



BERMUDA MONETARY AUTHORITY

BMA House
43 Victoria Street
Hamilton HM 12 Bermuda
P.O. Box 2447
Hamilton HM JX Bermuda

tel: (441) 295 5278 fax: (441) 292 7471
email: info@bma.bm website: www.bma.bm

BERMUDA MONETARY AUTHORITY
CONSULTATION PAPER ON ELIGIBLE CAPITAL
DECEMBER 2010

BERMUDA MONETARY AUTHORITY
CONSULTATION PAPER ON ELIGIBLE CAPITAL
DECEMBER 2010

Table of Contents

0. INTRODUCTION	2
1. EXECUTIVE SUMMARY	4
2. BACKGROUND	5
3. PURPOSE OF A TIERED STRUCTURE.....	7
4. ELIGIBLE CAPITAL.....	8
5. GROUP-WIDE SUPERVISION	14
6. RELATED INITIATIVES.....	14
7. REPORTING REQUIREMENTS	15
8. IMPLEMENTATION PROVISION.....	15
9. TRANSITIONAL PROVISION.....	15
10. APPENDIX A	16
11. APPENDIX B	22
12. APPENDIX C	24

BERMUDA MONETARY AUTHORITY
CONSULTATION PAPER ON ELIGIBLE CAPITAL
DECEMBER 2010

0. INTRODUCTION

1. This Consultation Paper outlines the Bermuda Monetary Authority's ("the Authority") proposed approach to determining capital resources eligible to meet regulatory capital requirement levels. It is largely a reproduction of the paper published on this topic in September 2009 with some amendments to reflect the Authority's current positions.

2. For the purposes of this paper,

"ancillary capital" means other fixed capital approved for statutory capital purposes;

"available capital" means the aggregate sum of the basic capital and the ancillary capital;

"available statutory capital and surplus", under the Act, refers to the total statutory capital and surplus (Form 1A, Form 1 or Form 4 statutory balance sheet, Line 40) reported by an insurer at the end of its reporting year, plus adjustments, if applicable, made under Section 6D of the Act and subject to eligible capital limits;

"basic capital" means the sum of the capital stock (Line 1(a)), contributed surplus (Line 1(b)), and statutory surplus (Line 2(h)) of Form 8, statutory statement of capital and surplus, plus adjustments, if applicable, made under Section 6D of the Act;

"insurers" includes "reinsurers" and "insurance" also refers to "reinsurance"; other than when used in the context of identifying classes, "insurers" also include "insurance groups";

"the Group Rules" refer to rules made under Section 27F of the Act;

"other fixed capital" means the other fixed capital (Line 1(c)) of Form 8, statutory statement of capital and surplus;

"the Act" refers to the Insurance Act 1978; and

BERMUDA MONETARY AUTHORITY
CONSULTATION PAPER ON ELIGIBLE CAPITAL
DECEMBER 2010

“the Regulations” refers to the Insurance Accounts Regulations 1980 and the Insurance Returns and Solvency Regulations 1980.

3. The views of the insurance industry and other interested persons on the proposals set out in this paper are invited. Comments should be sent to the Authority addressed to policy@bma.bm no later than February 28th, 2011.

BERMUDA MONETARY AUTHORITY
CONSULTATION PAPER ON ELIGIBLE CAPITAL
DECEMBER 2010

1. EXECUTIVE SUMMARY

4. The Authority is proposing to introduce a three-tiered capital system (“the tiered capital system”) as a critical component of its solvency regime. The tiered capital system is designed to assess the quality of insurers’ capital resources eligible to satisfy their regulatory capital requirement levels. Initially, the regime would be introduced to the Class E¹, 3A, 3B and 4 insurers effective 2011 financial year-end, in accordance with the proportionality principle. Similarly, the Authority proposes extending the tiered capital system to Class C and D licence holders¹.

5. The Authority is also proposing to implement the tiered capital system to groups for which the Authority is the group-wide supervisor. It is anticipated that the proposals in this paper would be applied to both solo entities and insurance groups.

6. A key objective of insurance supervision is to protect both existing and prospective policyholders. Insurers are often faced with uncertainty as to the timing and magnitude of policyholder obligations. To mitigate these uncertainties, it is important that insurers hold not only sufficient capital but capital of an appropriate quality to act as a shock absorber against adverse developments.

7. The tiered capital system (Tiers 1, 2, and 3) classifies capital instruments into a given tier based on their loss absorbency characteristics. Eligibility limits will then be applied to each tier in determining the amounts eligible to cover regulatory capital requirement levels.

8. The highest quality capital is eligible for Tier 1: able to absorb losses under all circumstances, including on a going-concern, run-off, winding-up, and insolvency. Tier 2, while providing full protection to policyholders in a winding-up or insolvency, has moderate loss absorbency on a going-concern basis. Tier 3 meets, on a limited basis, some of the characteristics exhibited in Tiers 1 and 2 (e.g. protection to policyholders in a winding-up or insolvency).

¹ The Insurance Amendment (No. 3) Act 2010 introduced Class C, D and E insurers within the long term insurance sector.

2. BACKGROUND

9. Continuing on its programme of regulatory change, the Authority proposes to enhance its solvency regime with the introduction of the tiered capital system. The proposals outlined in this paper will consider not only the quantity of capital available but equally important its quality (i.e. its ability to provide protection to policyholders over the obligation period) in determining capital eligible to meet regulatory capital requirement levels.

10. Initially, the proposals in this paper would be introduced to the Class E, 3A, 3B and 4 insurers, as well as insurance groups effective 2011 financial year-end. One year following implementation for these classes, the Authority anticipates cascading this regime to the Class C and D insurers in accordance with the proportionality principle.

