30 November 2023

STAKEHOLDER LETTER

Re: Consultation Paper – Updates to *"Proposed Enhancements to the Regulatory Regime 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 development of Bermuda's regulatory framework 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). On 28 July 2023, the Authority released a second version of the consultation paper (CP2) due to our continuous efforts to enhance the regulatory regime and the feedback received from our stakeholders and field testing results by 15 September 2023.

An important aspect of the CP2 is the revision of insurance rules (*Insurance (Prudential Standards), (Insurance Group Solvency Requirement) Rules 2011*) and guidance notes to transpose the changes proposed in the CP2 into the insurance rules and guidance to regulate the activities of insurers. These rules and guidance were published on the BMA website for consultation (Insurance - Discussion/Consultation Papers - BMA) in September 2023, requesting feedback from stakeholders to be submitted by 29 September 2023.

The Authority appreciates all feedback received on CP2, the revised rules and guidance notes 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 summarises the key substantive feedback on CP2, the revised rules and guidance notes that the Authority received from several stakeholders and the responses to these comments.

RESPONSE TO INDUSTRY FEEDBACK

I. Enhancements to Regulatory Regime

A. Technical Provisions

Group Risk Margin

Feedback Received:
Industry stakeholders echoed concerns previously raised about the theoretical soundness of the proposals and the operational burden they would impose on insurers. Nevertheless, they accepted the proposals given the rationale for the Authority's position and its recognition (via the draft guidance issued on the use of simplifications in calculating the group risk margin) that insurance groups will require some time to implement new processes and procedures. The industry stakeholders supported the BMA's proposed guidance on calculating the group risk margin, allowing for simplifications. However, they expressed concern that the proposed Technical Provision rules, as currently drafted, appear very prescriptive and may not allow this flexibility.

BMA Response/Action:
The Authority appreciates stakeholders' feedback and will implement the proposals as per CP2. The Authority does not consider that the proposed framework disallows simplifications in the calculation of the group risk margin. As always, when using simplifications, insurers must ensure they comply with the relevant rules and guidance.

Scenario Based Approach (SBA)

Feedback Received:
A broad range of feedback on the proposed enhancements was received from stakeholders. They indicated support for the aims of the enhancements but raised some concerns and made recommendations. Specifically, stakeholders noted that the changes proposed have complex impacts due to asset-liability interrelationships and the long-tailed nature of the liabilities; however, these changes are being introduced in a comparatively shorter time frame, which may not be adequate to calculate the impact of the enhancements fully.

Stakeholders welcomed the efforts to standardise default and downgrade costs for SBA reserving, but again, they cautioned against accelerated implementation. Some concerns were raised on the floor for default and downgrade costs for structured assets, with some stakeholders citing that the prescribed floors were higher (and potentially more punitive) than what was implied by post-2008 empirical default data. Stakeholders emphasised the concern that most long-term (life) (re)insurers can only underwrite their liabilities once at inception; therefore, significant changes to the regulatory capital framework after the underwriting stage need to be absorbed by the insurers' existing balance sheet. In another area of feedback on structured assets, stakeholders remarked that the proposed enhancement to require the Authority's prior approval for structured assets would likely cause significant implementation challenges to those with existing allocations to structured assets.

Stakeholders also sought clarity and made recommendations on how cases of limited experience data would be handled on some enhancements, e.g., calculation of the Lapse Cost.

Stakeholders also provided feedback on the admissible liquidity sources with a particular focus on what was viewed as the punitive treatment of liquid money market funds, certificate of deposits and covered bonds.

BMA Response/Action:
The Authority has noted and considered all the feedback received and engaged extensively with industry. While no material changes have been made to the CP2 proposals, some of the feedback will be taken into account in the design of the approval review processes and the application of the liquidity stress tests as instructed by the Authority. The BMA considers that a floor on default and downgrade costs for structured assets is consistent with its prudential objectives; thus, while acknowledging the feedback on post-2008 empirical data, the Authority will retain the floor.

