28 July 2023

STAKEHOLDER LETTER

Re: Consultation Paper – Updates to *"Proposed Enhancements to the Regulatory Regime and Fees for Commercial Insurers"*

The Bermuda Monetary Authority (Authority or BMA) would like to thank its stakeholders for their continued engagement and support in furthering the Bermuda regulatory framework's developments and critical strategic initiatives. On 24 February 2023, the Authority issued a Consultation Paper – *Proposed Enhancements to the Regulatory Regime and Fees for Commercial Insurers* (CP1). The Authority appreciates all feedback received on CP1 and is committed to working closely with its stakeholders to ensure that Bermuda's regulatory regime is effective, proportionate and aligned with international standards.

This letter provides a summary of the key substantive feedback on CP1 that the Authority received from several stakeholders and the responses to these comments, which are included in the updates to the second version of the consultation paper (CP2).

RESPONSE TO INDUSTRY FEEDBACK

I. Enhancements to Regulatory Regime

A. Technical Provisions

Risk Margin

Feedback Received:

Industry stakeholders raised concerns about the theoretical soundness of the proposals and the operational burden it would impose on insurers. While the stakeholders understood the Authority's motivation for proposing the changes, they believed that calculating the risk margin on an unconsolidated basis is technically incorrect because such a calculation ignores diversification and thereby overstates the cost of capital. They argued that the proposals could reasonably be applied in jurisdictions where all legal entities within an insurance group are already required to calculate risk margins which could readily be aggregated for group reporting, but this is not the case for Bermuda groups that have several subsidiaries in diverse jurisdictions with varying requirements for economic balance sheet or technical provision calculations. The stakeholders also stressed that the proposals would place an additional operational burden on Bermuda groups with no discernible improvement in policyholder protection.

BMA Response/Action:
The Authority understands the stakeholders' concerns regarding the operational burden, which may be accentuated by the short implementation timelines. The Authority will, therefore, continue to engage with industry to find ways to reduce the operational burden, particularly for the first few years post-implementation.

Scenario Based Approach (SBA)

Feedback Received:
A broad range of feedback on the SBA was received from stakeholders. For much of the feedback, stakeholders sought clarity and certainty on the Authority's criteria and process for approving insurers to use the SBA. Stakeholders observed that the proposals in CP1 suggest that new deals will be subject to an SBA approval process prior to deal closing; thus, they requested the Authority to outline a clear set of criteria to achieve SBA eligibility for deals considering the dynamic and time-sensitive nature of new deal processes. They also raised concerns that the SBA eligibility criteria may lead to some deals not qualifying for SBA at the deal close. They argued that in some situations, the new business modelling processes might not have the level of granularity required for SBA approval but would nevertheless capture the risks appropriately.

Other areas where stakeholders sought clarity from the Authority include how to demonstrate that model simplifications produce a more prudent Best Estimate Liability (BEL); how the SBA eligibility assessment will be implemented for existing legal entities with reinsurance flow contracts that include business written pre- and post 1 January 2024; what actions would be taken should a firm fail the stress tests relating to lapse risk; clarity on the ultimate goal and use of the results of the lapse stress tests in the SBA application process; guidance on the Authority's expectation of Chief Executive Officer, Chief Risk Officer, Chief Information Officer, Chief Internal Auditor and Chief Actuary attestations; clarifying the 'grey' areas around the treatment of affiliated business, the treatment of derivatives and definitions of blocks of business and fungibility; and addressing the apparent double counting of lapse conservatism (Lapse Provision for Adverse Development vs Lapse BSCR).

Stakeholders also noted that in view of the changes contemplated in CP1, it would be important that the BMA is sufficiently resourced to provide a quick turnaround on SBA applications. As currently drafted, CP1 introduces uncertainty regarding both the timeline and outcome of the SBA eligibility process, particularly as it relates to the execution of new reinsurance agreements, which is concerning because the pricing of such agreements requires reasonable certainty about the level of reserves and capital that will be required to support the business.