11. Insurance is characterised by the reversal of the production cycle whereby premiums are collected upfront but insurers are only obligated to pay if an event occurs at some future date. Insurers are faced with uncertainties relating to the timing and magnitude of future losses and the risk that the premiums charged and the reserves held will be insufficient to cover the losses. In addressing these uncertainties, sufficient capital of appropriate quality is critical to provide a buffer against adverse losses and ensure that the insurer meets its obligation to policyholders.

12. The current regime requires all insurers to hold available statutory capital and surplus (“the available capital”) equal to or exceeding the margin of solvency (“the MSM”), defined under the Act, Regulations and Group Rules (when these come into effect). In the case of legal entities, failure to meet the MSM represents a breach of the regulatory minimum capital requirement and is deemed statutory insolvency under the Act.

13. Effective 2008 financial year-end, the Authority introduced an additional level of regulatory capital requirement to Class 4 insurers. The second level obliged Class 4 insurers to maintain an available capital equal to or exceeding the enhanced capital requirement (“the

BERMUDA MONETARY AUTHORITY
CONSULTATION PAPER ON ELIGIBLE CAPITAL
DECEMBER 2010

ECR”). The ECR is equal to the higher of the MSM or the requirement computed from the standard risk-based capital model or an approved internal capital model.

14. The Authority also established a target capital level (“the TCL”) of 120% of the ECR effective 2008 financial year-end for all Class 4 insurers. Although this level was not legislated, it acts as an “early warning” system to assist the Authority in the supervision of Class 4 insurers. The Authority proposes to apply the ECR and TCL to Class 3B insurers effective 2010 financial year-end, and Class E and 3A insurers (as well as insurance groups) for the 2011 financial year-end. Phasing provisions may be applied depending on the results of the trial run (see paragraph 42). It is proposed that these capital levels will apply to Class C and D insurers for the 2012 financial year-end subject to any phasing in provisions.

15. The Authority recognises that capital instruments possess different qualities, and vary in the extent of protection provided to policyholders. For instance, certain capital instruments, such as common shares protect the interests of policyholders by absorbing losses under all circumstances (i.e. on a going concern basis, in run-off, in winding-up, and in the event of insolvency). Conversely, subordinated debt may only protect policyholders by absorbing losses in the event of insolvency or winding-up. To enhance policyholder protection, the Authority will consider the adequateness of capital both from a quantitative perspective and, equally critical, based on the quality of the capital instruments.

16. The international debate on capital has continued for a number of years: in the banking sector with the adoption of the Basel framework; in the European Union (“the EU”) with the enactment of the Solvency II Directive; at the International Association of Insurance Supervisors (“the IAIS”) with the publication of principles, standards, and guidance on capital; and in the United States with the National Association of Insurance Supervisors’ modernisation programme. Although there are differences, there is a general consensus that regulatory regimes must establish adequate capital requirement levels satisfied by capital resources of appropriate quality to protect policyholders in the event of an insurer experiencing unforeseen or adverse circumstances.

BERMUDA MONETARY AUTHORITY
CONSULTATION PAPER ON ELIGIBLE CAPITAL
DECEMBER 2010

17. The IAIS' Insurance Core Principle 23 recommends that solvency regimes establish criteria for assessing the quality and suitability of capital instruments, having regard to their ability to absorb losses on both a going concern and winding up basis². The EU's view is similar, and the Solvency II Directive looks to categorise capital instruments into three tiers and assign limits on the proportions of Tiers 1, 2 and 3 applicable for capital requirement levels.

18. Bermuda's solvency regime will be a critical component of its jurisdictional equivalence assessments. Where the Authority is assessed as being broadly equivalent with key jurisdictions, potential benefits to Bermuda insurers include:

- Ability to compete in global markets on a non-discriminatory basis;
- Reducing the risk of multiple capital requirements;
- Removing the need for group solvency calculations on a number of different regulatory bases; and
- Improved ability to optimise group capital, including increased fungibility³.

19. Presently, this paper outlines the Authority's proposed tiered capital system. Given that capital remains a key topic amongst international regulators and standard setting bodies, the Authority will also closely monitor and, where possible, participate in these debates to ensure Bermuda continues to adopt internationally recognised standards that are appropriate for its insurers.

3. PURPOSE OF A TIERED STRUCTURE

20. The Authority recognises that capital instruments behave differently by design to support insurers' business objectives and strategies. In determining the capital adequate to protect policyholders, the Authority must also be mindful of the uniqueness of capital instruments in

² IAIS – "International Association of Insurance Supervisors – Insurance Core Principles and Methodology", October 2003.

³ "Bermuda's Insurance Solvency Framework - The Roadmap to Mutual Recognition", March 2009, Pg 1.

BERMUDA MONETARY AUTHORITY
CONSULTATION PAPER ON ELIGIBLE CAPITAL
DECEMBER 2010

their ability to protect policyholders on a going concern basis or run-off and during times of distress such as in a winding-up or insolvency.

21. Accordingly, the Authority proposes to introduce the tiered capital system to complement the regulatory capital requirement levels (the MSM and the ECR) previously introduced. The MSM is the minimum regulatory capital requirement level, and breach of the MSM may trigger mandatory winding-up in the case of legal entities. Therefore, the highest quality capital must be available to support the MSM. The ECR (if higher than the MSM), on the other hand, is a second level capital requirement and thereby allows for greater flexibility.

4. ELIGIBLE CAPITAL

22. The Authority is proposing to introduce the tiered capital system; Tiers 1, 2, and 3. The examples of capital or qualifying debt instruments outlined in Appendix A are not exhaustive; where an insurer is uncertain of the application of a capital or debt instrument, it should consult with the Authority.

4.1 Tier Classification

23. Tier 1 capital is the highest quality capital; it is available when required and can fully absorb losses at all times. Capital instruments included in Tier 1 should fully satisfy the following characteristics (see Appendix A):

- Full loss absorbency in going concern, run-off, insolvency, and winding-up;
- Subordination in going concern, run-off, insolvency, and winding-up;
- Permanency (free from requirements / incentives to redeem);
- Perpetuality (undated / adequate duration); and
- Absence of mandatory fixed charges and encumbrances.

