BERMUDA MONETARY AUTHORITY

GUIDANCE NOTES

FOR APPLICATIONS FOR ADJUSTMENTS UNDER SECTION 6D OF THE INSURANCE ACT

8 SEPTEMBER 2023

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INTRODUCTION

1. The Bermuda Monetary Authority (Authority or BMA) continues to review Bermuda 's regulatory and supervisory regimes, to ensure that the jurisdiction adheres to international standards and best practices for insurance regulation and supervision. In that regard, the Authority during 2023 has conducted consultation rounds for a number of enhancements to the regulatory and supervisory regime for commercial insurers and insurance groups (collectively referred to as 'insurers' in this Guidance Note).

2. As part of these changes, the Authority has proposed the introduction of a new Schedule (Schedule of Adjustments) to the Insurance Prudential Standards for insurance groups (Insurance (Prudential Standards) (Insurance Group Solvency Requirement) Rules 2011), commercial general business insurance classes (Insurance (Prudential Standards) (Class 4 and Class 3B Solvency Requirement) Rules 2008, Insurance (Prudential Standards) (Class 3A Solvency Requirement) Rules 2011) and commercial long-term business insurance classes (Insurance (Prudential Standards) (Class C, Class D and Class E Solvency Requirement) Rules 2011)).

3. The introduction of the new Schedule of Adjustments aims to revise the Authority's section 6D of the Insurance Act 1978 framework to be more defined, standardised, and transparent in terms of the scope and requirements. Among other matters, it helps provide insurers with a better understanding of the areas and/or circumstances where an application for adjustments to the standard solvency framework may be allowed if it does not adequately reflect an insurer's risk profile without requiring the approval of a full or partial internal model for regulatory capital purposes.

4. This Guidance Note aims to provide guidance on the standards set out in the Schedule of Adjustments with a focus on providing further clarity on the types of adjustments insurers may apply for and the requirements insurers are expected to meet for the types of adjustment listed under paragraph 1 of the Schedule.

I. THE THREE ROUTES FRAMEWORK

5. With the aim of achieving better clarity, the majority of the adjustments listed under paragraph 1 of the Schedule of Adjustments have been allocated to one of three routes (Route 1 to 3). The routes allow for specific types of adjustments (listed under the relevant Scope sections) and set out the requirements (listed under the relevant Requirements sections) that insurers are expected to meet for each route. Higher numbered routes address more complex adjustments and have increased requirements.

Route 1 – Simple Adjustments

Scope – Simplest adjustments

6. Insurers may apply for the following adjustments under Route 1:

a. Treatment of material (re)insurance limits/risk mitigation techniques (e.g., consideration of material adverse development covers, stop loss, long-term excess of loss insurance or simple longevity swaps bought for protection);

b. Removal of Loss Portfolio Transfer (LTP) premiums to avoid double-charging LPT transactions;

c. Early adoption of the new BSCR rules (in their totality only);

d. Application to use issuer external rating from an approved credit rating agency:

    i. When no directly applicable (issue-level) credit rating exists; and

    ii. If the exposure in question ranks equally or senior to (other) senior unsecured exposures of that issuer.

e. Application to use ratings from a credit rating agency approved for regulatory capital purposes under other recognised regulatory regimes/jurisdictions (subject to limits on exposures/asset types/etc.).

Requirements:

7. The following requirements apply for applications made under Route 1:

    a. Support of application - Insurers should provide reasoning and supporting analysis as to why and how the arrangement results in the insurer's risk profile being materially different from the standard BSCR calculation;

    b. BSCR consistency - The assumptions underlying the modified capital calculation should be consistent, or more prudent, than the assumptions underlying the BSCR calculation. Among other things, this would apply to the following aspects of the BSCR calculation: stress factors, correlation assumptions, statistical and methodological consistency and calibration; and

    c. Data - The data used in the analysis should be demonstrated to be complete, accurate and appropriate.

Route 2 – Simple-Complex Adjustments

Scope – More complex than Route 1

8. Insurers may apply for the following adjustments under Route 2:

    a. Modification of premium or reserve risk factors; and

    b. Consideration of risk mitigation techniques not addressed under route 1 (typically relating to the use of derivatives used in non-shock-based approaches or more complex longevity swaps bought for protection).