In another area of feedback related to modelling challenges, stakeholders highlighted that while sophisticated actuarial models exist that can perform the SBA using granular projections for both assets and liabilities, it is not always possible to calibrate the models to replicate 'real world' management of a business fully and accurately. There are also general model limitations. Some of the proposed enhancements may be overly complex, prescriptive and difficult to implement inside an actuarial model, thus elevating model risks without a significant impact on the overall calculation. The model validation section of CP1 requires all SBA models to be validated before their use, which may be impractical during a 'live' transaction involving a new product type. Moreover, stakeholders believed that it may be inappropriate to model blocks of liabilities separately as this has the potential of violating the Authority's principles-based approach.

BMA Response/Action:
The Authority has noted and considered all the feedback received and engaged extensively with industry. This process of engagement will continue. The main revisions to CP1 include the following:

Section 2.2 (SBA Approval) – The Authority's original proposal in CP1 required existing entities already using the SBA to obtain prior approval from the BMA for all new insurance policies written post-implementation. The revised proposal in CP2 requires BMA's prior approval where there are material changes to the existing entities' SBA model. Additionally, the SBA models that are in use by existing insurers are currently and will continue to be subjected to appropriately tailored in-depth supervisory review processes. The information to include in the application package has been outlined in greater detail.

Section 2.4 (Lapse Risk) The Authority has renamed the Base Lapse Adjustment (BLA) to Lapse Cost (LapC) to better reflect the intended outcome and rationale for introducing the proposal, which is to assign a specific cost to lapsable products within the SBA. CP2 further provides a methodology to calculate the LapC, which shall be required to meet SBA eligibility, noting that insurers can use other approaches, provided the other approaches are shown to be prudent. The proposed methodology is expected to reduce modelling complexity as insurers will not need additional model runs as previously implied by CP1.

Section 2.7 (Default and Downgrade Costs) – For insurers seeking to use assets for which the BMA has not published the default and downgrade costs, the Authority has provided examples of limited cases where the BMA shall consider varying the required criteria (i.e., where an insurer has a BMA approved internal model or a BMA approved internal rating approach is in place).

Section 2.11 (Ring-Fencing Assets backing the SBA/BEL) – The Authority underscored the fact that the SBA uses the actual portfolio of specific assets assigned to back specific liabilities being valued under the SBA. As such, assets shall not be used or pledged for any purpose other than meeting the policyholder liabilities for which the assets are assigned. Insurers shall establish adequate controls to ensure that assets backing the SBA liabilities are only exposed to and used to meet payment of the liabilities being valued under the

SBA. The assets assigned to back the liabilities being valued under the SBA cannot be used to cover losses arising from other activities of the insurer.

Section 2.17 (Accountability) – To clarify the responsibilities of the internal audit function over the SBA model risk management, the Authority has outlined its expectation of the Chief Internal Auditor (CIA) to review SBA model(s) as part of CIA's regular program of assessing the effectiveness of an insurer's risk management program. While the Authority will not require an annual attestation from the CIA, it will monitor the activities of the CIA and the internal audit function relating to SBA model risk management. The Authority will require holistic annual regulatory reporting of the SBA model risk management activities, including any activities conducted by internal audit.

Standard Approach

Feedback Received:
Stakeholders were generally understanding and supportive of the proposal to adjust Euro-denominated (EUR) discount curves for the Standard Approach to match those published by EIOPA because the Solvency II calibration of discount curves is well-known.

BMA Response/Action:
The Authority has noted the feedback received. No significant changes are envisaged in the foreseeable future unless there are material international regulatory developments that prompt the Authority to reconsider its approach.