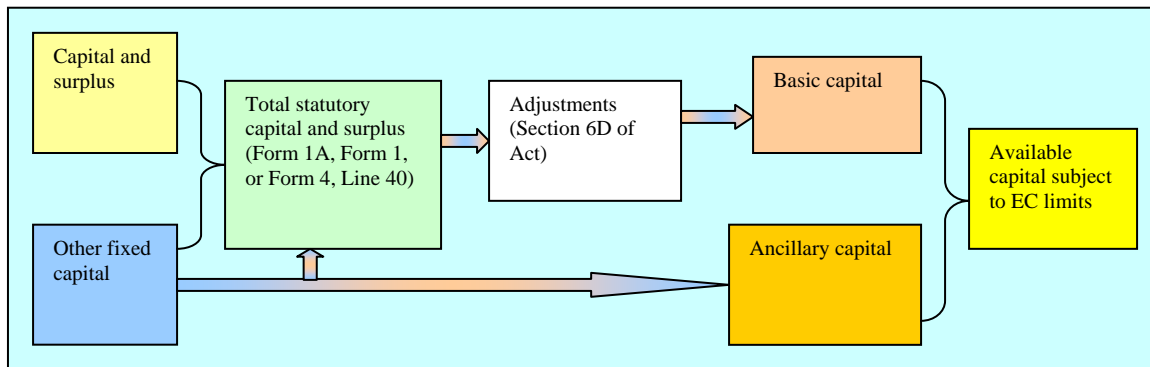
BERMUDA MONETARY AUTHORITY
CONSULTATION PAPER ON ELIGIBLE CAPITAL
DECEMBER 2010

24. Tier 2 capital includes other capital instruments that, to varying degrees fall short of the quality of Tier 1 capital, but nonetheless provide protection to policyholders (see Appendix A). Tier 3 consists of capital instruments not meeting all of the characteristics of Tier 1 or Tier 2 but have full subordination on winding-up (see Appendix A).

4.2 Capital Eligible for Tiers 1, 2, and 3

4.2.1 Available Capital

25. The available capital eligible to support regulatory capital requirement levels is equal to the aggregate sum of the basic capital and the ancillary capital. The ancillary capital includes off-balance sheet financial instruments approved by the Authority for statutory capital purposes. Insurers must examine and classify each capital and qualified debt instrument into the three tiers based on the criteria established for each tier (see Section 4.1 and Appendix A). The eligible limit of each tier will determine its ability to cover the MSM and the ECR (see Section 4.3).



4.2.1.1 Basic capital

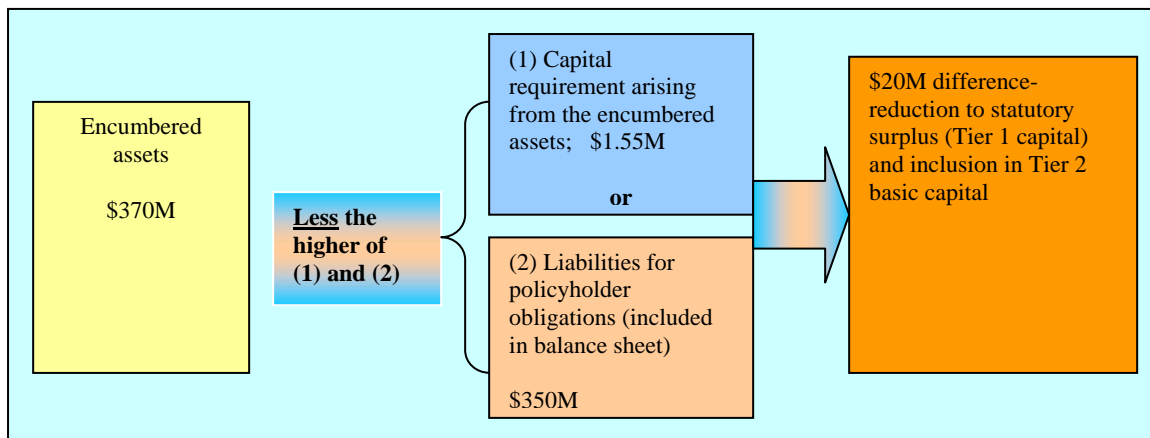
26. The basic capital is equal to the capital stock (Line 1(a)), contributed surplus (Line 1(b)), and statutory surplus (Line 2(h)) of Form 8, statutory statement of capital and surplus, *plus* adjustments, if applicable, made under Section 6D of the Act. Where an adjustment has been imposed under Section 6D of the Act, the amount may form part of the statutory surplus.

BERMUDA MONETARY AUTHORITY
CONSULTATION PAPER ON ELIGIBLE CAPITAL
DECEMBER 2010

27. Preference shares may be included, for the purposes of Form 8, in the capital stock (Line 1(a)); however, in determining instruments eligible for the respective tier, insurers must examine the characteristics of each instrument relative to the criteria specified in Appendix A. Accordingly, basic capital may be adjusted for preference shares not meeting a tier’s criteria.

28. The statutory surplus is the surplus of assets over liabilities *excluding* capital stock, contributed surplus, and other fixed capital. “Non-admitted assets” such as deferred tax assets and intangible assets are excluded from Bermuda’s statutory balance sheet and therefore adjustments are not required. However, encumbered assets, as discussed in paragraph 29, will result in the reallocation of the encumbered statutory surplus from Tier 1 capital to Tier 2 basic capital, provided that they are encumbered for an insurer’s own policyholder obligations (and would be available to all policyholders upon wind-up), else they are not eligible for any tier and excluded from available statutory capital and surplus altogether.

