



BERMUDA MONETARY AUTHORITY

GUIDANCE NOTE #20

SPECIAL PURPOSE INSURERS

5th October, 2009

GUIDANCE NOTE: SPECIAL PURPOSE INSURERS

1, Introduction

1. The class of Special Purpose Insurers (“SPIs”) was introduced by the passage of the Insurance Amendment Act 2008 on 30th July 2009 (IA(1)).
2. This note (the “Note”) sets out guidance in relation to the Authority’s licensing and supervisory regime in relation to SPIs. A primary focus of the Note is to demonstrate the Authority’s approach to the supervision of SPIs which involves setting out prudent and robust fundamental requirements that SPIs must meet in order to be licensed under Bermuda law.
3. The Authority is of the view that once licensing for an SPI has been achieved, regulatory attention should be placed upon the original cedant/insured. This is aligned with the fact that the SPI is by definition fully funded and therefore perpetually solvent. In this regard, the Authority expects that as the ceding entity benefits from capital relief associated with its risk-transfer to the SPI, it shall be adequately capitalised and technically equipped to manage all risk characteristics associated with the SPI cession.
4. The Authority recognises the need for clarity as to the scope and implementation of the provisions of the Insurance Act 1978 and related regulations (“the Act”)¹ if the regulatory system is to command the confidence of both (re)insurers and contract/policyholders. The Authority therefore seeks to ensure that those operating in Bermuda have a sound understanding of the Authority’s approach to implementing the Act in the context of SPIs.
5. While the Authority aims to provide clarity as to its approach, this 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 the activities associated with SPIs. Ultimately, it is the responsibility of the legal entity to ensure their compliance with the Act and all queries associated with this guidance should be directed to the Authority.
6. There is likely to be a need for some modification in the SPI guidance over time as new scenarios emerge. In this context, it is generally the approach of the Authority to pass material changes in process through industry consultation before being published, usually through the issuance of revised versions.

¹ "The Act" means the Insurance Act 1978 and its related regulations. The insurance legislation is comprised of the Insurance Act 1978 (as amended by the Insurance Amendment Acts, 1981, 1983, 1985, 1995, 1998, 2001, 2006 and 2008) (IA) 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, 1989 and 2008) and the Insurance Returns and Solvency Regulations 1980 (as amended by The Insurance Returns and Solvency Amendment Regulations 1981, 1985, 1989 and 2008).

2. The Registration Process

7. SPIs will be subject to a streamlined application and ongoing supervisory process, commensurate with the assumed risk of the venture.
8. The SPI application process will generally require that an SPI application form (“SAF”) be completed and signed by the applicant before being submitted to the Authority. The SAF will include a series of questions directed to the most pertinent details of the SPI transaction.
9. The Authority shall expedite approval of SPI applications when received. At a minimum, applications will be considered at the weekly Admissions and Licensing Committee (ALC) meeting.

3. Characteristics of Fully Funded Structures

10. The Authority recognises the numerous interpretations of the term “full funding” in evaluating the financial position and contractual arrangements inherent to SPI vehicles.
11. For the purposes of interpreting the provisions in the Act in the context of the SPI’s fully funded position, the following conditions shall apply to the SPI’s available assets and liabilities and its contractual arrangements. To be fully funded, an SPI will generally be expected to:
 - a) confirm full disclosure to the cedant or insured of the fact that the maximum reinsurance recovery from the SPI is limited to the lower of the stated contract limit and the available assets of the SPI;²
 - b) ensure that, under the terms of any debt issues or other financing mechanism used to fund its (re)insurance liabilities, the rights of providers of that debt or other financing are fully subordinated to the claims of creditors under its contracts of (re)insurance;

² Notwithstanding this expectation, to the extent that an SPI reinsurance agreement does not include limited recourse language, the SPI may be required to validate that it has in place adequate financial arrangements for the purpose of funding cedant/insured claims exceeding its available assets. In these circumstances the SPI may be required to demonstrate that any issuing counterparty:

1. Is a regulated financial institution subject to regulation by the Authority or equivalent regulation by another regulatory body; and
2. Has achieved a financial rating (counterparty, credit or financial strength as applicable) of at least A- as of the date of application and as determined by a recognised rating agency or,
3. Is of a sound financial quality (in the circumstance of unrated issuers or issuances,)

c) enter into contracts or otherwise assume obligations which are solely necessary for it to give effect to the (re)insurance special purpose for which it has been established; and

d) ensure that, to the extent that more than one (re)insurance contract is in place within the SPI, each of the (re)insurance contracts is structured so that the SPI meets the fully funded requirements individually for each contract.³

4. Sophisticated Participant

12. The Authority expects that only sufficiently Sophisticated Participants will engage in this highly specialised form of business, which in the context of this Note means a person who satisfies one or more of the criterion below:

a) high income private investors;⁴

b) high net worth private investors;⁵

c) sophisticated private investors;⁶

d) investment funds approved by the Authority under the Investment Funds Act (IFA)

e) bodies corporate, each of which has total assets of not less than five million dollars, where such assets are held solely by the body corporate or held partly by the body corporate and partly by one or more members of a group of which it is a member;

f) unincorporated associations, partnerships or trusts, each of which has total assets of not less than five million dollars, where such assets are held solely by such association, partnership or trust or held partly by it and partly by one or more members of a group of which it is a member;

g) bodies corporate, all of whose shareholders fall within one or more of the subparagraphs of this paragraph, except subparagraph (d);

³ This provision should not necessarily be deemed to require asset segregation by contract, but rather that that the Authority will at a minimum expect to be provided with assurance that there is clarity of contract obligations via specific contract language.

⁴ Means an individual who has had a personal income in excess of \$200,000 in each of the two years preceding the current year or has had a joint income with that person's spouse in excess of \$300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year - "current year" means the year in which he purchases an investment;

⁵ Means an individual whose net worth or joint net worth with that person's spouse in the year in which he purchases an investment exceeds \$1,000,000 - "net worth" means the excess of total assets at fair market value over total liabilities;

⁶ Means an individual: 1) who has such knowledge of, and experience in, financial and business matters as would enable him to properly evaluate the merits and risks of a prospective purchase of investments; and 2) who, in respect of each investment transaction, deals in amounts of not less than \$100,000.

h) partnerships, all of whose members fall within one or more of the subparagraphs of this paragraph, except subparagraph (d);

i) trusts, all of whose beneficiaries fall within one or more of the subparagraphs of this paragraph, except subparagraph (d);

j) any company quoted on a recognised stock exchange; and

k) any party deemed to have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment.

13. On a case by case basis, the Authority may approve other persons as suitable investors (in addition to the list of persons set out in 12 above).

5. Asset Quality and Disclosures

14. It is the expectation of the Authority that the SPI provide full disclosure to the cedant/insured(s) and investor/debt-holder(s) and makes available documentation setting out the investment guidelines governing the SPI structure. This documentation is expected to disclose detail such as the types of acceptable instruments (including contingent assets as applicable), issuers and credit ratings of permissible investments.

15. In addition, it is the expectation of the Authority that the SPI provide full disclosure to the cedant/insured(s) and investor/debt-holder(s) and agrees to make available to the relevant counterparties the following data, (as applicable): 1) the total composition of the assets of the SPI, 2) latest available market value of the assets, and/or 3) the latest available net asset value of such assets: (A) within a maximum of 10 business days after the end of each calendar month, and (B) within 2 business days of the request of any relevant participant where such data may not be aged by more than 30 days unless agreed upon by the relevant parties.

6. Contingent Assets⁷ as Forms of Collateral

16. The Authority recognises contingent assets such as reinsurance and/or LOCs from appropriately risk managed and regulated institutions as acceptable instruments for inclusion in the funding structures of SPIs.

17. In this context, where an SPI is funded through a balance of contingent assets the SPI must demonstrate that any issuer of these contingent assets:

⁷ The Authority defines a “contingent asset” as an asset in which, at the time of its purchase, the possibility of an economic benefit from the asset depends solely upon future events, where these events are fortuitous and therefore cannot be controlled by the company. (e.g. reinsurance, LOCs or other financial mechanisms such as swaps, contracts for differences etc.)

- a) is a regulated financial institution subject to regulation by the Authority or equivalent regulation by another regulatory body; and
- b) has achieved a financial rating (counterparty, credit or financial strength as applicable) of at least A- as of the date of application and as determined by a recognised rating agency, or
- c) is of a sound financial quality (in the circumstance of unrated issuers or issuances,)

18. To the extent that, as a result of deterioration in the value of contingent assets, the value of the SPI available assets falls below the value of the expected reinsurance recoveries or aggregate liabilities by a specified margin, then the Principal Representative shall forthwith inform the Authority. The quantification of this margin of deterioration will be left to the discretion of the relevant participants but must be fully disclosed at the time of making the SPI application.

19. The SPI must fully disclose, within the notes to its accounts, the existence of all contingent assets and similar funding vehicles. The SPI must be prepared to demonstrate, through documentation or otherwise, how the issuer(s) of the said contingent assets has satisfied the SPI that any concentration risks underwritten by the issuer(s) are within the risk appetite of the SPI. This evaluation, at a minimum, should involve standard credit risk analyses.

7. Multiple Cedant/Insured and/or Investor/debt-holder groups

20. The Authority shall review SPI structures on a case by case basis, generally only authorising structures established by one or more entities within the same group and not by a number of unrelated entities from different groups.

21. Where the SPI anticipates that multiple cedants/insureds will utilise the SPI, the Authority may require either special reporting responsibilities or separately incorporated SPI cells for each unrelated transaction.

22. On a case by case basis, the Authority may register SPIs where the SPI discloses that more than one (re)insurance agreement is in place, however it is the expectation of the Authority that, a) each of the (re)insurance contracts is individually structured; and b) that the SPI can individually meet the fully funded requirements for each contract.⁸

8. Programme Business and Prior Approval for Re-Use of an SPI

⁸ This provision should not necessarily be deemed to require asset segregation by contract, but rather that the Authority will, at a minimum, expect to be provided with assurance that there is clarity of contract obligations via specific contract language.

23. Any reuse of an SPI needs prior approval from the Authority, either at the time of initial application or upon reapplication, where, at the time of (re)approval, the Authority shall take into account any actual or anticipated changes to the original contractual terms.

9. Material Change in Business

24. If during the lifetime of the SPI it: 1) has any additional risks reinsured into it that were not contemplated in the initial transaction, or 2) has any material changes made to the contracts involved, or 3) makes any modifications to the material disclosures included in the original application, or 4) has further capital raised from investors and/or debt-holders after authorisation, or 5) makes any other changes pertinent to its business where these changes would be deemed by a reasonable and knowledgeable person to be material, then these changes are subject to prior supervisory approval.

25. The approval process for any material change in an SPI's business shall take into account the nature, scale and complexity of those changes as determined by the Authority through consultation with the applicant and may not require a full authorisation process as would be needed at the original establishment of the SPI.

26. In its deliberations, the Authority shall consider whether the changes constitute a change in the objectives of the SPI, and to the extent that they do, the Authority may require a more exhaustive authorisation process.

10. Exemption from Prior Approval for Capital Release

27. Section 31C of the Act – “Restrictions as to reduction of capital” is not applicable to SPIs. This is consistent with the Authority's risk based approach to regulation, and the Sophisticated Participant requirements associated with these entities.

11. Filing and External Audit Requirements for SPIs

28. The Authority shall, on a case by case basis, exercise its powers under section 56 to modify the annual accounting provisions in respect of an SPI, subjecting it to more streamlined filing requirements.

29. In this context, and for the purposes of an SPI's registration process and ongoing reporting, and where the appropriate Section 56 request has been granted, the Authority will accept unaudited management accounts from the SPI prepared in accordance with any one of the following standards or principles-

- a) International Financial Reporting Standards ('IFRS');
 - b) generally accepted accounting principles ('GAAP') that apply in Bermuda, Canada, the United Kingdom or the United States of America; or
 - c) such other accounting standard as the Authority may recognise.
30. Where management accounts are deemed to be acceptable to the Authority for the purposes of regulatory reporting, the SPI is required to provide to the Authority a copy of those accounts as soon as practicable after such management accounts have been submitted to participants and at a minimum within four months of the end of each financial year.
31. Notwithstanding the above, financial statements will be due in accordance with the requirements under the Act.⁹

⁹ However, upon the completion of a stub period, and the appropriate Section 56 directive, no annual accounts will be required. A "stub period," is a one-time incomplete accounting period that covers the time frame from the beginning of the last fiscal year to the time at which business activities are considered to effectively cease.