B. BSCR Computation

Long-Term Lapse and Expense Risk

Feedback Received:
Stakeholders generally agreed with the Authority's intention to introduce explicit risk-sensitive capital charges for lapse and expense risk to better reflect these risks in the Bermuda Solvency Capital Requirement (BSCR) framework. However, concerns were raised regarding the specific proposals in CP1. Stakeholders considered the total impact of the mass lapse proposals as being excessive, given there would be a direct impact through an increase in the BSCR and an additional knock-on impact in the risk margin calculation, effectively resulting in double counting of capital in their view. Stakeholders sought a better understanding of the rationale for the 'floor' applied to the mass lapse shock, noting that given the wide range of products available in the Bermuda reinsurance market, a 'one-size-fits-all' floor is a blunt instrument that could result in a capital requirement that would be disproportionate to the risk. Stakeholders believed that the proposal for the mass lapse shock to apply without offsets between homogeneous groups of policies is also overly conservative. Stakeholders understood that a premise of the mass lapse risk charge is a crisis of confidence that causes a 'run-on-the-bank' type of scenario but cautioned that a run-on-the-bank scenario is rare for insurance companies. Compared with other regimes, the combination of 'Option 2' lapse rates and no offset could potentially result in a more onerous mass lapse risk charge. Moreover, the approach currently proposed for lapse risk

could lead to significant volatility in capital requirements as economic environments change (particularly during periods of changing interest rates and credit spreads).

Stakeholders opined that lapse risk charges may create an incentive to write low-lapse products that include surrender charges and market value adjustments and disincentivise long-duration protection-type businesses. This could reduce overall diversification in the Bermuda market. Stakeholders referenced the partial internal model route available for lapse risk and sought clarification of the BMA's expectations/requirements for the partial internal model approach.

Regarding the expense risk, stakeholders requested that the underlying derivation and calibration of the expense risk capital rates be made transparent to industry participants. Stakeholders also considered the use of duration-dependent expense inflation assumptions as operationally complex; thus, simpler alternatives should be considered.

BMA Response/Action:
Section 4.1 (Separate Identification of Lapse and Expense Risk) includes clarification on the application of long-term insurance risk charges within the risk margin calculation. In section 4.2 (Lapse Risk), following a review of the feedback and field-testing data received, the Authority made further refinements to its approach to initial proposals in CP1 for lapse risk charges. The Authority recognises that lapse risk has a time-sensitive liquidity dimension. As part of the Authority's wider supervisory oversight of mass lapse risk, the Authority proposes to introduce additional prudential requirements with significant attention and focus on adequate liquidity to support adverse lapse scenarios. This is in recognition of the fact that mass lapse is better managed by assessing both the solvency and liquidity resilience of insurers.

<u>Property and Casualty Catastrophe Risk</u>

Feedback Received:
The Authority received a range of feedback from industry stakeholders on the proposal for the BSCR Catastrophe Risk module to be enhanced with the inclusion of a dedicated man-made catastrophe risk submodule. The stakeholders observed that the introduction of the man-made catastrophe risk charge would, in general, increase the capital requirement for P&C (re)insurers, but they recognised that the current lack of a dedicated man-made catastrophe risk submodule is inconsistent with other internationally recognised insurance capital models. The stakeholders noted that BMA's proposed scenarios are aligned with the International Association of Insurance (IAIS) Insurance Capital Standards (ICS) where applicable and Solvency II (SII) Solvency Capital Requirement (SCR) in cases where no specific IAIS ICS scenarios exist. When scenarios are present in both capital regimes, the industry appreciated that both have their own merits and limitations, but there was a preference for closer alignment to the Solvency II SCR catastrophe scenarios. This preference mainly stemmed from the industry's higher level of familiarity with the Solvency II SCR catastrophe scenarios. The stakeholders appreciated the BMA's proposal to phase in the man-made catastrophe charges over a three-year period (starting with year-end 2024 reporting).

BMA Response/Action:

The Authority, in response, revised the Terrorism Catastrophe scenario to be in line with the Solvency II SCR fire scenario and introduced the Solvency II Credit and Surety scenario as an alternative option to the already proposed ICS Credit & Surety scenario. Additionally, in line with feedback provided by the market, the Authority extended the time horizon of the ICS mortgage stress scenario and enabled an explicit allowance for outward reinsurance for the ICS Trade Credit stress scenario.

C. Section 6D Enhancements

Feedback Received:

The Authority did not receive material feedback on the proposals in this section of CP1.

BMA Response/Action:

No material revisions are proposed in this section of CP2.

