



# BERMUDA MONETARY AUTHORITY

CONSULTATION PAPER

GUIDANCE NOTE #20  
SPECIAL PURPOSE INSURERS

31<sup>ST</sup> March, 2009

## **Executive Summary and Discussion Points**

1. We are pleased to attach our Consultation Paper for Guidance Note #20 - Special Purpose Insurers.
2. As you may be aware, the Insurance Amendment Act 2008, which was passed on 30th July of that year, introduced three new insurance licensing classes, one of which was the class of Special Purpose Insurers (“SPIs”).
3. The purpose of the SPI amendment was to enhance the Bermuda Monetary Authority’s (the Authority’s) regulatory framework so as to ensure the prudent development of sound business forms associated with insurance side cars, cat bonds and other insurance-linked special purpose transactions in Bermuda.
4. The attached note sets out guidance in relation to the Authority’s licensing and ongoing supervisory activities associated with SPIs. A primary focus of the note is to facilitate a prudent applications and approval process of these vehicles through the development of a clear understanding of the regulatory issues associated with this class of insurer.
5. Special Purpose Insurers are a unique licensing class, with a wide range of structures and nuances. This said, and in line with the Authority’s approach to effective regulation, it is our desire to maintain a sound working partnership with industry in the development of this guidance so as to ensure its effectiveness in relation to the conduct of SPI business.
6. To this end we are in the process of setting up an SPI Advisory Group comprised of a broad cross-section of practitioners currently engaged in the design and execution of these vehicles. The purpose of this advisory group will be to finalise the guidance note in the context of current market developments and to review the SPI legislation and guidance for future amendments.
7. With this backdrop, we have developed a list of **Discussion Points** below where we specifically encourage your ideas and suggestions.
8. We thank you, in advance, for your participation during this consultative process, as we advance our regime to welcome the SPI licensing class; a class which so appropriately complements our already highly dynamic and diverse (re)insurance industry.

## Discussion Points

One goal of the Authority is to continually assess the relevance and appropriateness of our legislation so as to keep pace with market developments. In this vein we have developed the following list of questions in connection with this Consultation Paper for Guidance Note #20 - Special Purpose Insurers.

To this end we welcome your comments, including suggestions for future revisions on all aspects of this document and the legislation which supports it, and we thank you, in advance, for your contributions.

### **A. Disclosure of Assets and Collateral Quality**

1. Full disclosure of the quality of assets and collateral posted by SPIs on behalf of the investors and reinsureds respectively has become of increasing significance in the wake of recent financial market developments.
2. In the context of SPI licensing and authorisations, our approach is to provide assurances of expedited applications review if the planned asset quality of the SPI falls within the US Regulation 114 asset quality guidelines.
3. To the extent that other forms of assets are used, we will review closely planned asset quality guidelines and related disclosures to determine if they are appropriate.
4. We are aware that in past SPI ventures, disclosure of the investment guidelines to investors and sponsors has in many cases not been satisfactory to participants who found difficulty in gaining access to information pertaining to the composition of collateral posted. Moreover it appears that current impediments continue to block participants from achieving the level of disclosure desired.
5. The Authority is therefore seeking views on our approach and current wording, and whether it is reasonable to take our policy a step further by requiring that an on-going disclosure mechanism (such as a website) be in place, and accessible on a regular basis to all investors and sponsors to review details on current asset and collateral quality. In responding to this question we would like your views on: 1) whether the mandatory transparency mechanism would be suitable for all transactions or only those transactions with non 114 assets; 2) whether the mandatory transparency mechanism would be appropriate for all transaction types (e.g., sidecars, cat bonds, etc); and 3) how the transparency mechanism should operate.
6. In addition, please comment with respect to the adequacy of the guidelines provided in the Prudent Investment Guidelines, Reporting and Disclosure Requirements clause in the Note. Please specify any further instructions which should be a part of this section of the guidance.

**B. Risk Retention and Alignment of Interests**

1. In light of the recent economic downturn and the discovery that commercial banks had, in recent years, weakened their underwriting standards in the knowledge that they were not obligated to retain any of their underwriting risk, international standards are now being established to require some form of risk retention on the part of banking institutions.
2. In this context, and to better ensure quality underwriting standards and alignment of interests when cedants pass-off their risk to the SPI, the Authority seeks feedback on the reasonableness of a policy mandating some form of risk retention on the part of cedants. In addition, to the extent that the Authority takes this policy route, we are looking for feedback on the best approach and possible suitable metrics to be utilised in setting our policy standard in this regard.

**C. Definition of SPI**

1. Please comment on the need for inclusion, within the legislative definition of an SPI, a statement which highlights the fact that SPI liabilities cannot be co-mingled. This, in conjunction with the fact that each liability of the SPI is individually ring-fenced and offset with a segregated, fully funded, earmarked asset, has been described as the characteristic of SPIs which distinguishes them from leveraged insurance products. Do you believe the current legislative definition of SPIs needs to be amended to cater for these and other characteristics?

**D. Filing Requirements**

1. Current legislation requires SPIs to file audited financial statements, with the Authority's proposed policy to look favourably upon properly justified applications to waive this requirement on a case-by-case basis. There have been some indications that filing audited financial statements for SPIs can add both complexity and considerable cost to the SPI processes without comparable prudential gain. Please comment on the proposed policy requiring audited financial statements from SPIs.

**E. Fully Funded Definition**

1. Please indicate your views on the Authority's definition of "fully funded" which stipulates that the SPI will by nature be perpetually fully funded due to the fact that the liabilities must be limited to the net asset value of the SPI.
2. The Authority will not have a policy to mandate that assets be replenished to the level of aggregate exposure, but rather that the initial contract (between the sophisticated parties) will clearly stipulate how the funding and risk sharing will be managed. Please comment on the appropriateness of the Authority's approach not to require a "top up" of assets, leaving this decision to the Participants.

**F. Reinsurance Transformers**

1. Reinsurance Transformers are insurance linked vehicles with similar characteristics to those of SPIs but which do not currently fit within the SPI definition due to the fact that Transformers will carry out multiple individual and unrelated transactions throughout a time period. Please comment on the desirability of amending the SPI legislative definition to accommodate reinsurance transformer type transactions.

**G. Partitioning of Legislation and Guidance**

1. Although there is great diversity in the structures of SPIs, these vehicles have a great number of common characteristics which lend themselves to be grouped into a single Guidance Note. Please comment on the desirability of partitioning the Guidance Note (and possibly legislation) in a fashion specific to different categories of SPI structures.

**H. Loss Reserve Specialist Opinion**

1. The filing of a Loss Reserve Specialist (actuarial) Opinion (LRSO) is currently not stipulated in the Act as a requirement from SPIs. However, there are potentially circumstances where, in spite of the fully funded nature of these vehicles, expert actuarial opinion may be required to evaluate ultimate claims liabilities. As the Act stipulates the requirement of LRSOs for all other licensing classes (except Class 1s) and as other jurisdictions speak to the use of actuarial opinions in their SPI guidance, please comment on the section of the Act which does not include SPIs amongst the licensing classes required to file a LRSO. Please include in your response whether such an Opinion should be required for specific (named) structures.

**I. Contingent Assets**

1. The Authority has established policy to recognise reinsurance and/or LOCs from appropriately regulated and rated institutions as acceptable instruments for inclusion in the collateral structures of SPIs. Please indicate your views on the acceptability of Contingent Assets (such as reinsurance, LOCs and credit default swaps) as forms of collateral held by the SPI.

