvency Capital Requirement (BSCR) and company specific approved internal models for Class 4 insurers (“the Insurer”), as defined in Section 4 read in conjunction with Section 1 of the Insurance Act 1978 (“the Act”).

The views of the insurance industry and of other interested persons on the proposals set out in this paper are invited. Comments should be sent to policy@bma.bm no later than July 20, 2008.

1. Executive Summary

1. In its efforts to remain consistent with international best practice, the Authority is required to keep abreast of regulatory developments and approaches in other jurisdictions. Supervisory discretion with respect to capital add-ons has been established in Europe and forms part of the standards set by the International Association of Insurance Supervisors (“IAIS”). Changes to the European Union insurance directives and the introduction of a risk-based solvency regime (“Solvency II”) makes provisions for the supervisor to apply capital add-ons.

2. The Authority’s two primary objectives of insurance regulation are policyholder protection and development of the insurance market. The Authority’s implementation of a risk-based approach contributes towards the achievement of these objectives. Having a risk-based approach in place ensures that the Authority is on the path towards achieving

equivalency with key regulatory regimes, including Solvency II, and improves the chances of Bermuda insurers operating in foreign markets without the fear of having a competitive disadvantage as a result of other regulators having little confidence in the Authority's ability to supervise.

2. Solvency II—Pillar II

3. The main objective of Solvency II is to protect the interests of policyholders and beneficiaries by ensuring the financial stability of insurers. The approach is for the Regulatory Capital Requirement ("RCR") to be closely aligned to an insurer's risks. Drawing on banking concepts that have been applied to Basel II, Solvency II defines a mutually reinforcing three pillar structure that looks to ensure that an insurer has adequate financial resources, effective governance, and appropriate market discipline.

Pillar I Quantitative requirements for measuring financial position and capital adequacy.

Pillar II Insurers' self-assessment of capital needs and capital/risk management processes and procedures subjected to supervisory scrutiny.

Pillar III Increased market transparency through greater disclosure and reporting requirements.

4. Pillar II includes requirements for insurers to have in place sound and effective strategies to assess the risks to which they are exposed. Additionally, and for our purposes, Pillar II establishes the framework for a supervisor to evaluate, on an ongoing basis, the risk profile, adequacy of financial resources and prudent conduct of insurers. This component of Pillar II allows the supervisor to undertake an assessment of the adequacy of the risk-based capital requirements and risk management processes. It also grants the supervisor the ability to apply an adjusted RCR to an insurer (or capital add-on).

3. Bermuda's Capital Requirements

5. In line with the requirements set out in Pillar II and other regulatory regimes, the Authority has adopted a risk-based approach in determining solvency. This means that material risks that are inherent to an insurer's business model are identified, allowing the appropriate RCR to be determined.

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6. The Authority believes that insurers should operate on an ongoing basis with a view to maintaining their capital at a prudent level in excess of the RCR in order to minimize the risk of a shortfall in capital arising from an unexpected adverse deviation. In moving toward implementing the risk-based capital approach, the Authority is proposing that insurers operate at or above a threshold capital level - a Target Capital Level (“TCL”) – set in excess of the minimum amount calculated in accordance with the Bermuda Risk-Based Capital model (BSCR) or approved internal models (*see the BMA Internal Models Consultation Paper and the BSCR Consultation Paper for further details*).

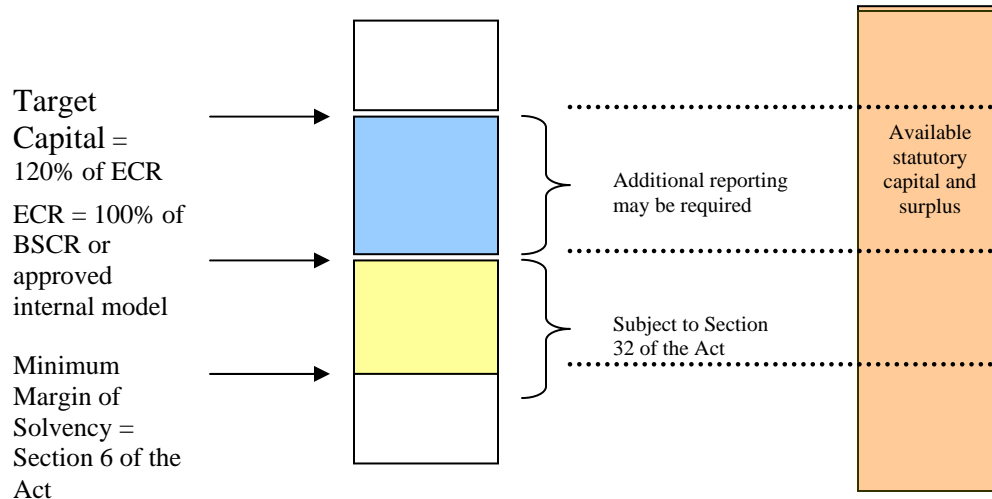
7. As of December 31, 2008, the Authority proposes to introduce prudential standards in relation to the Enhanced Capital Requirement (“ECR”) and the Capital and Solvency Return (“CSR”). The ECR will be determined using the BSCR or an approved internal model. The new standards will require insurers to hold available statutory capital and surplus equal to or exceeding the ECR prescribed by the Insurance (Prudential Standards) (Class 4 Solvency Requirement) Order 2008 (“Order”).

8. It is further proposed to introduce the concept of a TCL at 120% of the ECR. Where an insurer falls below the TCL, this provides an “early warning” that an insurer may be approaching solvency difficulties. The Authority proposes that the supervisory framework would offer scope for early supervisory action, in such circumstances (e.g. to require companies to develop action plans for restoring their statutory capital and surplus to or above the TCL or to provide more frequent or additional reporting to the Authority).