II. Proposed amendments to Long-Term Entity Fees

Feedback Received:

The industry feedback on the fees was broadly supportive with stakeholders acknowledging the need for the Authority to revise fees to meet the necessary cost of effective supervision given the increasing complexity and diversity of Bermuda insurers' long-term business models. Some concerns were noted around the magnitude of the fee increase with a request for a transitional period. Additionally, it was noted that there are some entity-specific circumstances that could necessitate a fee modification.

BMA Response/Action:

The Authority is agreeable to a three-year transitional/phase-in period for the annual business fees. In addition, the Authority will consider fee amendment requests on a case-by-case basis, as provided for under Section 14(10) of the Insurance Act; further guidance on this shall be provided.

The Authority is not re-consulting on the fee proposals in CP2. Please see the appendix for an outline of the anticipated fees.

III. Expected Impact of Proposals

The Authority received nearly 50 trial-run submissions across different classes of insurers and business models. The quality of submissions was generally acceptable, which meant industry understood the main aspects of the proposals being tested. Overall, the sample is representative and has enabled the Authority to extract meaningful conclusions notwithstanding the normal limitations associated with these exercises.

The results 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:

- At the market level, the proposed changes will have a moderate negative impact on the solvency position of long-term insurers and a small negative impact on the solvency position of P&C insurers. The proposed changes are thus unlikely to cause significant market solvency issues given the healthy capitalisation levels of the Bermuda market
- The standalone impact of the changes to the long-term lapse risk capital charges is expected to be fairly material, but the impact on the overall capital requirements is more contained as risks are aggregated and diversification benefits are applied
- The standalone impact of the changes to the P&C capital charges is expected to be moderate, but the impact on the overall capital requirements will be small as risks are aggregated and diversification benefits are applied
- The proposed changes appear to have a small to moderate negative impact on capital and surplus. The best-effort nature of the submission may have led insurers to assume simplifying and/or optimistic assumptions. We expect the actual (negative) impact to be higher
- The benefit of the transitional arrangements is more material for long-term insurers due to the phasing-in period being longer

The Authority would like to thank stakeholders for their feedback and remains committed to working with stakeholders and other interested parties to ensure optimal protection for policyholders and ensuring that the results achieved are in the best interest of the Bermuda market. Any stakeholder who wishes to seek further clarification or additional information on these matters should contact the Authority directly at riskanalytics@bma.bm.

Sincerely,

The Bermuda Monetary Authority

Appendix: Recommended Amendments to the Fees

I. Applications for renewal under section 6D of the Insurance Act 1978.

	Applying:		
		Subsequent renewal of adjustment to the enhanced capital requirement or available statutory capital and surplus or available statutory economic capital and surplus (where there are no major changes from the initial application) by changing certain capital factor charges in the BSCR under section 6D:	
		(i) To renew adjustment under route one: simple adjustment	$10,000
		(ii) To renew adjustment under route two: simple-complex adjustment	$10,000
		(iii) To renew adjustment under route three: complex adjustment	Assessed on a case-by-case basis per the following formula: [0.0005*(Capital requirement without the 6D approval – capital requirement with the 6D approval)], subject to a minimum of $10,000 and a maximum of $100,000
		Note: Applications made hereunder shall be subject to a sliding scale fee payment as determined by the Authority having regard to the scope and complexity of the review and the expected solvency impact of the application. Renewal fees are payable annually.	

II. Fees related to the supervision of the use of an internal scenario-based approach model.

	Applying:			
		Application for review and approval of a scenario-based approach model made under the provisions of a Rule made under section 6A. Note: Applications made hereunder shall be subject to a sliding scale fee payment as determined by the Authority, having regard to the structural complexity of the scenario-based approach model, the scale and complexity of assets or liabilities covered by the scenario-based approach model, or any other item deemed relevant by the Authority.		One-time fee assessed on a case-by-case basis per the following formula: [0.0005*(BEL using Standard Approach – BEL using SBA)], subject to a minimum of $120,000 and a maximum of $1,500,000
		Annual fee for monitoring of an approved scenario-based approach model made under the provisions of a Rule made under section 6A		$250,000
		Application for approval of a scenario-based approach model made under the provision of a Rule made under section 6A for:		
		(i)	initial approval for the use of 258E assets in Best Estimate Liability (BEL) calculation	max [$10,000, 0.0005 *(Vanilla SBA BEL – SBA BEL with 258E)]
		(ii)	annual renewal of approval for the use of 258E assets in Best Estimate Liability (BEL) calculation Note: Vanilla SBA BEL=BEL without 258E	$10,000