**J. Sophisticated Participants**

1. Please provide your feedback on the appropriateness of the “Sophisticated Participants” definition in Paragraph 4.1.4.6 and Appendix VI of the Guidance Note.

**K. Insurance Managers**

1. Please comment upon whether guidelines for Insurance Managers of the SPI should be a part of this Note. In addition, please comment upon whether fit and proper policy considerations with respect to those administering and managing SPIs should be established.

**L. Fast -Tracked Applications Process**

1. Please provide your feedback on the desirability of the Fast Tracked applications process where the standard ALC process will be replaced by an expedited review arrangement to the extent that the application conforms to the guidelines of this Note.

**M. Documentation on Participants**

1. Please comment on the timing of documentation requirements associated with SPIs. Thought is being given to the fact that very few of the Relevant/Sophisticated Participants from the investor group will be known at the time of making the SPI application. Moreover we are considering placing greater emphasis upon requesting these details at the time of the post-closing mandatory documentation process with the Authority relying upon clearly disclosed selling restrictions criteria included in the SPI application prior to closing.

**N. “No Petitioning” and/or “Extinguishing of Liabilities” provisions**

1. Please comment on the absence of “No Petitioning” and/or “Extinguishing of Liabilities” provisions in the Note protecting against 3<sup>rd</sup> parties gaining liens on the SPI. Please advise if it is desirable that these provisions be a part of the Note.

**O. Residual Risk**

1. The Authority is proposing a policy of requiring that all of its regulated entities are able to demonstrate their understanding of all applicable residual risks attendant to their SPI arrangements (including basis risk (e.g. timing, liquidity and trigger risk), tail risk, market risk, and counterparty credit risk) and that these risks are evaluated as a part of their modelled solvency assessment. Please comment on the appropriateness of this requirement.

**P. Index-Based Structures**

1. The Authority seeks feedback on the operation of the guidance and legislation from the perspective of index-based structures where payout triggers involve no indemnity element. In the past, a number of index-based structures have applied for a section 57a exemption from the need to receive an insurance license or to be regulated as a derivatives contract under the Investment Business Act. Please comment on the propensity to use index-based structures under the SPI legislation. Include in your response your views on the suitability of the guidance and/or legislation for index-based structures.

**Q. Asset Quality Test**

1. Please comment on the appropriateness of the Asset Quality Test in light of the fact that:
  - i. The SPI agreement as to the nature and composition of the collateral investment is established between sophisticated parties; and

- ii. The maximum liabilities of the SPI must be limited to its net asset value.

Your comments and suggestions are sought, in writing, on or before 31st May 2009.

Please forward all comments either by email or letter to:

Gina Smith  
Assistant Director - Actuarial Services  
Bermuda Monetary Authority  
BMA House  
43 Victoria Street  
Hamilton HM12  
Bermuda  
441 278 0271  
gsmith@bma.bm

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# **1. Introduction**

- 1.1. The passage of the Insurance Amendment Act 2008 (the “Amendment Act”) occurred on 30th July, 2008. The Act introduced three new licensing classes, one of which was the class of Special Purpose Insurers (“SPIs”)<sup>1</sup>.
- 1.2. The purpose of the SPI amendment was to enhance the Bermuda Monetary Authority’s (the “Authority’s”) regulatory framework so as to ensure the prudent development of sound business forms associated with side cars, cat bonds and other similar insurance-linked special purpose transactions in Bermuda.
- 1.3. This note sets out guidance in relation to the Authority’s licensing and ongoing supervisory activities associated with SPIs. A primary focus of the note is to facilitate a prudent applications and approval process of these vehicles through the development of a clear understanding of the regulatory issues associated with this class of insurer.
- 1.4. 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”)<sup>2</sup> if the regulatory system is to command the confidence of both insurers and 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.
- 1.5. While the Authority aims to provide clarity as to its approach, this guidance 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. All queries associated with this note should be directed to the Authority.
- 1.6. The Authority’s guidance is of a general application and seeks to take into account the wide diversity of entities that may be licensed as SPIs under the Act. There is likely to be a need for the guidance to be revised and developed over time. In this context, it is generally the policy of the Authority to pass material changes in the guidance through a consultative process before being published, usually through the issuance of revised versions.

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<sup>1</sup> The Insurance Amendment Act 2008 (the “Amendment Act”) created three new classes of insurance license, Class 3A, Class 3B and Special Purpose Insurers.

<sup>2</sup> 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) 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). References herein to the “Act” are to the Insurance Act 1978 (as amended) and the Regulations.

- 1.7. Although not obligatory, the Authority recognises that some issuers may wish to “exchange list” their SPI structures and/or related securities. The Authority is supportive of exchange listing activity, a sample of which is elaborated upon in Appendix V.
- 1.8. The Authority draws attention to the fact that in accordance with the Proceeds of Crime (Anti-Money Laundering and Anti-Terrorist Financing) (“AML/ATF”) Regulations 2008, all Independent Professionals<sup>3</sup> who engage in the implementation of an SPI by assisting in the planning or execution of the formation or otherwise act for or on behalf of a client in the transaction will be bound by their home country Anti-Money Laundering and Anti-Terrorist Financing regulations.

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<sup>3</sup> As found in the Proceeds of Crime (Anti-Money Laundering and Anti-Terrorist Financing) regulations 2008 - Part 1 – Preliminary - Interpretations - “Independent Professional” means a professional legal adviser or accountant being a firm or sole practitioner in independent practice who by way of business provides legal or accountancy services to other persons when participating in financial or real property transactions concerning:

1. buying and selling real property;
2. managing of client monies, securities and other assets;
3. management of bank, savings or securities accounts;
4. organization of contributions for the creation, operation or management of companies;
5. creation, operation or management of legal persons or arrangements, and buying and selling business entities

and, for this purpose, a person participating in a transaction by assisting in the planning or execution of the transaction or otherwise acting for or on behalf of a client in the transaction;

## 2. Interpretations

In this Guidance Note, the following terms are used.

- 2.1. "The Act" means the Insurance Act 1978 and its related regulations.
- 2.2. "Investment Grade Sovereign Nation ("IGSN") means a sovereign nation with a Fitch overall credit rating of BBB (or better) and a Fitch short-term credit rating of F1 (or better) or a non-sovereign nation deemed by the Authority to have an equivalent financial rating and/or international standing.<sup>4</sup>
- 2.3. "Special Purpose Business" (as defined in the Act) means insurance business under which an insurer fully funds its liabilities to the persons insured. Funding is provided through:
  - 2.3.1. the proceeds of any one or more of the following:
    - 2.3.1.1. a debt issuance where the repayment rights of the providers of such debt are subordinated to the rights of the person insured;
    - or
    - 2.3.1.2. some other financing mechanism approved by the Authority;
  - 2.3.2. cash; and
  - 2.3.3. time deposits
- 2.4. "Special Purpose Insurer" (as defined in the Act) means an insurer that carries on special purpose business

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<sup>4</sup> **Fitch Overall Ratings: BBB Good credit quality.** 'BBB' ratings indicate that there is currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions is more likely to impair this capacity. This is the lowest investment-grade category.