Given the material impact of the changes, it was deemed appropriate to transition the uncertainty margin over five years to ensure an orderly transition. This transition will not apply to default costs and is limited to existing business only. These enhancements are accompanied by the following measures:

a. The BMA will establish capital management supervisory measures, emphasising the active involvement of company boards in their capital management strategies throughout the transition period.
b. Companies will be expected/required to implement enhanced assessments and reporting as part of their CISSA/GSSA during the transition phase, with a primary focus on ensuring companies remain adequately capitalised post the transition period.
c. While there will not be a general imposition of dividend restrictions on companies, the BMA retains the discretion to do so on a case-by-case basis, depending on its supervisory assessment of how the company is being managed.

Standard Approach

Feedback Received:
As in CP1, stakeholders generally understood and supported 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 and will implement the proposals as per CP2.

B. BSCR Computation

Long-Term Lapse and Expense Risk

Feedback Received:
Stakeholders welcomed the enhancements made by the Authority to increase the risk-sensitivity of the lapse risk charges, particularly the mass lapse stress, by further differentiating between regions, product types and product features. Stakeholders generally expressed support for the new lapse and expense risk charges. Some concerns continued to be raised regarding operational complexities in applying the granular stresses (for both lapse and expense risks), as well as the potential for increased volatility of the lapse risk capital requirements (especially mass lapse) as economic environments change, particularly for companies using the SBA. While stakeholders welcomed the proposed partial offset for certain parts of the mass lapse calculation, many continued to advocate for a full offset.

BMA Response/Action:
The Authority has noted and considered all the feedback received. The BMA will issue further instructions on the application of the lapse and expense stresses, including the application of mass lapse stresses for SBA users (regarding the impact of stress on the liability discount rate). On the operational complexities, the Authority notes that there is a general trade-off between risk-sensitivity and a certain level of complexity. The BMA expects insurers to ensure they can measure risks accurately where these are material. However, simplifications are not disallowed where appropriate (as per the rules and guidance), provided these can be demonstrated to be prudent. Regarding offsets, it is recognised that, under scenarios underpinning a mass lapse event, some policyholders may be compelled to withdraw their funds even if it is economically disadvantageous to them (e.g. regardless of whether penalties apply on surrender); nevertheless, for the purposes of establishing required capital, the Authority does not deem it appropriate to assume this applies to all policyholders and all situations. Therefore, the BMA considers that the partial offsets introduced strike the right balance in the context of the revised mass lapse calibration in light of the Authority's prudential objectives.

Property and Casualty Catastrophe Risk

Feedback Received:
Overall, the industry stakeholders expressed support for the refinements to the proposals regarding the man-made catastrophe risk submodule in CP2. Furthermore, the stakeholders expressed their preference to maintain both (Solvency II and the International Association of Insurance Supervisors' Insurance Capital Standard-based) scenarios for the Credit and Surety Catastrophe Risk charge, considering the diversity of the Bermuda insurance market and the differences in operational complexity of the two options.

BMA Response/Action:
The Authority appreciates the feedback received; it recognises the stakeholders' points in relation to the Credit and Surety Catastrophe Risk scenarios and agrees to keep both subject to appropriate controls being put in place, namely that once selected, change in the approach requires BMA prior approval. The BMA will, therefore, implement CP2 proposals with this amendment.

C. Section 6D Enhancements

Feedback Received:
The Authority did not receive material feedback on the proposals in this section of CP2. Similar to CP1, the industry was generally supportive of the proposals.

Regarding Long-term Lapse and Expense Risk, industry stakeholders pointed out some areas where they considered further clarification was needed in the rules, e.g. on the interaction of the long-term insurance risk transitional and risk margin and on the application of mass lapse shocks for SBA users.

BMA Response/Action:
The Authority appreciates the feedback received and will implement the proposals as per CP2.

Long-term Lapse and Expense Risk – The BMA has incorporated clarifications and additions into the rules on the areas identified in the feedback. The Authority will be issuing instructions on further details as necessary.

D. Prudent Person Principle (PPP)

Both CP1 and CP2 outlined the Authority's requirements and expectations relating to insurers' investments in assets covering best estimate liabilities valued using the SBA. These requirements must be applied within the context of the PPP, clear structures of accountability, disciplined risk management, and strong but proportionate governance.

The BMA would like to remind insurers, particularly long-term insurers, to pay close attention to compliance with the PPP. In particular, paragraph 46 of the Insurance Code of Conduct states that, in relation to the insurer, the PPP *"requires that the insurer, in determining the appropriate investment strategy and policy, may only assume investment risks that it can properly identify, measure, respond to, monitor, control and report while taking into consideration its capital requirements and adequacy, short-term and long-term liquidity requirements, and policyholder obligations. Further, the insurer must ensure that investment decisions have been executed in the best interest of its policyholders."* The Authority reminds insurers that it assesses compliance with PPP on a case-by-case basis, taking into account the relevant facts and circumstances, but in an objective manner rather than focusing on the insurer's own subjective view of PPP. While the Authority expects insurers to perform their own assessment of their compliance with PPP, the Authority will exercise its independent and objective judgement in assessing insurers' compliance with PPP, in line with the BMA's supervisory approach to the application of its regulatory framework with emphasis on strengthened enforcement and market discipline interventions.

The Authority would like to remind the boards and senior management of long-term insurers, especially those with high allocations to non-traditional investments, including those characterised by higher illiquidity, challenging valuation, lower transparency, embedded leverage and complex structures, among other risk factors, of their responsibility to comply with the PPP.

E. Approval of Affiliate, Related or Connected Party Credit Exposure

Section 2.9 of CP2 noted that Bermuda insurers generally fund long-term liabilities using investments in unaffiliated counterparties. The BMA proposed requiring prior approval of all assets having counterparty credit exposure to an affiliate, related party or connected party.

Feedback Received:
Stakeholders proposed limiting the scope of this approval to assets on the balance sheet of Bermuda insurance companies and not applying it to assets in modified coinsurance accounts on the balance sheet of ceding companies. They argued that assets held by ceding companies are subject to the insurance laws and rules of the ceding companies' jurisdiction. Application of Bermuda laws to ceding company accounts may present both regulatory duplication and regulatory incongruity.

Stakeholders also sought additional clarification in relation to assets managed by affiliates but with no counterparty credit exposure to an affiliate, related party or connected party.

BMA Response/Action:
The Authority believes it is appropriate to require regulatory approval of all assets (that fund long-term liabilities) having counterparty credit exposure to an affiliate, related party or connected party. This includes assets held in modified coinsurance accounts on the balance sheet of ceding companies. The BMA's supervisory experience has shown that affiliated, related or connected party assets can be complex and prone to a potential conflict of interest, creating additional risks and governance challenges. The ultimate responsibility for sound and prudent management of these risks rests with the insurer's board of directors. The Authority's review and approval process shall consider all of the relevant facts and circumstances of the affiliated, related or connected party exposure. To obtain regulatory approval, insurers must demonstrate that the decision to invest in an affiliated, related party or connected party comply with the PPP (i.e. *the insurer must ensure that investment decisions have been executed in the best interest of its policyholders).* The BMA expects it would be a high bar for insurers to demonstrate that such investments are appropriate for covering policyholder liabilities.

Regarding clarification in relation to assets managed by affiliates, the BMA confirms that approval will apply to assets with affiliated, related or connected counterparty credit risk. Insurers shall look through the underlying counterparties (not asset managers) in determining the nature of the credit exposure.

II. Expected Impact of Proposals

The Authority received approximately 60 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 BMA 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 material negative impact on the solvency position of Long-term insurers and a small negative impact on the solvency position of P&C insurers. Both segments of the market are expected to remain adequately capitalised
- The standalone impact of the changes to the Long-term capital charges will be fairly material, but the impact on the overall capital requirements is more contained as risks are aggregated and diversification benefits are applied. The key driver of the results is the revised lapse risk charge
- The standalone impact of the changes to the P&C capital charges will 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 moderate negative impact on the capital and surplus, with the negative impact most pronounced for the Long-term entities. The key driver of the results is the changes made to the scenario-based approach
- The benefit of the transitional arrangements is more material for long-term insurers due to longer phasing-in periods

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 ensure 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