		(iii) initial approval of use 258F assets in Best Estimate Liability (BEL) calculation	max [$10,000, 0.0005 *(Vanilla SBA BEL – SBA BEL with 258F)]
		(iv) annual renewal of approval for the use of 258F assets in Best Estimate Liability Calculation	$10,000
		Note: Vanilla SBA BEL=BEL without 258F	
		(v) Use of insurer-specific default cost assumptions	$15,000
		(vi) Renewal of approval for the use of insurer-specific default cost assumptions	$10,000
		Note: The renewal fee for the use of insurer-specific default cost assumptions will be payable every two years.	
		(vii) For any other application for post-approval adjustment to the scenario-based approach model	$20,000

III. Enhanced registration fees for Class C, D and E insurers.

	Registering as an:		
	(a)	Insurer:	
		Class C insurers, except those carrying on domestic business only, where total assets are expected to:	
		(A) Not exceed $50 million	$50,000
		(B) Exceed $50 million but not exceed $150 million	$75,000
		(C) Exceed $150 million but not exceed $350 million	$150,000

		(D) Exceed $350 million but not exceed $1 billion	$210,000
		(E) Exceed $1 billion but not exceed $3 billion	$270,000
		(F) Exceed $3 billion but not exceed $5 billion	$380,000
		(G) Exceed $5 billion	$430,000 + 0.001% for assets above $5 billion
		Class D insurers, except those carrying on domestic business only, where total assets are expected to:	
		(A) Not exceed $500 million	$270,000
		(B) Exceed $500 million but not exceed $1 billion	$300,000
		(C) Exceed $1 billion but not exceed $3 billion	$350,000
		(D) Exceed $3 billion but not exceed $5 billion	$380,000
		(E) Exceed $5 billion	$430,000 + 0.001% for assets above $5 billion
		Class E insurers, except those carrying on domestic business only, where total assets are expected to:	
		(A) Not exceed $500 million	$270,000
		(B) Exceed $500 million but not exceed $1 billion	$300,000
		(C) Exceed $1 billion but not exceed $3 billion	$350,000
		(D) Exceed $3 billion but not exceed $5 billion	$380,000

		(E) Exceed $5 billion	$430,000 + 0.001% for assets above $5 billion
		Class C insurer carrying on domestic business only, where total assets are expected to:	
		(A) Not exceed $150 million	$25,000
		(B) Exceed $150 million but not exceed $350 million	$28,000
		(C) Exceed $350 million but not exceed $2 billion	$31,000
		(D) Exceed $2 billion but not exceed $5 billion	$61,000
		(E) Exceed $5 billion but not exceed $10 billion	$65,000
		(F) Exceed $10 billion	$100,000
		Class D insurer carrying on domestic business only, where total assets are expected to:	
		(A) Not exceed $750 million	$75,000
		(B) Exceed $750 million	$80,000
		Class E insurer carrying on domestic business only, where total assets are expected to:	
		(A) Not exceed $1 billion	$95,000
		(B) Exceed $1 billion but not exceed $5 billion	$114,000
		(C) Exceed $5 billion but not exceed $10 billion	$152,000
		(D) Exceed $10 billion	$190,000