**Short-Term Credit Ratings: F1 Highest credit quality.** Indicates the strongest capacity for timely payment of financial commitments; may have an added "+" to denote any exceptionally strong credit feature

### **3. Standard Characteristics of SPIs<sup>5</sup>**

- 3.1. In its basic form, an SPI is a special purpose, single transaction or single customer insurance company which assumes (re)insurance risks and which typically fully funds its exposure to such risks through the proceeds of a debt issuance or some other financing mechanism, where the repayment rights of the providers of such debt or other financing mechanism are subordinated to the (re)insurance obligations of that vehicle.
- 3.2. The SPI's obligations are often fully collateralised either through cash, time deposits, or some other rated financial instrument such as a reinsurance contract, limited recourse notes, equity issue, and/or a derivative contract where the repayment rights are subordinated to the rights of the person(s) insured.
- 3.3. An SPI is usually established to enter into a single transaction or a single set of transactions all entered into simultaneously at the commencement of the company's business.
- 3.4. As per Section 5 (2) of the Act, in considering whether to register a body as a Special Purpose Insurer, the Authority shall, in addition to the matters set out above, have regard to the following matters —
  - 3.4.1. whether the insurer is solely insuring or reinsuring one or more risks or group of risks with one or more policyholders; and
  - 3.4.2. the sophistication<sup>6</sup> of the policyholders or the sophistication of the parties to a debt issuance or other funding mechanism.

### **4. Licensing and Authorisations (“L&A”) Process**

#### **4.1. The Fast Tracked Commitment**

- 4.1.1. Unlike most other (re)insurers an SPI will be fully funded to meet its (re)insurance obligations. It is, therefore, not exposed to insurance risk to the same extent as other reinsurers and as such, under specified conditions, the Authority shall permit SPIs to be subject to a more streamlined applications

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<sup>5</sup> An SPI is generally considered to be a special purpose exempted (re)insurance company, formed for a specified purpose for the benefit of sophisticated participants whereby the risks of the SPI are fully funded. Characteristics often common to SPIs include:

- (a) The SPI's (re)insurance or insurance obligations are fully collateralised;
- (b) An SPI is established for a specified or limited purpose typically for a limited duration.
- (c) SPI transactions are carried out between a limited number of sophisticated participants
- (d) The liabilities of the SPI are limited to its net asset value;

<sup>6</sup> The Authority will measure the degree of “sophistication” of the SPI participants in accordance with the definition found in the Authority's Investment Business (Exemptions) Order 2004 – Schedule – Exempted Persons, Part 1. This definition can be found in Appendix VI.

and ongoing supervisory process commensurate with the assumed risk of the venture.

- 4.1.2. The Fast Tracked SPI application process is intended to facilitate the fully funded, single transaction orientated nature of the SPI business environment, and is consistent with the Authority's risk-based approach to Licensing and Authoriations.
- 4.1.3. In this context, SPI business applications will not be processed in accordance with standard procedures but will have expedited review arrangements to the extent that they conform to the guidelines of this Note.
- 4.1.4. The Application for an SPI will be expected to include the following information:
  - 4.1.4.1. Details of the SPI business and how and through what mechanism(s) the SPI will fully fund its business;
  - 4.1.4.2. Details of how and through what mechanism(s) the SPI will fully collateralise its obligations;
  - 4.1.4.3. Confirmation that the SPI's insurance and (re)insurance liabilities are fully funded;
  - 4.1.4.4. Confirmation that the cedant or insured is aware of the fact that the liabilities of the SPI are limited to its net asset value<sup>7</sup>;
  - 4.1.4.5. Confirmation and supporting information of full disclosure of all key risk factors associated with participation in the SPI transaction including disclosures of Investment Risks<sup>8</sup> to investors and Basis Risks<sup>9</sup> to the reinsured(s);<sup>10</sup>
  - 4.1.4.6. Confirmation and supporting documentation that all Relevant Participants<sup>11</sup> fall within the "Sophisticated Participant" definition (See Appendix VI). In general a party is considered to be "sophisticated" if they have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment; and

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<sup>7</sup> In the context of this Guidance Note, all references to "assets" and "asset value" include "contingent assets" and the "contingent asset value" as applicable and unless otherwise indicated,

<sup>8</sup> Investment Risks include, but may not be limited to, General Investment Risks, Loss of Principal and Interest, Market Risks and Counterparty Reinvestment Risks.

<sup>9</sup> Basis Risks include, but may not be limited to, Trigger Risk, Timing Risk, Currency Risk, Model Risk, Data Risk, Operational Risk and Liquidity Risk.

<sup>10</sup> All risk disclosures will be expected to be commensurate with Rule 506 of Regulation D of the US Securities Act of 1933 and applicable to Private Placement Memorandum.

<sup>11</sup> In the context of this Note, "Participant" or "Relevant Participant" means those sophisticated participants in the special purpose business designated as being fully knowledgeable of the entire transaction and able to attest to the accuracy of the SPI Application Form on behalf of the (re)insured group(s) and the investor group(s). In the case of the investor group(s), the designated Relevant Participant may be the appropriately licensed securities broker responsible for placing the funding investments.

- 4.1.4.7. Any additional information that the Authority shall require in support of the SPI Application.

## **4.2. Financing Aspects of Fully Funded Structures**

- 4.2.1. The Authority recognises the numerous interpretations of the term “full funding” in evaluating the financial position and contractual arrangements inherent to SPI vehicles.
- 4.2.2. For the purposes of interpreting the provisions in the Act applicable to the fully funded position of SPIs, the policy of the Authority is that the following rules shall apply to the SPI’s assets and liabilities and its contractual arrangements. To be fully funded, an SPI will be expected to:
  - 4.2.2.1. Include, in each (Re)insurance Contract, a provision which limits the aggregate liabilities of the SPI to its net asset value;
  - 4.2.2.2. ensure that, under the terms of any debt it issues or other financing mechanism used to fund its insurance or (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;
  - 4.2.2.3. 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
  - 4.2.2.4. 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 individually structured so that the SPI meets the fully funded requirements individually for each contract.

## **4.3. Sophisticated Participant**

- 4.3.1. Underpinning the SPI regulation and guidance is the Authority’s risk-based approach to insurance supervision. It follows that in line with the minimal capital and solvency and other L&A requirements for SPIs, Section 5(2) of the Act stipulates that the Authority will evaluate an SPI application based upon the Authority’s evaluation of “the sophistication of the policyholders or the sophistication of the parties to a debt issuance or other funding mechanism.”
- 4.3.2. This stipulation is intended to make clear that the Participants engaged in the SPI process will be expected to be sufficiently sophisticated to engage in this highly specialised business, and as such, where its Participants fall

within the Sophisticated Participant Definition<sup>12</sup>, the Authority will have a policy of expediting the SPI application.

#### **4.4. Asset Quality Test and Disclosures**

- 4.4.1. For the purposes of SPI structures, the Authority has established policy to ensure that the asset quality guidelines of proposed SPIs are fully disclosed to Participants and are in conformity with prevailing market standards.
- 4.4.2. Where proposed assets are solely comprised of those included in the Quality Asset list<sup>13</sup> found in the Appendix IV, the Authority can provide applicants with a high degree of certainty that their application, on the basis of the Asset Quality Test, will continue to be eligible for fast tracked approval.
- 4.4.3. The SPI Asset Quality Test has been established by the Authority to be in conformity with its risk-based approach to regulation and is geared around a materiality standard which stipulates a heightened level of disclosure and reporting when less than 100% of contract limits of liability are held in the Authority's established Quality Asset category.
- 4.4.4. Where the SPI proposes that its net contract limits will not be 100% comprised of a basket of the Quality Asset instruments described in this section, then the SPI Application will be expected to include a detailed description of planned asset quality disclosures. In such circumstances, the SPI will continue to be eligible for licensing; however the expedited review process may not be possible, dependent upon the nature of the risk characteristics of the assets.

