BMA
BERMUDA MONETARY AUTHORITY

17th July 2018

Dear Stakeholders:

Re: Bermuda Solvency Capital Requirement (BSCR) Update Proposals - November 2017 and March 2018 and Associated Trial-Run Exercises

I. Introduction

The Bermuda Monetary Authority (the Authority) would like to thank stakeholders for their continued support of our key initiatives. The Authority appreciates the feedback received and is committed to working closely with its stakeholders to ensure that Bermuda's regulatory regime is effective and aligned with international standards.

On 30th November 2016, the Authority issued a Consultation Paper on a series of potential adjustments to the BSCR standard formula. Responses to industry comments were provided in our "Response to Industry Comments – Bermuda Solvency Capital Requirement Update Proposal, November 2016" posted on 15th March 2017.

On 15th March 2017, the Authority issued a revised version of the Consultation Paper taking into account market feedback and conducted a field testing exercise of the proposals therein contained. A summary of the main findings of the trial-run exercise was provided in our "Findings of the Trial Run Exercise – Bermuda Solvency Capital Requirement Update Proposal, March 2017" posted on 30th November 2017.

On 30th November 2017, the Authority issued a new Consultation Paper that further updated the March 2017 Consultation Paper and introduced additional adjustments with the ultimate goal of further increasing the risk sensitivity of the BSCR standard formula and better reflecting how insurers manage risks. The Authority also carried out a round of field testing on the proposed adjustments to the BSCR standard formula in the fall of 2017 using financial figures as of 31/12/2016.

On 31st March 2018, the Authority re-issued the referred November 2017 Consultation Paper taking into account consultation feedback and the results of the trial-run exercise using financial data as of 31/12/2016. Alongside the Consultation Paper, the Authority also republished the associated BSCR models and draft rules. The Authority conducted a final round of field testing on the proposed changes in the spring of 2018 using financial figures as of 31/12/2017.

This letter provides a summary on the feedback from the last two consultation documents and the last two rounds of trial-run and resulting actions.

II. Main comments received from the BSCR Update Proposals - November 2017 and March 2018

Interest rate risk and management actions

November 2017 Proposal

Stakeholders raised concerns about the magnitude of interest rate shocks under the proposed alternative shock based approach for interest rate and liquidity risk, particularly the downward shock for currencies experiencing low or negative interest rates, and the treatment of the Long-Term Forward Rate (LTFR) and the process for updating the shocks. Stakeholders also provided suggestions on how to apply the shock based approach for insurers using the so called "scenario based approach" to determine the Best Estimate Liability (BEL). Additionally, Stakeholders requested that the current duration based method be enhanced to be viewed more consistent with the alternative shock based method. Some stakeholders also requested the publication of discounting yield curves for the Hong-Kong Dollar (HKD). Stakeholders requested that market risk related capital requirements be determined after considering management actions, including where the insurer is calculating the interest rate risk capital charge using the duration based approach. Lastly, some Stakeholders did not feel it appropriate to confine allowance for management actions to only those actions that adjust non-guaranteed benefits.

The Authority, taking into account the feedback provided by Stakeholders and the results of the trial-run exercise using financial data as of 31/12/2016, revised in the March 2018 consultation document the downward interest rate risk shocks and the treatment of the LTFR for the shock based approach for interest rate and liquidity risk; provided further guidance and tested alternatives for the application of the shock based approach for insurers using the scenario based approach to determine the BEL; and tested a modified duration based approach. The Authority also started publishing discounting yield curves for the Hong-Kong Dollar (HKD).

March 2018 Proposal

Stakeholders welcomed the changes made to the shock based approach but still raised concerns regarding the magnitude of interest rate shocks and the treatment of the LTFR and the process for updating the shocks and reaffirmed their suggestions on the application of the shock based approach for insurers using the scenario based approach to determine the BEL and on the treatment of management actions. Stakeholders were unsupportive of the proposed modified duration based approach and highlighted the need for further study and testing if the duration based approach is to be changed.

Other

November 2017 Proposal

Stakeholders requested that the proposed treatment for the deferred tax assets and the risk mitigating effect of deferred taxes to be brought forward to the financial year commencing in 2018 due to the significant tax changes driven by factors outside Bermuda's influence. The Authority found the request reasonable, namely agreeing that the proposed treatment is more risk sensitive and reflective of best supervisory practices, and amended the March 2018 consultation document accordingly.

Some stakeholders requested additional clarification on the application of the look-through criteria and made minor suggestions of changes to the criteria which the Authority found mostly reasonable and amended the March 2018 consultation document to the extent considered appropriate.

Stakeholders also requested refinements to the grandfathering of equity risk charges and allowance for risk mitigation approaches but the Authority believed the proposal in the consultation document to be reasonable and in line with supervisory best practices and has kept them unchanged in March 2018 consultation document.