Requirements:

9. The following requirements apply for applications made under Route 2:

   a. All Route 1 requirements (as relevant) and additionally;

   b. ECR ratio - The insurer operates at an ECR ratio of equal to or greater than 120%;

   c. Support - Insurers should provide reasoning and supporting analysis as to why and how the proposed revision is a more accurate reflection of the insurer's risk profile than the BSCR;

   d. BSCR consistency - The proposed adjustment should not produce material inconsistencies in the BSCR calculation;

   e. Cherry picking – The applicant should confirm that there are no other areas of risk where, based on their internal view of risk and capital, the BSCR is considered to be materially understating the insurer's risk exposure;

   f. Calibration – Applicants should use the 1-in-100 TVaR over a one-year view. An alternative metric may also be used if it can be demonstrated to be at least as prudent in determining the ECR;

   g. Statistical test:

      i. The methodologies used should be based on rigorous actuarial and statistical techniques;

      ii. The modelling techniques used should be appropriate to the nature, scale and complexity of the risks to which the insurer is exposed;

      iii. All material assumptions/expert judgment have been assessed for veracity and suitability;

      iv. The areas that rely on expert judgement are known, and sufficient challenges have been applied to these areas; and

      v. The proposed capital modification should not introduce material statistical or methodological inconsistencies.

   h. Validation - Key aspects of the modification [1]should undergo validation annually; and

   i. Documentation - Documentation should be kept for the following:

      i. Internal sign-off process for the proposed modification;

      ii. Governance of the data underlying the analysis;

      iii. Process of estimating the modification and its governance;

[1] for avoidance of doubt this includes underlying data, models, processes, methodologies...

iv. Material assumptions/expert judgement used and their governance; and

v. Validation results.

Route 3 – Complex Adjustments

Scope – Most complex cases:

10. Insurers may apply for the following adjustments under Route 3:

a. Use of internal credit ratings when ratings from BMA-approved institutions are not available; and

b. Applications not covered elsewhere in the section 6D framework, if:

i. Application is within the spirit of the framework; and

ii. Insurer's adjusted BSCR (after allowing for the benefit of any adjustments from any of the three routes) is no less than 10% lower than the standard BSCR.

11. Under certain conditions, modifications to the scope of the Loss-Absorbing Capacity of Deferred Taxes (LAC DT) in the BSCR could be considered within Route 3, subparagraph b. This is expected to apply mainly to the recognition of additional DTA based on the expected future taxable profits.

Requirements

12. The following requirements apply for applications made under Route 3:

a. All Route 2 requirements and additionally:

b. Governance - A dedicated governance framework should be in place that ensures the ongoing appropriateness of the design and operations of the modelling that supports the capital modification and continues to reflect the insurer's risk profile appropriately. Among others, this would require the following:

i. A model change policy that distinguishes between minor and major changes;

ii. Key stakeholders (risk management, users of modelling output, heads of affected business units, senior management) should understand the modelling, which is commensurate to their direct or indirect use;

iii. Ensuring there are adequate, independent review procedures in place; and

iv. Documentation of the modelling process (i.e., data, assumptions/expert judgement, parameterisation, modelling and output) and any changes to it.

c. Use test - The modelling underlying the capital modification should be used in the insurer's risk management system and decision-making processes;

d. Validation - The data, assumptions/expert judgement, parameterisation, modelling and output should undergo independent validation annually. Among others, this would require the following:

    i. A validation policy; and

    ii. The monitoring of performance, review of the ongoing appropriateness of modelling specifications, and testing of results against experience.

e. Documentation - There should be documentation to provide a detailed description of the structure, design, theory, operational details, input assumptions, parameters, governance process and controls of the modelling underlying the capital modification.

13. The following additional requirements apply for the use of internal credit ratings:

    a. Identification of risks - The internal credit assessment should consider all relevant factors and sources of risk—qualitative, quantitative, systemic, and idiosyncratic—which could influence the credit risk associated with the exposure being rated, including: The financial position (including liquidity) and financial policies of the issuer;

        i. The financial position (including liquidity) and financial policies of the issuer;

        ii. The financial position (including liquidity) and financial policies of the issuer; complexity of the issuer's business model;

        iii. The issuer's size, growth and the level of diversity in its activities;

        iv. The quality of the issuer's management;

        v. The competitive position of the issuer;

        vi. External market factors, including past and expected sector and industry dynamics and economic outlook;

        vii. Impact of economic stresses;

        viii. Terms and conditions of the instrument/loan agreement (including seniority, security and any covenants in place);

        ix. Cash flow predictability;

        x. Any collateral and volatility of its value;

xi. The impact on the issuer's risk profile and financials of issuing the debt being rated;

xii. Refinancing risk;

xiii. The issuer's ownership structure;

xiv. Risks arising from third parties (e.g., sponsors, parties involved in the servicing and managing of the debt, if applicable);

xv. Legal, political and regulatory risks;

xvi. Country risk; and

xvii. Potential future and emerging risks (e.g., the impact of climate risks).