#### **4.5. (Re)insurance, Letters of Credit (LOCs) and other Contingent Assets as Forms of Collateral**

- 4.5.1. The Authority recognises that there are numerous possible structures to fully collateralize the obligations of SPIs. Notwithstanding the perceived security of many of these instruments, it will be the policy of the Authority to request a heightened level of disclosure where "contingent assets" are being proposed as a source of an SPI's collateral base.
- 4.5.2. The Authority defines a "contingent asset" as an asset in which the possibility of an economic benefit from the asset depends solely upon

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<sup>12</sup> See Appendix VI

<sup>13</sup> The Authority's proposed asset quality standards are in line with those of Regulation 114 Insurance Trusts found in US law

future events where these events are fortuitous and therefore cannot be controlled by the company. Due to the uncertainty of the future events, these assets are not placed on the company's balance sheet. These assets, such as outwards (re)insurance and LOCs, may, however, be found in the company's financial statement notes.

4.5.3. Where an SPI's (re)insurance liabilities are collateralised through a balance of "contingent assets" (e.g. reinsurance, LOCs or other financial mechanisms such as swaps, contracts for differences etc.) the SPI will be expected to confirm that the said Issuer of these contingent assets:

4.5.3.1. Is a regulated financial institution subject to regulation by the BMA or a regulatory Authority considered to have an equivalent standing; and

4.5.3.2. Has achieved a financial rating of at least BBB+ as of the date of application and as determined by a recognised rating agency.

4.5.4. This means that the Authority has established policy to recognise reinsurance and/or LOCs from appropriately regulated and rated institutions as acceptable instruments for inclusion in the collateral structures of SPIs. It should be noted, however, that the Authority expects full disclosure of the contingent nature of these instruments to all Participants.

#### **4.6. Capital Relief Resultant from SPI Activities**

4.6.1. In line with the prudential reporting requirements contained within the Act, the Authority will allow a Bermuda (re)insurer to treat amounts recoverable from an SPI as:

4.6.1.1. a relevant asset, or

4.6.1.2. (re)insurance for the purposes of calculating its technical reserves, or

4.6.1.3. (re)insurance reducing its Enhanced Capital Requirement for companies subject to the Bermuda Solvency Capital Requirement ("the BSCR") returns as prescribed by the Insurance (Prudential Standards Class 4 Solvency Requirements) Order 2008,

however only to the extent that the ceding (re)insurer can demonstrate its ability to quantify the impact of the SPI (re)insurance protection upon its modelled losses and its net loss reserves respectively.

4.6.2. Entities regulated by the Authority, who purchase reinsurance protection from SPIs, are expected to ensure that they have in place (or have access to) the appropriate systems required to model the risk exposures inherent to their SPI reinsurance agreements.

- 4.6.3. In addition, these legal entities are expected to ensure that they have in place adequate systems of communication with the SPI so as to be regularly apprised of its net asset value and collateral position at suitable intervals. The Authority deems these communications to be necessary so as to assure the regulated entity of the net asset value of current and/or future recoverables.
- 4.6.4. Upon the request of the Authority, details should be made available evidencing that all residual risks associated with the SPI arrangement (including but not limited to basis, credit, market, liquidity and operational risks) are considered in modelled results. Where an SPI's (re)insurance liabilities are collateralised through a balance of "contingent assets" (e.g. reinsurance, LOCs or other financial mechanisms such as swaps, contracts for differences etc.) the SPI will be expected to confirm that the said Issuer of these contingent assets:
- 4.6.4.1. Is a regulated financial institution subject to regulation by the BMA or a regulatory Authority considered to have an equivalent standing; and
- 4.6.4.2. Has achieved a financial rating of at least BBB+ as of the date of application and as determined by a recognised rating agency.

#### **4.7. Prudent Investment Guidelines, Reporting and Disclosure Requirements**

- 4.7.1. In line with the Asset Quality disclosures, and in accordance with the prudent investment guidelines set out in the Authority's Investments Guidance Note #15, the SPI Board and Principal Representative are expected to exercise sound and thorough judgment in monitoring, fully disclosing and reporting upon the funding and collateralisation position and processes, and the investment management activities associated with the SPI.
- 4.7.2. As such, it is the expectation of the Authority that the Board and the Principal Representative shall ensure that the overall processes and procedures for the: a) funding and investment management of the SPI assets and b) collateralisation of the obligations of the SPI are in place, are prudently approached, are appropriate to the nature of the SPI contract and are operating effectively so as to maximize the likelihood that the expected outcomes of the counterparties are met.

#### **4.8. Contractual Limits of Liability and (Re)Insurance Regulator to Regulator Dialogue**

- 4.8.1. The Authority acknowledges that SPI structures contain contractual "limits of liability" language obliging the SPI to pay the reinsured an amount up to the contractual liability limits at the time of the occurrence

of a covered event. These SPI contract limits may include but may not be limited to language limiting the SPI contract to a specified Probable Maximum Loss (PML), Loss Ratio Cap, Tail Value at Risk (TVAR) or other prescribed amount(s).

- 4.8.2. Notwithstanding these varied approaches to structuring contract limit wording, it will generally be the policy of the Authority only to approve SPI applications where the limited recourse position of an SPI (i.e. the stipulation that the ultimate liability of the SPI will always be limited to its net asset value) always supersedes the contract liability limit language. This is to say that it will generally be the policy of the Authority only to approve SPI applications where in the event that the contract limit exceeds the net asset value of the SPI, then the SPI will be liable only to the amount of its net asset value. The portion of the contract limit which might exceed the net asset value of the SPI and which may become payable, will become the liability of one or more Participants (other than the SPI) identified within the residual risk language of the contract terms.
- 4.8.3. In this regard, the Authority places a heightened emphasis upon the Prudent Investment Guidelines and related disclosure and reporting responsibilities of the Board and Principal Representative (as discussed in this guidance) in relation to the level of funding and collateralisation and the quality of the SPI's assets.
- 4.8.4. It is the expectation of the Authority that SPIs will be funded and collateralised to 100% of the agreed levels whether these levels are established as the fully exposed aggregate liability limits or some agreed portion thereof.
- 4.8.5. Still, the nature of the net asset/liability balance of the SPI, along with the SPI's implicit "fully funded" position, renders the SPI to be in a perpetual position of solvency, irrespective of the relationship between the net asset value and the 100% agreed upon funding levels.
- 4.8.6. Notwithstanding this "fully funded" definition and the SPI's perpetual position of solvency, the Authority remains sensitive to the accounting and regulatory implications related to the recognition of (re)insurance recoveries due from an SPI on the balance sheets of companies who have purchased outward (re)insurance from SPIs.
- 4.8.7. In this context, and in the case of foreign regulatory queries, the Authority is committed, in accordance with its policy of regulatory cooperation, to engage in all necessary and prudent "regulator-to-regulator" dialogue so as to ensure that all valid documentation, as requested from the appropriate authorities, is made available for review and audit for the purpose of

validating the efficacy of assets available to settle (re)insurance recoveries due from SPIs licensed under the Authority.