March 2018 Proposal

Stakeholders requested clarification on the calculation of the operational risk charge, namely that it should be applied after consideration of the risk mitigation effect of management actions (by reducing liabilities for future bonuses or other discretionary benefits).

Stakeholders also requested minor changes to the definition of strategic holdings for the purposes of calculating the equity risk charge to make it more in line with international accounting standards.

III. Findings of the Associated Trial-Run Exercises

The Authority received nearly 50 trial-run submissions in the associated November 2017 proposal trial-run exercise (using financial data as of 31/12/2016) and over 100 trial-run submissions in the associated March 2018 proposal trial-run exercise (using financial data as of 31/12/2017) across different classes of insurers and business models. The quality of both submissions was generally good which meant industry understood the main aspects of proposals being tested. Overall, the representative sample received has enabled the Authority to extract meaningful conclusions from the exercises, particularly from the last one.

Results for both trial-run exercises were broadly in line with *a priori* expectations namely in terms of main drivers and impact. While the effect of the proposals varied based on specifics of the risk profile and business model, the Authority has nevertheless concluded the following:

- The modified duration based approach for interest rate and liquidity risk did not produce reasonable results and was not found fit for purpose. The remaining conclusions presented are therefore based on the shock based approach or the current duration based approach as selected by the trial-run participants.
- The proposed changes are unlikely to cause significant market solvency issues although they will cause Enhanced Capital Requirement (ECR) ratios to moderately decrease and may cause solvency issues on a very limited number of already thinly capitalised insurers; the introduction of phase-in and grand-fathering provisions further smooths the impact of the proposals and allows insurers sufficient time to adapt to the new changes without undue market disruption.
- The variability around results and the number of outliers has decreased on the associated March 2018 proposal trial-run exercise when compared to previous trial-run exercises.
- The main drivers of the results were the changes to dependencies followed by equity risk.
- The impact of the proposed changes on operational risk, multi-year insurance contracts, and concentration risk have reduced when compared to previous trial-run exercises but were still noticeable for a few selected insurers.
- The changes made to the shock based approach for interest rate and liquidity risk moderated to some extent the impact of the downward shock for currencies experiencing low interest rate environments.

IV. Actions Taken Based on the Industry Feedback and Trial-Run Exercises

Having in due regard the feedback received from stakeholders on the proposed changes and the results from the trial-run exercises, the Authority concluded that the BSCR Update Proposal March 2018 forms a sound basis for changing the BSCR standard formula and decided to proceed with the proposed changes with minor amendments, namely:

- The current duration based approach for interest rate and liquidity risk will remain unchanged at this stage. It is a simple approach with well-known advantages and limitations. Insurers will have the option of continuing with the duration-based BSCR method or moving to the proposed shock-based method. However, once in the proposed shock-based method insurers will not be able to revert back to the duration based method without prior supervisory approval. The Authority will further consider the process and frequency of updating the interest rate shocks.
- Minor changes to the definition of strategic holdings for the purposes of calculating the equity risk charge to make it more in line with international accounting standards.
- Extension of grandfathering of equity charges to the concentration risk calculation.
- Additional clarification on the calculation of the operational risk charge, namely that it should be applied after consideration of the risk mitigation effect of management actions (by reducing liabilities for future bonuses or other discretionary benefits).

The final version of the new rules was published on 17th July 2018. The new rules will enter into force on 1st January 2019 notwithstanding grade-in provisions. They will apply (as applicable) to all Classes of insurers in the so called “commercial regime”, i.e. Class 3A, Class 3B, Class 4, Class C, Class D, Class E and Groups.

We also draw the attention of stakeholders to the fact that not all provisions presented on the BSCR Update Proposal March 2018 will be transposed under the form of rules. The following provisions will be transposed under the form of instructions or guidance to be included in the respective upcoming BSCR Handbooks:

- Look-through.
- Management actions.
- Risk mitigation.
- For equity risk:
  - Definition of “strategic holding”.
  - Definition of “infrastructure”.
  - Definition/list of “Bermuda approved stock exchange or any exchange set out under instructions”.
  - Definition of “selected mutual funds” in “equities listed on developed markets and selected mutual funds”.
  - Definition of “qualifying unlisted equity investments”.
- Aspects of the application of the shock-based approach to interest rate and liquidity risk for insurers using to scenario-based approach to BEL calculation.

The Authority would like to thank stakeholders for their comments on the BSCR Update Proposals, November 2017 and March 2018 and for their participation in the associated Trial-Run Exercises, and we remain committed to working with the industry and other interested parties to ensure that results achieved are in the best interest of the Bermuda market.

Yours sincerely,

Bermuda Monetary Authority