b. Internal credit assessment methodology and criteria - The internal credit assessment methodology and criteria should:

i. Set out the overall credit assessment philosophy and the rating process;

ii. Set out the scope of the types of exposures and entities that the methodology applies to;

iii. Set out the scope of risks covered and define the credit and other relevant risks being measured[2];

iv. Where an accepted credit rating agency has published a credit rating methodology for an asset class, consider at least the same range of risks, qualitative and quantitative factors and risk mitigating aspects (or justify differences in the scope);

v. Consider the characteristics of comparable assets for which a credit assessment by an accepted credit rating agency is available;

vi. Describe how different asset features, risks and other relevant factors are assessed;

vii. Set out the key assumptions and judgements underlying the assessment, including the treatment of any assumed risk-mitigating actions that rely on the firm's own or outsourced processes involved in managing assets through their lifecycles;

viii. Define whether the credit assessment is calibrated to a through–the-cycle or point-in-time view, and comment on the appropriateness;

[2] 'Accepted' (credit) rating agency means external credit rating agencies accepted for BSCR purposes, as laid out in the instructions in force.

ix. Use both qualitative and quantitative factors;

x. Explain the limitations of the internal credit assessment (e.g., risks which are not covered), and when it would not be appropriate to allow for these limitations by overriding judgements.

c. Internal credit assessment methodology and criteria - i.e., where the insurer has decided that its internal credit assessment methodology for a particular asset class should be based on an accepted rating agency's published credit rating methodology applicable for that asset class, the insurer should apply that methodology in full in the manner applied by the rating agency. This is not intended to prohibit targeted enhancements where appropriate[3]; however, such adjustments must be clearly identified, justified and their impact quantified. Based on the overall review, the Authority may further decide to disallow such adjustments at its discretion.

d. Data and expert judgment:

i. Insurers should consider the availability, appropriateness, and quality of the data over the credit cycle upon which their internal risk assessments and calibrations are based;

ii. Insurers should clearly document how any incomplete or missing data has been allowed for in the internal credit assessment;

iii. Expert judgements made in the determination of the internal credit assessment and BSCR mapping should be transparent, justified and documented, and consideration should be given to the circumstances in which judgements on the rating would be considered false. The key judgements should be subject to an appropriate level of governance within the overall credit assessment process;

iv. The history of judgements applied to deviate from the results of the internal credit rating methodology should be well documented, as should any other end-of-process overriding adjustments to the internal credit ratings themselves.

e. Expertise and potential conflicts of interest:

i. The credit rating methodology and criteria development and approval, credit assessment and BSCR mapping should be performed by individuals with the relevant asset-specific credit risk expertise and competency who are both independent and have minimal conflicts of interest. This applies to both internal resources and those potentially external to the insurer;

ii. Insurers should demonstrate the independence of the internal credit assessment function and demonstrate that effective controls are in place to manage any potential conflicts of interest between the different

[3] e.g., taking account of a specific credit enhancement feature which is otherwise ignored by the selected rating agency framework.

stakeholders involved in the overall management of the assets;

iii. The internal credit assessment should be procedurally independent of the decision to underwrite;

iv. Individuals deciding or approving the internal ratings (e.g., voting members of the credit committee) should be without conflicts of interest and independent of both the investment decisions and management of the assets; and

v. The rating approval process should be organised and structured in a way that ensures independence of the decisions and does not cause incentives or put pressure on the individuals to decide in a certain way.