#### **4.9. SPI Application Form (“SAF”)**

- 4.9.1. The SPI application process will generally require that a SAF<sup>14</sup> be completed by the applicant and signed by designated Relevant Participants before being submitted to the Authority.
- 4.9.2. The policy of the Authority will be to expedite the SPI application approval only to the extent that at least one Participant from both the (re)insured group(s) and the investor group(s) is designated by the applicant as a Relevant Participant and where a representative from each Relevant Participant group attests to the accuracy of the information submitted within the SAF by way of signature.
- 4.9.3. In circumstances where the identity of one or more of the “designated” Relevant Participants is unknown at the time of the original application<sup>15</sup>, the SAF must be resubmitted with all pertinent signatures at the time of submitting the mandatory post-closing documentation (see Section 4.10)
- 4.9.4. The SAF will include short answer questions directed to the most pertinent details of the transactions surrounding the formation and execution of the SPI. These questions may include, but not be limited to, the following details:
  - 4.9.4.1. The Cedant
    - 4.9.4.1.1. Details of the team/sponsor of the SPI
    - 4.9.4.1.2. Track record, expertise, reputation of sponsor
  - 4.9.4.2. Sophisticated Participants Test
    - 4.9.4.2.1. Supporting information that each Participant falls (or shall fall) within one or more of the categories found in the Sophisticated Participants Definitions (Appendix VI) as of the date of the Application (or the date of closing)
  - 4.9.4.3. The Deal Terms
    - 4.9.4.3.1. Description of the SPI insurance and (re)insurance business along with risks assumed
    - 4.9.4.3.2. Acknowledgment that the SPI’s liabilities will be limited to its net asset value

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<sup>14</sup> The SAF will be comprised of a standard Pre-Incorporation Form 1B tailored to suit SPI structures.

<sup>15</sup> The Authority will be satisfied if only one Participant from each of the (re)insured group(s) and the investor group(s) is designated by the applicant as a Relevant Participant. Moreover it is anticipated that a number of Participants will be unknown at the time of the application.

- 4.9.4.3.3. Details describing how the SPI will fully collateralize its liabilities
- 4.9.4.3.4. Details of collateral requirements and collateral release;
- 4.9.4.3.5. Disclosure of Assumed Risks including Tail and other Residual Risks
- 4.9.4.3.6. Details of the characteristics of all Relevant Participants
- 4.9.4.3.7. Details with respect to underwriting, claims and claims handling
- 4.9.4.4. The Board of Directors (“the Board”)
  - To be comprised of at least two persons, one of whom may be the Principal Representative
  - Personal Details to include:
    - 4.9.4.4.1. Name
    - 4.9.4.4.2. Nationality
    - 4.9.4.4.3. Occupation (preceding five years to present)
    - 4.9.4.4.4. Years of Experience in Investment and/or Insurance Business
    - 4.9.4.4.5. Relationship to Counterparties
- 4.9.4.5. The Service Providers
  - 4.9.4.5.1. Details on the Insurance Managers
  - 4.9.4.5.2. Details on the Principal Representative

**4.10. Post-Closing Mandatory Document Completion**

- 4.10.1. All pre-closing approvals will be subject to a mandatory Document Completion Process within one week of closing.
- 4.10.2. Post-Closing documentation requested by the Authority will be specified in conditions to the insurance license and will include, but may not be limited to, finalised closing details of all items specified in 4.9 above.
- 4.10.3. In addition, in accordance with Section 29(A) and (B) of the Act, the Authority reserves its right to audit and/or review all documentation related to any SPI transaction during the life of the SPI.
- 4.10.4. To the extent that post-closing documentation evidences diversion from the licensing conditions, the SPI will be in breach of its licensing agreement and will risk cancellation thereof.

#### **4.11. Application Fee**

- 4.11.1. The Authority will assess a one-off, non-refundable \$525 registration fee to process an application.

#### **4.12. Annual Business Fee**

- 4.12.1. As per the Act, the Authority will assess an annual business fee of \$10,000 for each registered SPI.

#### **4.13. Filing Requirements for SPIs**

- 4.13.1. The Authority recognizes the mitigated risks associated with SPIs due in large part to the level of sophistication of the Participants, the general short term nature of the (re)insurance agreements and the typical fully collateralised nature of SPIs.

- 4.13.2. As such the Authority's policy will be to look favourably upon exercising its powers under section 56 to modify the accounting provisions in respect of an SPI, subjecting it to more streamlined filing requirements as compared to that of other (re)insurers. Therefore, given consent through a section 56 directive in this regard, the Bermuda Statutory filing requirements will be waived for the purpose of the SPI's annual filings.

- 4.13.3. For the purposes of an SPI's L&A and ongoing reporting, and where the appropriate Section 56 request has been granted, the Authority will accept financial information prepared in accordance with any one of the following standards or principles—

- 4.13.3.1. International Financial Reporting Standards ('IFRS');
- 4.13.3.2. generally accepted accounting principles ('GAAP') that apply in Bermuda, Canada, the United Kingdom or the United States of America; or
- 4.13.3.3. such other GAAP as the Authority may recognise.

- 4.13.4. Approved audited financial statements will be due within four months of the accounting date.

- 4.13.5. It remains the responsibility of the Principal Representative under Section 8A of the Act to report immediately any condition which would jeopardise the ability of the SPI to remain in compliance.

## Appendix I

### Examples of SPI Transactions<sup>16</sup>

#### 1. Typical Insurance-Linked Securitisation Transactions

- (a) In these transactions an SPI is established for the purpose of entering into a single (re)insurance contract. In order to fund its obligations under that contract, the SPI will issue notes (the "Notes") to investors in an amount equal to its maximum liability under the (re)insurance contract.
- (b) The Notes will be limited recourse notes and provide that the SPI's obligation to pay interest and principal to the note holders diminishes by an amount equal to the amount the SPI pays under the (re)insurance contract.
- (c) The insurance company does not enter into any other business, save for ancillary agreements such as interest rate swaps on guaranteed investment contracts that ensure the interest can be paid on debt and other obligations.

#### 2. Catastrophic Risk (CAT) Bonds (Exhibits - Fig. 1)

- (a) CAT bonds are modeled on asset-backed-security transactions that have been executed for a wide variety of financial assets including mortgage loans, automobile loans, aircraft leases, and student loans. CAT bonds are part of a broader class of assets known as risk-linked bonds, which pay off on the occurrence of a specified event or events. Most risk-linked bonds issued to date have been linked to catastrophes such as hurricanes and earthquakes, although bonds also have been issued that respond to mortality events.
- (b) In these transactions an SPI may be established to allow that transaction to access the (re)insurance markets. Alternatively, a single transaction insurance company might be established to participate in a credit transformation, whereby the insurance company issues a single financial guarantee insurance policy and fully secures that contract by purchasing a matching credit default swap contract.

#### 3. Sidecars (Exhibits - Fig. 2)

- (a) Sidecars are SPIs typically formed by a single (re)insurance company to avail itself of additional capacity to write (re)insurance, usually for property catastrophes and marine risks. Sidecars typically serve to accept property catastrophe quota share or excess of loss retrocessions exclusively from a single reinsurer (sponsor) and sidecars generally have limited lifetimes.

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<sup>16</sup> Cummins, David J.  
Special Purpose Insurers  
Bermuda Monetary Authority  
March 2009

- (b) Most sidecars are capitalised by private investors such as hedge funds, but insurers and reinsurers also participate in this financing device. Sidecars receive premiums for the (re)insurance underwritten from the (re)insurance company sponsor and are liable to pay claims under the terms of the (re)insurance contracts.
- (c) In addition to providing capacity, sidecars also enable the sponsoring reinsurer to move some of its risks off-balance sheet, thus improving leverage.