29. Collateral requirements are common in the insurance industry; and are designed to protect a specific group of policyholders against their insurer’s credit risk. The collateralised assets are not available to all policyholders until the obligations of the underlying policyholders have been satisfied. Therefore, the statutory surplus must be adjusted to recognise the limited accessibility of these assets. It is proposed that this adjustment be calculated as the difference between the encumbered assets and the higher of 1) respective policyholders’ obligations recognised in the statutory balance sheet and 2) the capital requirements arising from the encumbered assets (see Appendix C).



BERMUDA MONETARY AUTHORITY
CONSULTATION PAPER ON ELIGIBLE CAPITAL
DECEMBER 2010

30. The Authority is also mindful of assets potentially losing their value during times of distress. Such assets in most cases are normally “non-admitted assets”; however, in the event that any are included on the statutory balance sheet, adjustments may be required for tier eligibility purposes arising from the reduction in loss absorbency under distressed conditions.

4.2.1.2 Ancillary capital

31. The Authority considers off-balance sheet instruments (e.g. letters of credit, contingent capital, etc.) as potential sources of capital as they may be called upon to absorb losses, albeit under limited circumstances. In order to determine the eligibility of such instruments, each must receive approval from the Authority before inclusion as ancillary capital.

32. In approving these off-balance sheet instruments (see paragraph 31) or debt instruments (see paragraph 34), the Authority will consider the following:

- Ability and willingness of the counterparty to honour their commitment;
- Terms of the instrument (e.g. duration, subordination, etc.);
- Credit risk of the counterparty; and
- Relevant supplementary information, such as past behavior of the counterparty.

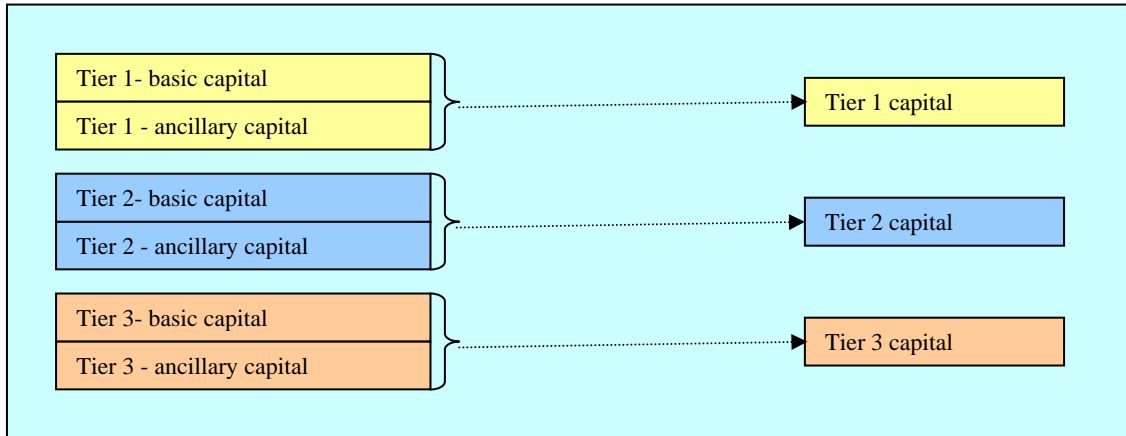
33. Depending on the instrument, the approval may restrict the coverage period or amount eligible. The Authority may also issue directions with its approval potentially triggering mandatory regulatory disclosures.

34. Certain debt instruments (e.g. subordinated liabilities) may meet all the criteria for Tier 1 capital and be considered as Tier 1 ancillary capital (see Appendix A) when the behavior on a going-concern basis (i.e. first to absorb losses) or in a winding-up (i.e. highest subordination) is similar to that of common shares. To be classed as Tier 1, the debt agreement must include explicit terms relevant to the tier (e.g. duration period, subordination, etc.) and it must receive

BERMUDA MONETARY AUTHORITY
CONSULTATION PAPER ON ELIGIBLE CAPITAL
DECEMBER 2010

approval from the Authority (see paragraph 32) in order to qualify for inclusion. Some other debt instruments may qualify for inclusion into Tiers 2 or 3. Ancillary capital also includes unpaid or callable capital. Depending upon the features, these may qualify as Tier 2 ancillary capital.

4.3 Eligibility Limits

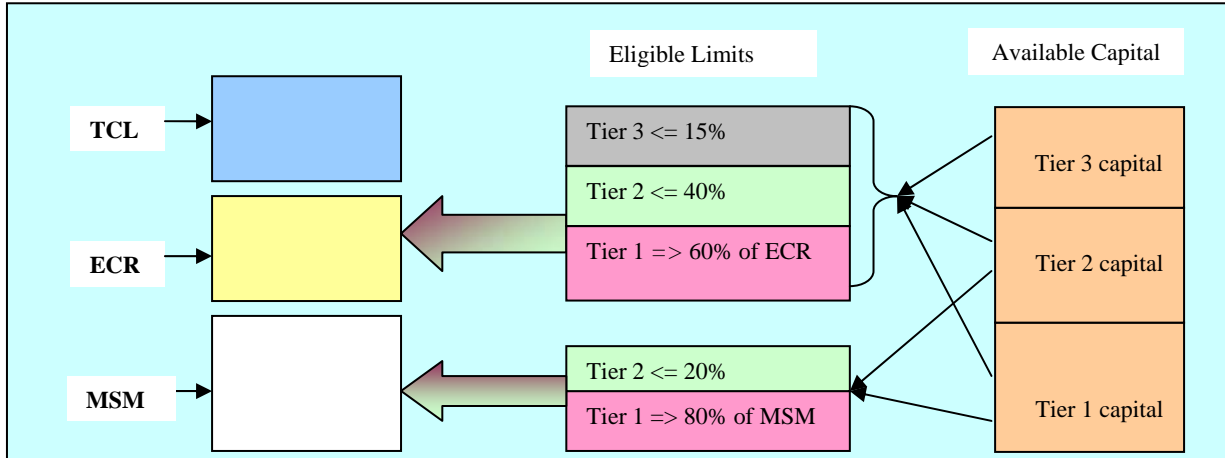


35. As noted in paragraph 21, only the high quality capital of Tiers 1 and 2 may cover the MSM. Further, given that a breach of the MSM would constitute insolvency for regulatory purposes, a higher portion of Tier 1 capital must be available to meet the insurer's MSM. Consequently, the Authority proposes that a minimum of 80% of Tier 1 capital and maximum of 20% of Tier 2 capital (equivalent to Tier 2 not exceeding 25% of Tier 1) are eligible to meet the MSM.