IV. Enhanced annual business fees phased over three years for Class C, D and E insurers.

	Annual fee under section 14(2) payable by an:				
	(a)	Insurer:	Year 2024	Year 2025	Year 2026
		Class C insurers, except those carrying on domestic business only, where total assets are expected to:			
		(A) Not exceed $50 million	$30,000	$40,000	$50,000
		(B) Exceed $50 million but not exceed $150 million	$45,000	$60,000	$75,000
		(C) Exceed $150 million but not exceed $350 million	$90,000	$120,000	$150,000
		(D) Exceed $350 million but not exceed $1 billion	$126,000	$168,000	$210,000
		(E) Exceed $1 billion but not exceed $3 billion	$162,000	$216,000	$270,000
		(F) Exceed $3 billion but not exceed $5 billion	$228,000	$304,000	$380,000
		(G) Exceed $5 billion	$258,000 + 0.001% for assets above $5 billion	$344,000 + 0.001% for assets above $5 billion	$430,000 + 0.001% for assets above $5 billion
		Class D insurers, except those carrying on domestic business only, where total assets are expected to:			
		(A) Not exceed $500 million	$162,000	$216,000	$270,000
		(B) Exceed $500 million but not exceed $1 billion	$180,000	$240,000	$300,000
		(C) Exceed $1 billion but not exceed $3 billion	$210,000	$280,000	$350,000

		(D) Exceed $3 billion but not exceed $5 billion	$228,000	$304,000	$380,000
		(E) Exceed $5 billion	$258,000 + 0.001% for assets above $5 billion	$344,000 + 0.001% for assets above $5 billion	$430,000 + 0.001% for assets above $5 billion
		Class E insurers, except those carrying on domestic business only, where total assets are expected to:			
		(A) Not exceed $500 million	$162,000	$216,000	$270,000
		(B) Exceed $500 million but not exceed $1 billion	$180,000	$240,000	$300,000
		(C) Exceed $1 billion but not exceed $3 billion	$210,000	$280,000	$350,000
		(D) Exceed $3 billion but not exceed $5 billion	$228,000	$304,000	$380,000
		(E) Exceed $5 billion	$258,000 + 0.001% for assets above $5 billion	$344,000 + 0.001% for assets above $5 billion	$430,000 + 0.001% for assets above $5 billion
		Class C insurer carrying on domestic business only, where total assets are expected to:			
		(A) Not exceed $150 million	$25,000		
		(B) Exceed $150 million but not exceed $350 million	$28,000		
		(C) Exceed $350 million but not exceed $2 billion	$31,000		
		(D) Exceed $2 billion but not exceed $5 billion	$61,000		

		(E) Exceed $5 billion but not exceed $10 billion	$65,000	
		(F) Exceed $10 billion	$100,000	
		Class D insurer carrying on domestic business only, where total assets are expected to:		
		(A) Not exceed $750 million	$75,000	
		(B) Exceed $750 million	$80,000	
		Class E insurer carrying on domestic business only, where total assets are expected to:		
		(A) Not exceed $1 billion	$95,000	
		(B) Exceed $1 billion but not exceed $5 billion	$114,000	
		(C) Exceed $5 billion but not exceed $10 billion	$152,000	
		(D) Exceed $10 billion	$190,000	

V. Supplementary annual fee for insurers who write retail business.

	Supplementary annual fee to be paid by a Class C, Class D and Class E insurers who writes retail business, in addition to the fee payable for its class of business: :	
	Where total assets are expected to:	
	(A) Not exceed $100 million	$30,000
	(B) Exceed $100 million but not exceed $500 million	$50,000
	(C) Exceed $500 million but not exceed $5 billion	$75, 000

	(D)Exceed $5 billion	$100,000
	Note: Where an insurer carries on domestic business only, the supplementary annual fees under paragraph this section do not apply.	

VI. Annual business fee is payable by the Head of an Internationally Active Insurance Group (IAIG).

		Annual fee payable by the Head of the IAIG on behalf of the IAIG where total consolidated group assets at the preceding year-end to the year of assessment:	
		(i) Did not exceed $50 billion	$1,000,000
		(ii) Exceeded $50 billion	$1,000,000 + 0.0015% for assets above $50 billion
		Note: IAIG fees are only applicable to an insurance group carrying on Long-term business where Long-term assets for the group exceed 20% of total assets and where such insurance group meets the criteria for and is designated as an IAIG in accordance with the Act.	
		Note: Where a designated insurer is subsequently designated as Head of an IAIG, only one annual fee is payable.	
Annual fees with respect to the above are due on or before 31 March.			