#### 4. Dual Trigger Industry Loss Warranties

- (a) Dual Trigger ILWs are (re)insurance contracts which have a (re)insurance retention trigger based on:
  - i. the incurred losses of the insurer buying the contract as well as
  - ii. a warranty trigger based on an industry-wide loss index
- (b) As such the contracts pay off on the dual event that a specified industry-wide loss exceeds a particular threshold at the same time that the issuing insurer's losses from the event equal or exceed a specified amount.
- (c) Both triggers have to be hit in order for the buyer of the contract to receive a payoff. The issuing insurer thus is covered in states of the world when its own losses are high and the (re)insurance market is likely to enter a hard-market phase.
- (d) ILWs cover events from specified catastrophe perils in a defined geographical region. For example, an ILW might cover losses from hurricanes in the South Eastern U.S.
- (e) The term of the contract is typically one year.
- (f) ILWs may have binary triggers, where the full amount of the contract pays off once the two triggers are satisfied or pro rata triggers where the payoff depends upon how much the loss exceeds the warranty.
- (g) The principal advantages of ILWs are that they are treated as (re)insurance for regulatory purposes and that they can be used to plug gaps in (re)insurance programs. They also represent an efficient use of funds in that they pay off in states of the world where both the insurer's losses and industry-wide losses are high.
- (h) Capital market participants provide the majority of risk capital in the ILW market, just as they do in the CAT bond market. In addition, ILWs can be packaged and securitised, broadening the investor base.

## Appendix II

### Some Risks Inherent to SPI Activities<sup>17</sup>

#### 1. Basis Risk

- a. Basis Risk is the risk that the amount, timing or currency of the receipts resultant from a transaction fails to cover the expected losses subject to indemnity associated with the transaction.
- b. Types of Basis Risk include:
  - i. Trigger Risk – This risk addresses the possibility that the modelled recovery is less than the modelled portfolio loss when the contract is written typically with a non-indemnity trigger (see Appendix III – Examples of SPI Triggers).
  - ii. Timing Risk - This risk addresses the likelihood that the delay between the event date and the date of indemnification is longer than is likely in a traditional (re)insurance transaction
  - iii. Currency Risk – This risk addresses exchange rate movement from the date the transaction is entered into until the date the contract is completed and funds are disseminated.
  - iv. Model Risk – This risk captures the probability that the catastrophe model misestimates the impact of one or more catastrophic events. Parameter estimates which may be inaccurate include the event frequency, severity, location, and damage factor assumptions in catastrophe models.
  - v. Data Risk – These risks arise when portfolio data submitted for modelling analysis is incomplete or inaccurate.
  - vi. Operational Risk – This risk arises due to errors and omissions in the operations of key counterparties. Risks including law suits and contract cancellation exist if data quality leads to a claim of misrepresentation by investors or if funds are not prudently invested by investment managers.
  - vii. Liquidity Risk – This risk arises when assets are not suitably matched with liabilities.

#### 2. Tail Risk

- a. Tail Risk is the risk that actual losses exceed expected modelled losses in the tail of the assumed loss distribution utilised to model events assumed in the contract terms.
- b. Tail risk is typically associated with a reinsured's PML or TVaR and reflects the risk that actual losses exceed the estimated PML and/or TVaR.

### 3. Market Risk

- a. Market Risk addresses movement in financial market indicators from the date the transaction is entered into until the date the contract is completed and funds are disseminated. Sources of market risk include movements in equity prices, bond prices and interest rates.

### 4. Counterparty Credit Risk

- a. Counterparty Credit Risk addresses the risk that a counterparty will be unable to fulfil its financial obligations in a contract.

## Appendix III

### Examples of SPI Triggers<sup>18</sup>

#### 1. Indemnity Triggers

- a. Indemnity contract triggers mirror the actual losses of the reinsured and can be likened to a non proportional contract often with a commutation at the end of an extension period artificially imposed to allow the contract to have a legal final maturity.
- b. Risks arise within these contracts if the ultimate loss exceeds the loss estimated at the time of commutation.

#### 2. Non-Indemnity Triggers

- a. Non-Indemnity triggers are contract triggers which are not designed to mirror the actual losses of the reinsured. Examples of non-indemnity triggers include:
  - i. Modelled Loss
    1. Modelled loss triggers are evaluated according to whether modelled losses fall above a certain threshold.
    2. The modelled losses are calculated from an exposure portfolio designed to reflect as closely as possible the actual underlying portfolio and which is compatible with a specified catastrophe modelling software. When an event occurs, the event parameters are run against the exposure database in the CAT model to determine whether the contract is triggered.
    3. Risk within these contracts is a function of how accurately the notional portfolio matches that of the actual business written. Risks also arise due to the quality of the calibration of the modelling software.
  - ii. Parametric
    1. Parametric triggers are a type of non-indemnity trigger where loss payment is determined by a mathematical formula related to the quantifying characteristics of an event (e.g. earthquake magnitude and depth, or maximum wind speed).
    2. Risk within these contracts depends upon the granularity and appropriateness of the weights in the parametric index and the accuracy and availability of related sources (e.g. wind stations) which measure the event compared to the reinsured's modelled exposure.

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<sup>18</sup> Ratings Direct, September 12, 2008  
Special Purpose Insurers  
Bermuda Monetary Authority  
March 2009

iii. Industry Loss Warranty

1. Industry Loss Triggers (a.k.a. ILWs) are a non indemnity trigger activated when the insurance industry loss reaches a certain threshold.
2. Unless the reinsured is a well diversified national writer, covering major lines of business, there is significant risk that the payout from the SPI contract will not match the losses incurred.

## Appendix IV

### Quality Asset List<sup>19</sup>

Quality Assets shall consist only of:

- (a) cash
- (b) certificates of deposit (issued by a solvent entity domiciled within an Investment Grade Sovereign Nation (“IGSN”) (see “Interpretations” section above)
- (c) Investments of the following types:
  - i. Government obligations - Obligations which are not in default as to principal or interest, which are valid and legally authorised, and which are issued, assumed, guaranteed or insured by an IGSN or by any agency or instrumentality thereof.
  - ii. Obligations of IGSN entities.
    - a. Obligations which are issued by any solvent IGSN entity or which are assumed or guaranteed by any solvent IGSN entity and which are not in default as to principal or interest provided such obligations:
      - i. are adequately secured by collateral security having a market value not less than the principal amount thereof and have investment qualities and characteristics wherein the speculative elements are not predominant, or
      - ii. are rated BBB or higher (or the equivalent thereto) by a securities rating agency recognised by the Authority, or if not so rated, are similar in structure and in all material respects to other obligations of the same entity which are so rated, or
      - iii. are insured by one or more authorised insurance companies (other than the sponsoring insurer or any parent, subsidiary or affiliate of such insurer) who are licensed to insure obligations in an IGSN and, after considering such insurance, are rated BBB (or the equivalent thereto) by a securities rating agency recognised by the Authority
  - iii. Preferred or guaranteed shares issued or guaranteed by a solvent IGSN entity if all of the institution’s obligations are eligible as investments under item ii.a.ii. of this subsection.

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<sup>19</sup> These standards are in line with those of Regulation 114 Insurance Trusts found in US regulation  
Special Purpose Insurers  
Bermuda Monetary Authority  
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- iv. Equity interests
  - a. Investments in common shares or partnership interests of any solvent IGSN institution, if:
    - i. all its obligations and preferred shares, if any, are eligible as investments under i, ii. or iii above and
    - ii. such equity interests of any such entity are registered on a national securities exchange recognised by the Authority, provided that an SPI may invest under this paragraph an amount not exceeding five percent (5%), of the SPI's net asset value.
- v. Investment companies.
  - a. Securities of any investment company registered in an IGSN, if such company:
    - i. invests at least ninety percent of its assets in the types of securities which qualify as an acceptable investment pursuant to the provisions this subsection of paragraph i., ii., iii. of this subsection or which invest in securities which are determined by the Authority to be substantively similar to the types of securities set forth in such paragraphs; or
    - ii. invests at least ninety percent of its assets in the types of equity interests which qualify as a acceptable investment pursuant to the provisions of paragraph iv. of this subsection.

## Appendix V

### Insurance-Linked Securities

### Benefits of Exchange Listing<sup>20</sup>

The following have been cited as benefits to listing insurance-linked securities on a “recognised stock exchange”:

1. Exchange listing can provide regulators and investors with a greater degree of comfort in that the listed vehicle would be subject to international regulatory standards, including transparency and public dissemination of relevant information.
2. Increased standards of transparency ensure that existing and potential investors are given sufficient and timely information to enable them to make properly informed assessments in relation to the value and merits of the exchange listed vehicles.
3. Some investment in exchange listed instruments is often mandatory for larger investment structures, such as pension plans, which typically have fiduciary responsibilities to their ultimate investors. Many such plans limit their investment allocations in unlisted securities to ensure the efficacy of asset quality.
4. Trading through a recognised stock exchange provides access to increased liquidity for listed vehicles. This provides investors with a greater degree of flexibility to manage their investments in insurance-linked products either by increasing or decreasing their stakes as desired.

In support of Bermuda’s indigenous insurance industry, the Bermuda Stock Exchange (BSX) has created regulations to support the listing of insurance related products and operates and publishes the RG/BSX Bermuda Insurance Index which is a bell weather indicator of the market performance of those publicly listed insurance companies with mind and management in Bermuda

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<sup>20</sup> Contributed by the Bermuda Stock Exchange (BSX); [www.bsx.com](http://www.bsx.com). The BSX was established in 1971, and operates as an internationally recognised stock exchange and settlement platform in Bermuda with listings numbering over 650.

The BSX Official List is comprised of equity, debt, collective investment vehicles (including hedge funds), equity derivative warrants and specialised debt products such as catastrophe bonds.

**Appendix VI**  
**Sophisticated Participant**  
**Definition<sup>21</sup>**

“Sophisticated Participant” in the context of this Guidance means a Participant who satisfies one or more of the below criterion as found in the Investment Business (Exemptions) Order 2004:

- (a) high income private investors;<sup>22</sup>
- (b) high net worth private investors;<sup>23</sup>
- (c) sophisticated private investors;<sup>24</sup>
- (d) collective investment schemes approved by the Authority under the Bermuda Monetary Authority (Collective Investment Scheme Classification) Regulations 1998 or any provision of law amending or replacing such Regulations;
- (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);
- (h) partnerships, all of whose members fall within one or more of the subparagraphs of this paragraph, except subparagraph (d);

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<sup>21</sup> This definition mirrors that found in the Investment Business (Exemptions) Order 2004 (the “Order”) – Schedule – Exempted Persons, Part 1. As defined in the Order, parties are considered to be “sophisticated” if they have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment.

<sup>22</sup> Defined in the Order to mean 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; and "current year" means the year in which he purchases an investment;

<sup>23</sup> Defined in the Order to mean 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; and "net worth" means the excess of total assets at fair market value over total liabilities;

<sup>24</sup> Defined in the Order to mean 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.

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

In addition the Authority shall include in this list, any company quoted on a recognised Stock Exchange and 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.

**Appendix VII**  
**Special Purpose Insurers**  
**Frequently Asked Questions**

**1. What are the advantages to incorporating an SPI?**

Ceding entities obtain access to tailored, fully collateralised, (re)insurance capacity in a very cost effective structure.

Investors enjoy, amongst other things, the ability to invest in (re)insurance markets quickly, with readily available access to underwriting expertise, with expected high returns and with no need to set up infrastructure.

**2. How much will it cost to apply?**

There will be a one-off, non-refundable \$525 fee to process an application.

**3. Will there be any restrictions upon the realisation of Capital Relief Resultant from SPI Activities**

In line with the prudential reporting requirements contained within the Act, the Authority will allow a Bermuda (re)insurer to treat amounts recoverable from an SPI as:

- a relevant asset, or
- (re)insurance for the purposes of calculating its technical reserves, or
- as (re)insurance reducing its Enhanced Capital Requirement for companies subject to the Bermuda Solvency Capital Requirement (“the BSCR”) returns as prescribed by the Insurance (Prudential Standards Class 4 Solvency Requirements) Order 2008,

however only to the extent that the ceding re(insurer) can demonstrate its ability to quantify the impact of the SPI (re)insurance protection upon its modelled losses and its net loss reserves respectively.

Upon the request of the Authority, details should be made available evidencing that all residual risks associated with the SPI arrangement (including but not limited to basis, credit, market, liquidity and operational risks) are considered in modelled results.

**4. What is the significance of the “Sophisticated Participant” requirement in the SPI guidance?**

Underpinning this SPI Guidance Note is the Authority’s risk-based approach to regulation. In line with the minimal capital and solvency and other contractual requirements for SPIs, the parties engaged in the process will be expected to be adequately qualified to engage in this highly specialised and sophisticated business.

With the Sophisticated Participant stipulation and the requirement to fully fund the SPI, the Authority will be inclined to grant a Section 56 request, requiring less information

from an SPI during both the application and ongoing filing processes than conventional (re) insurers.

#### **5. What are the minimum capital requirements for SPIs?**

The Act stipulates that the minimum capital and surplus requirements for Special Purpose Insurers is \$1.

#### **6. What are the fully funded requirements?**

Guidance Note #20 of the Insurance Amendment Act 2008 (Special Purpose Insurers) includes guidance on the requirements for an SPI to be 'fully funded'. It includes rules applying to the SPI's assets and liabilities and its contractual arrangements which ensure the SPI remains fully funded.

To be fully funded, an SPI will be expected to:

- include terms in each contract of (re)insurance which bind all parties to the condition that the net asset value of the SPI will at all times exceed its aggregate liabilities;
- ensure that, under terms of any debt issues or other financing arrangement 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;
- enter only into contracts or otherwise assume obligations which are necessary for it to give effect to the (re)insurance special purpose for which it has been established; and
- ensure that, to the extent that more than one (re)insurance contract is in place within an SPI, each of the (re)insurance contracts is individually structured to meet the fully funded requirements for the SPI.

#### **7. Can (Re)insurance and other Contingent Assets be used for Collateral?**

The Authority recognises the numerous forms of proposed vehicles available to fully collateralise SPI vehicles. Notwithstanding the perceived security of many of these instruments, it will be the policy of the Authority to request a heightened level of disclosure where “contingent assets” are being proposed as a source of a SPI’s collateral base.

The Authority defines a “contingent asset” as an asset in which 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. Due to the uncertainty of the future events, these assets are not placed on the company’s balance sheet. These assets, such as outwards (re)insurance, may, however, be found in the company's financial statement notes.

Guidance Note #20 stipulates that where an SPI's (re)insurance liabilities are collateralised through a balance of "contingent assets" (i.e. (re)insurance, LOCs or other financial mechanisms such as swaps, contracts for differences or other debt mechanisms) the authority will expect the SPI to confirm that the said issuer of these assets has a rating of at least BBB+ as of the date of the application and as determined by a recognised rating agency.

In addition, the Issuer of any contingent asset will be expected to be a regulated financial institution subject to regulation by the BMA or a regulatory Authority considered to have equivalent standards.

This means that the Authority has established policy to recognise reinsurance and/or LOCs from appropriately regulated and rated institutions as acceptable instruments for inclusion in the collateral structures of SPIs.

It should be noted, however, that the Authority expects full disclosure of the contingent nature of these instruments to all Participants.

**8. How does the Authority ensure that the funds held by the SPI will be solely available to pay losses of the reinsured and that no unrelated participant will be indemnified from the SPI fund?**

The Act stipulates that one measure of the efficacy of a SPI is whether the insurer is "solely" insuring or reinsuring one or more risks or group of risks with one or more policyholders.

This provision is intended to address the "risk sharing" characteristics of SPI structures utilising language which assures that there is no opportunity for the co-mingling of liabilities amongst unrelated (re)insured parties.

This clause is established to ensure no ambiguity in the extent of the fully collateralised requirement of an SPI and no question as to the availability of the entirety of the "fund" to a single policyholder or related policyholder group.

**9. How will the Authority ensure that the SPI remains solvent?**

The approved Principal Representative of the SPI will be required to ensure that at all times the net assets (including contingent assets) of the SPI are equal to or greater than its liabilities where these liabilities are valued according to Generally Accepted Accounting Principles (GAAP) or another approved internationally recognised accounting standard.

At the time of application, the applicant will be required to validate the entries in the pro-forma balance sheet of the SPI showing, at a minimum, its expected position at inception.

In addition the projected position of the SPI at 12 months after inception should also be presented.

## **10. What will be the filing requirements for SPIs?**

Where the appropriate Section 56 request has been granted to an applicant, Bermuda Statutory filing requirements will not be required for the purpose of the annual filings for an SPI. In such instances, the Authority will accept financial information prepared in accordance with any one of the following standards or principles—

- International Financial Reporting Standards ('IFRS');
- generally accepted accounting principles ('GAAP') that apply in Bermuda, Canada, the United Kingdom or the United States of America; or
- such other GAAP as the Authority may recognise.

For the purpose of annual filings, audited GAAP financial statements within four months of the accounting date will be required.

## **11. What are the requirements for companies already involved in SPI related activities?**

Existing companies established with “fully collateralised” (re)insurance contracts or companies already engaged in SPI related activity will not be required to re-register as SPIs.

Should any entity wish to avail themselves of this new category of registration, the company should make application to the Authority for a change of class through the standard L&A procedures.

All existing regulatory approvals related to existing “fully collateralised” (re)insurance entities, including but not limited to section 56 directions, relevant asset approvals and other fixed capital approvals shall remain in force.

As ongoing policy demands, the Authority shall review prior approvals to ensure that said approvals remain appropriate. Should the Authority deem any previously granted approval to fall outside of the SPI guidance, the Authority shall consult with the applicant prior to amending or voiding said approval.

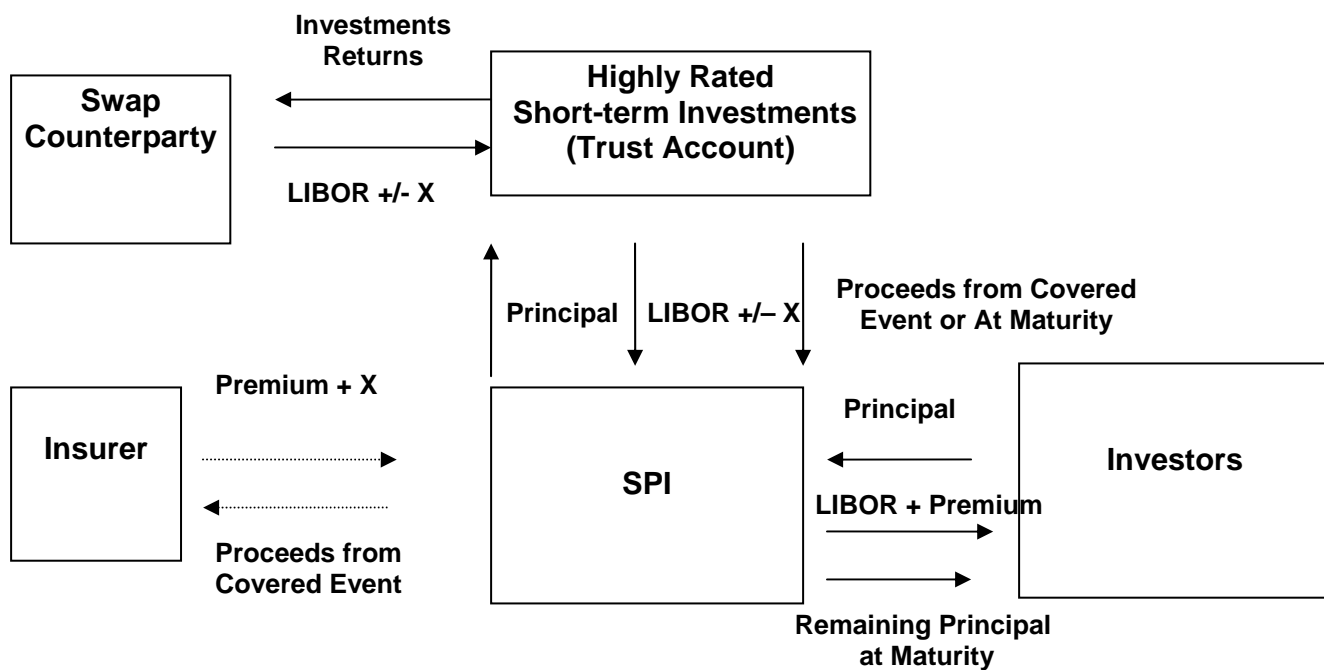
## **13. How much will it cost to register?**

A fee of \$10,000 will be assessed annually.

## **14. When does the application process for SPIs begin?**

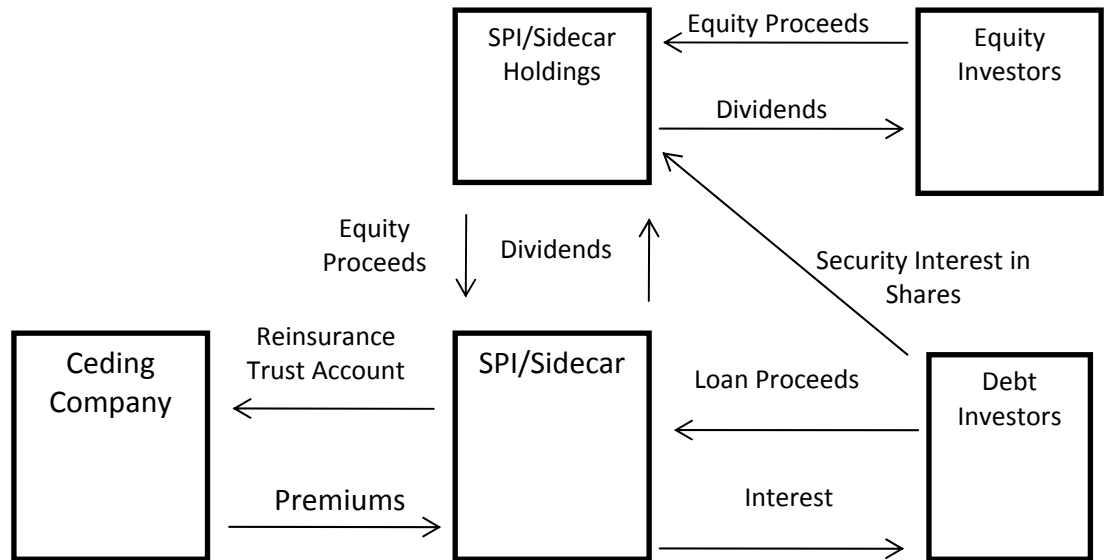
With the passage of the “Amendment Act” on 30th July, 2008, applications for “SPIs” are currently being accepted.

# Figure 1 Typical CAT Bond with SPI



Source: Cummins, David J.

# Figure 2 Typical Sidecar Structure



Source: Horseshoe Group