36. The ECR, on the other hand, is a second level of regulatory capital requirement; therefore, the Authority may exercise greater flexibility in determining the capital eligible to meet the ECR. The Authority proposes for Class 3B and 4 insurers (and insurance groups) that a minimum of 60% of Tier 1 capital and maximum of 15% Tier 3 capital must be available to cover the ECR. Once the insurer has sufficient capital in Tiers 1, 2, and 3 to meet the MSM and the ECR, any combination of Tiers 1, 2, and 3 capital may be eligible to meet the TCL. The Authority proposes to allow Class 3A, C, D and E insurers to hold a minimum of 50% Tier 1 capital and a maximum of 15% Tier 3 capital for the purposes of the ECR.

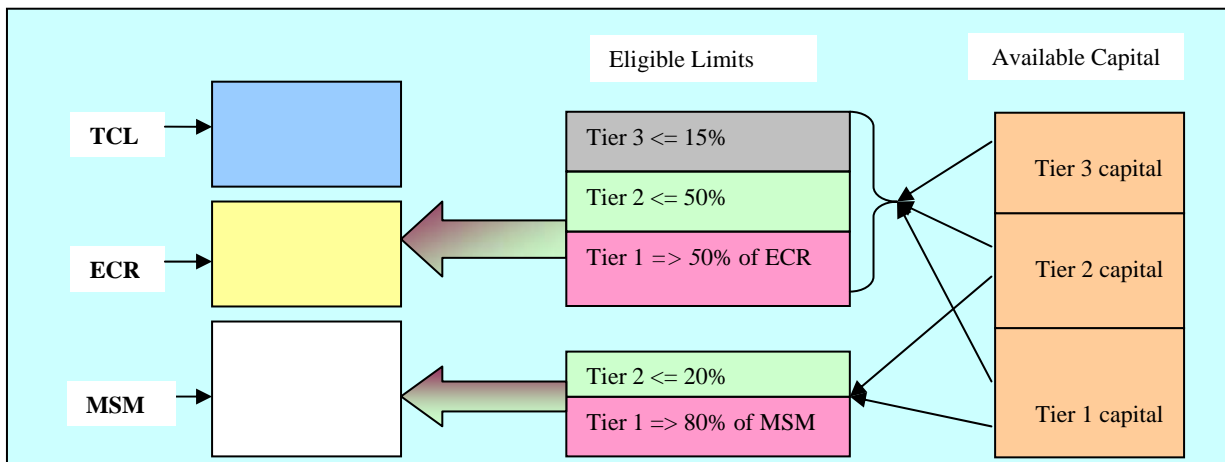
BERMUDA MONETARY AUTHORITY
CONSULTATION PAPER ON ELIGIBLE CAPITAL
 DECEMBER 2010

37. Regulatory capital requirement levels and the eligible tier limits for Class 3B and 4 insurers, and insurance groups:



The above, otherwise stated, is equivalent to Tier 3 capital not exceeding 17.65% of the sum of Tiers 1 and 2, and the sum of Tiers 2 and 3 not exceeding 66.67% of Tier 1.

38. Regulatory capital requirement levels and the eligible tier limits for Class 3A, C, D and E insurers:



The above, otherwise stated, is equivalent to Tier 3 capital not exceeding 17.65% of the sum of Tiers 1 and 2, and the sum of Tiers 2 and 3 not exceeding 100% of Tier 1.

5. GROUP-WIDE SUPERVISION

39. The Authority anticipates that the proposals in this paper would also be applicable to insurance groups where the Authority is the appointed group-wide supervisor. The examples provided in Appendix A are not exhaustive; insurance groups should contact the Authority where they are unclear as to the application of an instrument. Further, some examples included in the Appendix A (e.g. approved parental guarantees, Tier 2 ancillary capital) may not be relevant to insurance groups and should be disregarded.

6. RELATED INITIATIVES

40. The Authority recognises the importance of an economic valuation of balance sheet instruments and is currently working on proposals to enhance its statutory reporting and valuation. These proposals will impact the underlying assets and liabilities used to determine regulatory capital requirements. The IAIS recommends that “insurer management, regulation and supervision need to be firmly rooted in economic valuation. Only a current economic valuation of assets, obligations, and risk exposures related to all balance sheet items can provide sufficiently relevant and reliable information and insight into the financial position of the insurer”⁴. The Authority has written a discussion paper on the topic, and is currently considering both the responses to that paper and how to develop a regime appropriate for the Bermuda market where assets and liabilities are valued on a consistent economic basis to reduce or eliminate, where possible, any accounting mismatch where there is no underlying economic mismatch. A consultation paper on the topic is planned for 2011 with a view of phasing any proposals for applicable classes over the 2013 and 2014 financial years.

⁴ IAIS – “The IAIS common structure for the assessment of insurer solvency”, February 2007, Pg 19 - 20

BERMUDA MONETARY AUTHORITY
CONSULTATION PAPER ON ELIGIBLE CAPITAL
DECEMBER 2010

7. REPORTING REQUIREMENTS

41. Insurers should retain documents supporting the assessment of their tiered capital for supervisory review. The Authority proposes to enhance the reporting requirement of the Capital and Solvency Return (prescribed by the Insurance (Prudential Standards)(Class 4 Solvency Requirement) Order 2008) to include disclosure of all capital instruments eligible for the respective tiers. Similar disclosure is proposed for the other classes and insurance groups.

8. IMPLEMENTATION PROVISION

42. The Authority is proposing to implement the regime effective from the 2011 financial year-end for Class E, 3A, 3B and 4 insurers, and insurance groups for which the Authority is the group-wide supervisor. It is further envisaged that this regime would be applicable to Class C and D insurers for the 2012 financial year-end subject to any phasing proposals. The Authority proposes to require trial runs for the 2010 financial year-end for Class E, 3A, 3B and 4 insurers, and insurance groups for which the Authority is the group-wide supervisor to assess the impact of the proposals prior to implementation.

9. TRANSITIONAL PROVISION

43. Upon application, and on a case-by-case basis, the Authority may allow instruments previously approved for capital purposes to be eligible to support the MSM and ECR for grandfathering purposes. The Authority will use the results of the 2010 financial year-end trial runs to assist in concluding its policy.

BERMUDA MONETARY AUTHORITY
CONSULTATION PAPER ON ELIGIBLE CAPITAL
DECEMBER 2010

10. APPENDIX A

Tiers	Criteria	Key Features	Examples Items
Tier 1 - basic capital	<p>Loss-absorbency</p> <p>Subordination</p> <p>Perpetuality</p> <p>Permanency</p> <p>Free of mandatory fixed charges</p> <p>Free of encumbrances</p>	<p>(1) statutory surplus <i>less</i> adjustments on encumbered assets (see paragraph 29);</p> <p>(2) capital stock and contributed surplus;</p> <p>(3) excludes capital instruments included in Tier 1 ancillary, Tier 2 basic, Tier 2 ancillary, Tier 3 basic, and Tier 3 ancillary capital;</p> <p>(4) capital instruments that satisfy the following:</p> <p>(a) capable of absorbing losses in a going concern either by way of:</p> <p style="padding-left: 40px;">(i) write down of the principal amount or until losses cease; or</p> <p style="padding-left: 40px;">(ii) mandatory conversion to capital stock when losses accumulate;</p> <p>(b) highest level of subordination in a winding-up;</p> <p>(c) Paid-up or called;</p> <p>(d) undated or have estimated maturity of not less than 10 years from date of issuance;</p> <p>(e) non-redeemable or settled only with the issuance of an instrument of equal or higher quality;</p> <p>(f) free of incentives to redeem;</p> <p>(g) the coupon payment on the instrument, upon breach (or if it would cause a breach) in the ECR is:</p> <p style="padding-left: 40px;">(i) cancellable; or</p> <p style="padding-left: 40px;">(ii) deferrable indefinitely;</p> <p>(h) free of encumbrances;</p>	<p>Examples include:</p> <ul style="list-style-type: none"> ➤ fully paid common shares; ➤ statutory surplus / deficit or retained earnings <i>less</i> adjustments on encumbered assets (see paragraph 29); ➤ contributed surplus or share premium; and ➤ qualifying undated or with estimated duration of not less than 10 years hybrid capital instruments (e.g. non-cumulative, perpetual or fixed term preference shares).

BERMUDA MONETARY AUTHORITY
CONSULTATION PAPER ON ELIGIBLE CAPITAL
DECEMBER 2010

Tiers	Criteria	Key Features	Examples Items
		<p>(i) do not contain terms or conditions designed to accelerate or induce an insurer's insolvency; and</p> <p>(j) do not give rise to a right of set off against an insurer's claims and obligations to the investor or creditor.</p>	
Tier 1 - ancillary capital	<p>Loss-absorbency</p> <p>Subordination</p> <p>Perpetuality</p> <p>Permanency</p> <p>Free of mandatory fixed charges</p> <p>Free of encumbrances</p>	<p>(1) excludes capital instruments included in Tier 1 basic, Tier 2 basic, Tier 2 ancillary, Tier 3 basic, and Tier 3 ancillary capital;</p> <p>(2) capital instruments that are approved by the Authority for inclusion (see paragraph 31) and satisfy the following:</p> <p>(a) capable of absorbing losses in a going concern either by way of:</p> <p style="padding-left: 20px;">(i) write down of the principal amount or until losses cease; or</p> <p style="padding-left: 20px;">(ii) mandatory conversion to capital stock when losses accumulate;</p> <p>(b) highest level of subordination in a winding-up;</p> <p>(c) Paid-up or called;</p> <p>(d) undated or have estimated maturity of not less than 10 years from date of issuance;</p> <p>(e) non-redeemable or settled only with the issuance of an instrument of equal or higher quality;</p> <p>(f) free of incentives to redeem;</p> <p>(g) the coupon payment on the instrument, upon breach (or if it would cause a breach) in the ECR is:</p> <p style="padding-left: 40px;">(i) cancellable; or</p> <p style="padding-left: 40px;">(ii) deferrable indefinitely;</p> <p>(h) free of encumbrances;</p>	<p>Examples include:</p> <ul style="list-style-type: none"> ➤ perpetual or fixed term subordinated liabilities.