9. The above is relevant because the ECR, and as a result the TCL, could be adjusted by the Authority applying a capital add-on. The following illustrates the proposed solvency control levels:

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Insurers should have available statutory capital and surplus:



10. Where an insurer's available statutory capital and surplus is:
- a. Between the TCL and the ECR, the insurer is not considered insolvent under the Act, or in breach of the Order, but **additional reporting requirements or other enhanced oversight may be imposed by the Authority.**
 - b. Between the ECR and the Minimum Margin of Solvency ("MSM"), the insurer is not considered insolvent from a statutory perspective under the Act but **may be subject to regulatory actions taken by the Authority under Section 32 of the Act.** The insurer is in breach of the Order.
 - c. Below the MSM, the insurer is insolvent from a statutory perspective and subject to such provisions under the Act.

4. Capital Add-On & Reductions

11. A capital add-on is a supervisory tool that allows supervisors to closely align an insurer's RCR with its risk profile. Although it is acknowledged that an approved internal model should also align an insurer's RCR with its risk profile, misalignment may occur as a result of changes in operations or other events. According to the IAIS:

"The supervisor should have the flexibility to impose additional capital requirements (capital add-ons) or take other supervisory action to address any perceived weaknesses in an internal model, either prior to approving the use of the model, as a condition on the use of the model or in the context of a review of

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the ongoing validity of an internal model for regulatory capital purposes. It may be necessary to introduce additional supervisory powers, to allow such supervisory actions and measures, when internal models are allowed for regulatory capital purposes in a supervisory regime. ”¹

12. It should be noted that the Authority only proposes to apply the capital add-on under exceptional conditions. These circumstances relate to a significant deviation between the insurer’s risk profile and (1) the underlying assumptions of the BSCR or an approved internal model and/or (2) the insurer’s self-assessment of its risk management policies and practices. With respect to the latter, the Authority proposes to allow insurers to determine the operational risk charge component of the ECR via a self-assessment of its risk management program. The Authority proposes that the self-assessment be reviewed during the normal onsite cycle by the Authority’s Compliance Team (*more details of this process is disclosed in the Operational Risk Consultative Paper*).

13. Exceptional circumstances may arise from the following areas:

- a. operational risk charge;
- b. provisions for reserve deficiencies or premium inadequacies;
- c. specified non-admitted assets;
- d. significant growth in premiums;
- e. notification under Section 8A(f) of the Act;
- f. report made under Section 31AA(1)(b) of the Act.

14. Circumstances where capital add-ons or capital reductions may be applied include:

- a. Operational risk charge: the Authority proposes an operational risk charge of 1% to 10% of an insurer’s ECR based upon the quality of the insurer’s risk management program via an insurer’s self-assessment program. Where the Authority believes that the self-assessment, subsequent to an onsite inspection, does not reasonably reflect the insurer’s risk management policies and practices, an add-on may be applied to the operational risk charge provided that the charge does not exceed 10% (*more details of this process is disclosed in the Operational Risk Consultative Paper*).
- b. Provisions for reserve deficiencies or premium inadequacies: the ECR is affected by the insurer’s reserving levels. A capital add-on may be warranted where the Authority deems that either the insurer has under

¹ IAIS, Guidance Paper on the Use of Internal Models for Regulatory Capital Purposes , May 2008, p.17

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reserved or unearned premiums are insufficient to cover the insurer's future liabilities.

- c. Non-admitted assets: a capital reduction may be applied in the event the Authority gives the insurer credit for hybrid capital on application by the insurer.
- d. Significant growth in premiums: the BSCR uses actual premiums as a proxy for future premiums in determining the ECR. Further, significant growth may result in the average annual loss being extremely high relative to actual net premium. As the average annual loss is used to estimate catastrophe premiums this amount is subtracted from both the premium capital charge and the catastrophe charge. If the amount is too high, the charges will be too low. Where the Authority is of the opinion that actual business activity, in the insurer's case, will vary materially from the prior year activity of the next year then a capital add-on may be assessed.
- e. Sections 8A(f) and 31AA(1)(b) of the Act: significant events may have a material impact upon the insurer's reserving levels and ability to collect from creditors. This may render the ECR inappropriate and a capital add-on may be assessed.

15. Although this Paper has primarily focused on capital add-ons, where the insurer believes that it has been unduly penalized by the BSCR as a result of its risk profile deviating significantly from the assumptions underlying the BSCR (i.e. the BSCR is too stringent given the risk characteristics of the insurer's operations), the insurer may make application to the Authority for a capital reduction. The Authority proposes to consider the insurer's representation and notify the insurer of the final decision.

5. Capital Adjustment Administrative Procedures

16. The Authority supports due process and proposes to introduce an appeals process for an insurer aggrieved by the Authority's decision to apply a capital add-on. In this regard, the Authority proposes the following administrative process surrounding capital add-ons:

- 1** The Authority will notify the insurer of its intention to adjust its available statutory capital and surplus or ECR and provide the insurer with the opportunity to make representation.
- 2** The insurer will have 28 days to make representation to an in-house panel at the Authority comprising of Risk, Actuary, and Supervisory staff members at the Authority.

Should the insurer decide to forgo an appeal, the adjustment or charge will come into effect not less than 90 days after notification or where the insurer appeals, longer, as the Authority may determine.
- 3** The in-house panel will consider the representation of the insurer before reaching a decision. Once a decision is reached by the in-house panel, the insurer will be notified of the Authority's final decision. The adjustment will be effective 90 days or longer from the date of the final decision as determined by the Authority.
- 4** Where the insurer does not accept the in-house panel decision, the insurer may appeal to a tribunal pursuant to Section 44A Part VIIIA of the Act.

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The capital add-on process is outlined in the following schematic:

