

## **Bermuda - A clean bill of health.**

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The Bermuda Monetary Authority (BMA) is on a bit of a roll. Not only is it due to complete its compliance with the Solvency II directive in the next 18 to 24 months but it has just been given a relatively clean bill of health by the International Monetary Fund (IMF).

The BMA has had severe tongue lashings by the international body in the past but massive reforms and a determination to improve the island's international regulatory standing have paid off.

With a budget of \$34m and a staff of 140, the regulator of Bermuda's financial services, including insurance and reinsurance, has been focusing on getting the island's insurers and reinsurers in regulatory good shape and ready to comply with the European directive Solvency II.

### **Bringing into line**

The BMA has hired a raft of former Financial Services Authority (FSA) employees, and is training up its existing staff in order to bring the authority in line with the EU legislation, which is set to tighten up regulation and set capital requirements for (re)insurers.

"The real drive to change the BMA is because of what has happened to the Bermuda market, which is a leading insurance market," said Matthew Elderfield, chief executive officer of the BMA, who joined from the retail banking arm of the FSA last year. "It is important that the BMA is a leading financial regulator for insurance. We are the number one captive jurisdiction. We are the number three domicile for reinsurance. You have got major global players here with a global reach in those markets. In the BMA, the idea is to drive forward a programme to enhance solvency regulation."

The BMA's beefed-up headcount, which has more than doubled in 10 years, includes specialist teams of actuaries, a run-off team and a dedicated risk and policy team for insurance. And for the first time insurance companies are getting on-site visits and have to comply with much more stringent reporting requirements.

All of this has a cost implication, however. Fees paid by Class 4 insurers to the BMA have risen sharply, from \$55,000 to \$200,000 in 2006 and are expected to rise to \$400,000 a year.

Joelina Redden, associate of insurance at Bermuda law firm Appelby, said the regulatory changes had generally been welcomed by the international companies that make Bermuda their home.

"The BMA has been busy with Solvency II and making sure Bermuda is meeting international standards," said Redden. "A lot has been going on in the past 18 months, some hirings, promotions and streamlining of work plus the recent approval of the Insurance Amendment Act, which brings us up to date."

Redden added that the classifications for insurance and reinsurance companies was also getting clarified, with the catch-all 'Class 3' being split into more easily identifiable captives and more capitalised larger insurance companies. Currently, insurance companies are split into four classes. Class 1 and 2 are captives and rent-a-captives and Class 4 are large (re)insurers. Class 3 has always had a mixture of companies within this classification, making it hard to identify whether they are a captive or a large (re)insurer by the classification.

"There is a lot of work to do going forward," added Redden. "But a lot has been done. There are now site visits, and they have put together a compliance team."

Colm Homan, insurance partner at PricewaterhouseCoopers, Bermuda, said: "They really have a quite significant amount of accumulated experience. They have brought in a lot more transparency - all Class 4 insurers have to file generally accepted accounting principles (GAAP) financial statements now, which is an important development in responding to some international standards."

Homan also pointed to the fact that the BMA had published a business plan, which was a public document, which had helped the stakeholders be open about their objections, while the BMA could maintain an aggressive time line.

"While the BMA has been building up over time, the most significant trigger has been Solvency II," said Homan. "And this in turn means Bermuda needs to get the equivalent (regulation)."

### **Challenging remit**

Elderfield was brought in with the challenging remit of bringing Bermuda quickly into line. He says work on changing the BMA's focus started before he arrived - originally the insurance supervision had been under the Ministry of Finance before it was split and put under the wing of the BMA, under the guidance of Cheryl-Ann Lister as CEO, and Jeremy Cox as supervisor of insurance - and he is just continuing their work.

"The headline from the IMF report is there is a high level of compliance (by the BMA) with international standards, so that is very positive," added Elderfield. "But what we are doing is pushing beyond what the IMF is looking at, to continue a programme of changes to our solvency rules."

He said there were two principal reasons for the push to change solvency rules. The first was due to the growing insurance and reinsurance market in Bermuda, which meant the island's regulation needed to match this growth and change accordingly.

"Secondly, there is this dynamic called mutual recognition going on, whereby all jurisdictions around the world are moving towards opening their markets and providing better access - but on the condition that the quality of regulation in the other jurisdiction is adequate and equivalent," added Elderfield. "The first mover on this mutual recognition is going to be Europe with Solvency II."

### **Setting standards**

He said that while, in the main, the Solvency II directive primarily deals with European issues such as passporting rights between member countries and setting minimum standards, it is also setting standards for jurisdictions that would like to do business with Europe.

"It also says, 'if you want to do business into Europe, we are going to measure your regulation and see whether it is equivalent to ours'. And we can see other jurisdictions doing that in short order - the US, through the National Association of Insurance Commissioners is moving towards the process and individual states are also in the process doing something similar.

"The benefits to the market are better global access, less duplicative rules between different jurisdictions, and the ability to optimise your group structure. So, we are not resting on our laurels with the IMF saying we have high standards. We want to make absolutely sure our rules pass the Solvency II test and pass whatever tests other jurisdictions have."

He said the main focus of the BMA has been solvency regulation as Bermuda is a wholesale market, where there are no "can't do business" rules.

Bermuda has always had solvency rules with minimal capital requirements. This year, however, for the first time a risk-based solvency framework for Bermuda's largest commercial insurers was introduced.

"It is very much consistent with Solvency II and looks at the different types of underwriting that insurers do, puts it into risk buckets or risk categories, and sets a charge against each of those categories," added Elderfield. "It also sets a charge for credit risk, for market risk and for operational risk - so it is a more sophisticated way of looking at risk."

He said the Bermuda market was unique because of the amount of catastrophic risk written, which added its own challenges, so they have added a parametric charge or a modelled charge, for the cat risk.

"It is quite a sophisticated risk-based approach, or way to assess risk, and that come in for the largest insurers," said Elderfield. "What we are doing next year is moving beyond that and starting to accept the use of economic capital models for insurers. We are currently in the midst of a survey of our market practice, to see how good our modelling is."

From this a report will be published at the end of this month about market practice on modelling. And by the start of 2009 the BMA will set out some minimum standards for firms that want to use economic capital modelling.

"That is very consistent with what you see in Solvency II which has a modelling alternative to standardised rules," said Elderfield. "So that is a big programme of change."

While the BMA's methods to calculate the capital adequacy to calculate solvency address the "Pillar I" aspects of Solvency II, they are also working on Pillar II and Pillar III of the directive.

Pillar III addresses disclosure and transparency and, in 2008, the BMA brought in rules that require the largest commercial insurers to publish their GAAP accounts.

"We also have a task force with the industry to look at further disclosure of information, not just of purely financial information but also of risk data," added Elderfield. "We are working with the industry on that and we are doing a consultation next year about another wave of disclosure which will complete our work on III."

Pillar II addresses the qualitative aspects of solvency and the BMA has been improving its ability to look at the models and calculations and this is helped by their on-site visits.

"There are some innovations we are bringing in, and I would say there are two I would highlight," said Elderfield. "One is we now have a programme of stress testing where we prescribe stress tests for the largest commercial insurers and capital add-ons. What we do in the stress tests is we require the firms to do a standardised stress test - an equity mark movement, an interest rate movement and also to say tell us what your exposure to three realistic disaster scenarios (RDS) would be." The RDS are a set of scenarios that Lloyd's of London publishes and are widely used in the market.

"In that way," Elderfield continued, "we can line everybody up in the Bermuda industry side by side, and if they all have these three biggest hits and these two market events, who is the most vulnerable? Who are the outliers? We chose three because Katrina, Rita and Wilma showed you could have three events in one year as a conservative bench mark. That is a fascinating tool and we are using it right now to see if there anyone with outlying risk."

He added that they are making way for legislation to set capital add-ons. He said: "If we think the stress tests show a problem, or if we have other indications there is a weakness in the way the capital model is working, we can require additional capital."

Going beyond the Solvency II requirements, the BMA is now looking to implement group supervision.

"Our rules are focused right now on the legal entities operating in Bermuda but its best practice to look at group supervision," said Elderfield. "It is not widely practiced in insurance legislation - it is in Europe and the UK - the rest of the world has not fully embraced group supervision but is slowly moving towards it."

"We are doing this and we will have a discussion paper which we will publish in January on group supervision and that will complete our set, if you like."

### **High praise**

Elderfield certainly has been running through his to-do list at a break-neck speed but his work has led to high praise of insurance legislation on the island.

The IMF report said: "The BMA has instituted a strongly risk-focused supervisory approach in line with the diversified range of insurers in Bermuda, and the Bermuda insurance regulatory system is based on hands-on risk-sensitive supervision."

It also said: "Bermuda's insurance supervision, especially for the large commercial (re)insurance companies, is highly observant of the core principals, established by the International Association of Insurance Supervisors." This is high praise from the IMF, and is a volte face from 10 years ago, and a huge change from even five years ago (even though it says it still needs to do more on anti-money laundering and combating the financing of terrorism).

"I like to think of us as being at the front of the pack of being ready for Solvency II," said Elderfield. "And fast forward 18 or 24 months and we will have completed our Solvency II programme."