BERMUDA MONETARY AUTHORITY
CONSULTATION PAPER ON ELIGIBLE CAPITAL
DECEMBER 2010

Tiers	Criteria	Key Features	Examples Items
		<p>(i) do not contain terms or conditions designed to accelerate or induce an insurer's insolvency; and</p> <p>(j) do not give rise to a right of set off against an insurer's claims and obligations to the investor or creditor.</p>	
Tier 2 - basic capital	<p>Loss-absorbency</p> <p>Subordination</p> <p>Perpetuality</p> <p>Permanency</p> <p>Free of mandatory fixed charges</p> <p>Free of encumbrances</p>	<p>(1) adjustments on encumbered assets (difference between encumbered assets for policy holder obligations less adjustments (see paragraph 29) ;</p> <p>(2) excludes capital instruments included in Tier 1 basic, Tier 1 ancillary, Tier 2 ancillary, Tier 3 basic, and Tier 3 ancillary capital;</p> <p>(3) Capital instruments that satisfy the following:</p> <p>(a) capable of absorbing a moderate level of losses on a going concern, include suspending coupon payments if ECR is breached;</p> <p>(b) subordinated to policyholder obligations in a winding-up;</p> <p>(c) undated or have estimated maturity of not less than 5 years from date of issuance;</p> <p>(d) non-redeemable if ECR is breached or settled only with the issuance of an instrument of equal or higher quality;</p> <p>(e) free of incentives to redeem;</p> <p>(f) the coupon payment is deferrable indefinitely when ECR is breached;</p> <p>(g) free of encumbrances;</p> <p>(h) do not contain terms or conditions designed to accelerate</p>	<p>Examples include:</p> <ul style="list-style-type: none"> ➤ qualifying hybrid capital instruments with estimated duration of not less than 5 years (e.g. cumulative preference shares); and ➤ adjustments on encumbered assets (see paragraph 29).

BERMUDA MONETARY AUTHORITY
CONSULTATION PAPER ON ELIGIBLE CAPITAL
DECEMBER 2010

Tiers	Criteria	Key Features	Examples Items
		<p>or induce an insurer's insolvency; and</p> <p>(i) do not give rise to a right of set off against an insurer's claims and obligations to the investor or creditor.</p>	
Tier 2 - ancillary capital	<p>Loss-absorbency</p> <p>Subordination</p> <p>Perpetuality</p> <p>Permanency</p> <p>Free of mandatory fixed charges</p> <p>Free of encumbrances</p>	<p>(1) capital instruments that would otherwise qualify as Tier 1 capital but are callable on demand and are unpaid;</p> <p>(2) excludes capital instruments included in Tier 1 basic, Tier 1 ancillary, Tier 2 basic, Tier 3 basic, and Tier 3 ancillary capital;</p> <p>(3) Capital instruments that are approved by the Authority for inclusion (see paragraph 31) and satisfy the following:</p> <p>(a) callable and convertible on demand to Tier 1 capital when losses begin to accumulate or when ECR is breached;</p> <p>(b) subordinated to policyholder obligations in a winding-up;</p> <p>(c) undated or have estimated maturity of not less than 5 years from date of issuance;</p> <p>(d) non-redeemable if ECR is breached or settled only with the issuance of an instrument of equal or higher quality;</p> <p>(e) free of incentives to redeem;</p> <p>(f) the coupon payment is deferrable indefinitely when ECR is breached;</p> <p>(g) free of encumbrances;</p> <p>(h) do not contain terms or conditions designed to accelerate or induce an insurer's insolvency;</p>	<p>Examples include:</p> <ul style="list-style-type: none"> ➤ unpaid and callable common shares; ➤ qualifying unpaid and callable hybrid capital instruments meeting Tier 1 - basic or Tier 1 - ancillary criteria (e.g. qualifying unpaid and callable non-cumulative, perpetual preference shares); ➤ approved irrevocable letters of credit; and ➤ approved parental guarantees.

BERMUDA MONETARY AUTHORITY
CONSULTATION PAPER ON ELIGIBLE CAPITAL
DECEMBER 2010

Tiers	Criteria	Key Features	Examples Items
		<p>and</p> <p>(i) do not give rise to a right of set off against an insurer's claims and obligations to the investor or creditor.</p>	
Tier 3 - basic capital	<p>Subordination</p> <p>Perpetuality</p> <p>Permanency</p> <p>Free of mandatory fixed charges</p> <p>Free of encumbrances</p>	<p>(1) excludes capital instruments included in Tier 1 basic, Tier 1 ancillary, Tier 2 basic, Tier 2 ancillary and Tier 3 ancillary capital;</p> <p>(2) capital instruments that satisfy the following:</p> <p>(a) subordinated to policyholder obligations in a winding-up;</p> <p>(b) undated or have estimated maturity of not less than 3 years from date of issuance;</p> <p>(c) non-redeemable if ECR is breached or settled only with the issuance of an instrument of equal or higher quality;</p> <p>(d) the coupon payment on the instrument, upon breach (or if it would cause a breach) in the ECR is:</p> <p style="padding-left: 40px;">(i) cancellable; or</p> <p style="padding-left: 40px;">(ii) deferrable indefinitely;</p> <p>(e) free of encumbrances;</p> <p>(f) do not contain terms or conditions designed to accelerate or induce an insurer's insolvency; and</p> <p>(g) do not give rise to a right of set off against an insurer's claims and obligations to the investor or creditor.</p>	<p>Examples include:</p> <ul style="list-style-type: none"> ➤ qualifying short-term hybrid capital instruments (e.g. cumulative preference shares).

BERMUDA MONETARY AUTHORITY
CONSULTATION PAPER ON ELIGIBLE CAPITAL
DECEMBER 2010

Tiers	Criteria	Key Features	Examples Items
Tier 3 - ancillary capital	<p>Subordination</p> <p>Perpetuality</p> <p>Permanency</p> <p>Free of mandatory fixed charges</p> <p>Free of encumbrances</p>	<p>(1) excludes capital instruments included in Tier 1 basic, Tier 1 ancillary, Tier 2 basic, Tier 2 ancillary and Tier 3 basic capital;</p> <p>(2) Capital instruments that are approved by the Authority for inclusion (see paragraph 31) and satisfy the following:</p> <p>(a) subordinated to policyholder obligations in a winding-up;</p> <p>(b) undated or have maturity of not less than 3 years from date of issuance;</p> <p>(c) non-redeemable if ECR is breached or settled only with the issuance of an instrument of equal or higher quality;</p> <p>(d) the coupon payment on the instrument, upon breach (or if it would cause a breach) in the ECR is:</p> <p style="padding-left: 40px;">(i) cancellable; or (ii) deferrable indefinitely;</p> <p>(e) free of encumbrances;</p> <p>(f) do not contain terms or conditions designed to accelerate or induce an insurer's insolvency; and</p> <p>(g) do not give rise to a right of set off against an insurer's claims and obligations to the investor or creditor.</p>	<p>Examples include:</p> <ul style="list-style-type: none"> ➤ short-term approved irrevocable letters of credit; and ➤ short-term approved parental guarantees.

BERMUDA MONETARY AUTHORITY
CONSULTATION PAPER ON ELIGIBLE CAPITAL
DECEMBER 2010

11. APPENDIX B

Illustrations to compute available capital eligible to cover the MSM and the ECR

In Year X, company XYZ has available capital of \$3,700 comprised of Tier 1 capital of \$1,700, Tier 2 capital of \$1,500, and Tier 3 capital of \$500. Determine the eligible capital available to cover:

i) MSM = \$2,000

ii) ECR = \$3,000

a) Solution – Class 3A, C, D and E insurers

Available capital eligible to cover MSM:

- Limited to Tier 1 capital and Tier 2 capital only;
- At least 80% of the MSM must be supported by Tier 1 capital and the remainder by Tier 2 capital.

Tier	Available statutory capital and surplus	Eligible capital for MSM	Sufficient capital (Y/N)	Comments
Tier 1	\$1,700	\$1,700	Y	
Tier 2	\$1,500	\$425	Y	Tier 2 cannot exceed 25% of Tier 1 and 20% of available statutory capital and surplus.
Tier 3	\$500			
Total	\$3,700	\$2,125	Y	Eligible capital for MSM \$2,125 is greater than the MSM of \$2,000.

Available capital eligible to cover ECR:

- At least 50% of ECR must be supported by Tier 1 capital; and
- Tier 3 is limited to a maximum of 15% of available statutory capital and surplus.

Tier	Available statutory capital and surplus	Eligible capital for ECR	Sufficient capital (Y/N)	Comments
Tier 1	\$1,700	\$1,700	Y	Tier 1 must be a minimum of 50% of ECR.
Tier 2	\$1,500	\$1,500	Y	Tier 2+Tier 3 cannot exceed Tier 1.
Tier 3	\$500	\$200	Y	Tier 3 cannot exceed 15% of available statutory capital and surplus. Or Tier 3 cannot exceed 17.65% of Tier 1+Tier 2.
Total	\$3,700	\$3,400	Y	Eligible capital for ECR \$3,400 is greater than the ECR of \$3,000.

BERMUDA MONETARY AUTHORITY
CONSULTATION PAPER ON ELIGIBLE CAPITAL
DECEMBER 2010

b) Solution – Class 3B and 4 insurers

Available capital eligible to cover MSM:

- Limited to Tier 1 capital and Tier 2 capital only;
- At least 80% of the MSM must be supported by Tier 1 capital and the remainder by Tier 2 capital.

Tier	Available statutory capital and surplus	Eligible capital for MSM	Sufficient capital (Y/N)	Comments
Tier 1	\$1,700	\$1,700	Y	
Tier 2	\$1,500	\$425	Y	Tier 2 cannot exceed 25% of Tier 1 and 20% of available statutory capital and surplus.
Tier 3	\$500			
Total	\$3,700	\$2,125	Y	Eligible capital for MSM \$2,125 is greater than the MSM of \$2,000.

Available capital eligible to cover ECR:

- At least 60% of ECR must be supported by Tier 1 capital; and
- Tier 3 is limited to a maximum of 15% of available statutory capital and surplus.

Tier	Available statutory capital and surplus	Eligible capital for ECR	Sufficient capital (Y/N)	Comments
Tier 1	\$1,700	\$1,700	Y	Tier 1 must be a minimum of 60% of ECR.
Tier 2	\$1,500	\$1,133	Y	Tier 2 cannot exceed 66.67% of Tier 1 and Tier 2+Tier 3 cannot exceed 66.67% of Tier 1.
Tier 3	\$500		Y	Tier 3 cannot exceed 15% of available statutory capital and surplus. Or Tier 3 cannot exceed 17.65% of Tier 1+Tier 2. As such there is no capacity to include Tier 3 into eligible capital.
Total	\$3,700	\$2,833	N	Eligible capital for ECR \$2,833 is less than the ECR of \$3,000. The insurer is required to increase its Tier 1 capital to increase the capacity to include more Tier 2 and Tier 3 capital.

BERMUDA MONETARY AUTHORITY
CONSULTATION PAPER ON ELIGIBLE CAPITAL
 DECEMBER 2010

12. APPENDIX C

Illustration to compute the capital requirements arising from encumbered assets

Company XYZ has encumbered assets in a trust equal to \$370. The composition of the assets is as follows:

Asset	Amount
Cash	\$100
Government bonds	\$200
Corporate bonds (AAA)	\$50
Corporate bonds (A)	\$20
Total assets in trust	\$370

Regulatory capital	Amount	Comments
Bermuda Solvency Capital Requirement (“BSCR”) (prior to covariance adjustment)	\$1,500	
BSCR (after covariance adjustment) - ECR	\$1,200	
Diversification	0.8	BSCR after covariance adjustment <u>divided by</u> BSCR prior to covariance adjustment (1200/1500)
MSM	\$600	

Solution

Apply capital factor from BSCR standard model as follows:

Asset	Amount	BSCR capital factor	Required capital
Cash	\$100	0.3%	\$0.30
Government bonds	\$200	0.3%	\$0.30
Corporate bonds (AAA)	\$50	0.8%	\$0.40
Corporate bonds (A)	\$20	3.2%	\$0.64
Subtotal	\$370		\$1.94
Apply diversification factor using as a proxy overall diversification to arrive at the ECR			0.8
Capital requirements arising from encumbered assets for ECR [(1.94) X (0.80)]			\$1.55
Capital requirement arising from encumbered assets for MSM [(1.55) X (600/1200)]			\$0.78