f. On-going review and assessment:

i. Insurers should validate the internal credit assessment methodology and criteria, including how it has identified and allowed for all relevant sources of credit risk (whether quantitatively or qualitatively);

ii. Insurers should have a robust process for the ongoing review of the credit assessments, including demonstrating how the insurer has satisfied itself that the assessments will remain appropriate over the lifetime of the assets and operate robustly under a range of different market conditions and operating experiences;

iii. The credit assessments should be reviewed, and the assets re-rated at regular intervals, as well as in response to changes in relevant external market conditions or other factors that are expected to impact the rating; and

iv. Insurers should ensure and monitor that the internal credit assessment criteria are applied consistently both within and across asset categories and over time.

g. Limits and restrictions:

i. Where, for an internally rated asset, external ratings exist from any one or several accepted credit rating agencies, the final rating used for BSCR purposes is capped to be no higher than the lowest of such external ratings;

ii. Internal credit ratings cannot be used for related, affiliated or connected assets for Section 6D applications[4]; they may, however, be allowed with an approved internal model;

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[4] For the purposes of this section, 'related, affiliated or connected assets' include (credit) exposures to related, affiliated or connected party and (otherwise unrelated, unaffiliated or unconnected) assets originated by related, affiliated or connected party.

iii. The amount of assets for which internal credit ratings can be used in the BSCR is subject to limits and will be no more than 20% of total investments; and

iv. The Authority may, based on a holistic evaluation of all aspects of an insurer's internal credit assessment framework and process, as a condition for approval, require a downward adjustment (notching down) on the insurer's internal credit ratings for BSCR purposes. The size of such adjustment will be determined on a case-by-case basis. The adjustment will be permanent, but its continued appropriateness may be reviewed periodically if circumstances warrant.

14. The following additional requirements apply for modifications to the scope of the Loss-Absorbing Capacity of Deferred Taxes (LAC DT) in the BSCR

   a. insurers should provide substantiation of LAC DT and demonstrate their calculation;

   b. independent studies substantiating future taxable profits and demonstrating the recoverability of Deferred Tax Asset should be provided.

II. OTHER ADJUSTMENTS

15. Insurers may also continue to apply for the following additional adjustments that are typically not expected to fall under the three routes framework.

Scope

16. Insurers may use internal models for calculating the variable annuity guarantee risk charge for long-term business.

17. Insurers may assess the correct classification of specific assets or liabilities.

18. Insurers make specific adjustments relating to the Technical Provisions and/or Scenario Based Approach, including -

   a. Production of part or all of the Economic Balance Sheet using principles of other EBS regulatory frameworks (like Solvency II, or such other economic valuation principles that the Authority has approved in advance for this purpose);

   b. Use of transitional arrangements for certain long-term technical provisions for business written on or before 31 December 2015 as described in the Schedule of Economic Balance Sheet Valuation Principles within the relevant Prudential Standards on the Solvency Requirements;

   c. Determination of suitable yield curve for discounting under the standard (discounting) approach of the Technical Provisions for currencies that are not published by the Authority;

d. Approval for long term liabilities beyond 30 years to allow for use of assets that would be otherwise not considered acceptable on the Scenario Based Approach;

e. Approval to use in the Scenario-Based Approach structured securities including mortgage-backed securities, asset backed securities, commercial mortgage loans, and collateralised loan obligations;

f. Approval to use assets for which the Authority has not published the default and downgrade costs on the scenario-based approach; and

g. Approval of assets having counterparty credit exposure to an affiliate, related party or connected party on the Scenario Based Approach.

19. Modifications to the calculation of the Minimum Solvency Margin.

Requirements

20. The requirements for the adjustments listed under this section will depend on the nature, scale and complexity and scope of the application. In determining the requirements applicable to a specific application, as a first step, insurers should consult the list of requirements set out in Section I of this Guidance Note and paragraphs 3 and 4 of the Schedule of Adjustments.

III. ADMINISTRATIVE CONSIDERATIONS

Application Process for Section 6D Adjustments

21. Insurers who wish to make adjustments under section 6D should submit a formal application pack that, at a minimum, provides evidence that the relevant requirements are met, along with any additional material requested. Following its review, the BMA will reach out to communicate its conclusions. For more complex cases (typically under route 3), insurers are encouraged to contact the BMA for preliminary discussions.

Annual Review of Section 6D Adjustments

22. BMA approvals under section 6D will continue to be subject to an annual regulatory review. Insurers would need to submit an application package that demonstrates ongoing compliance with the standards set out under the respective applicable route.

Transitional Arrangements for Existing Adjustments Falling Outside the Revised Section 6D Regime.

23. Transitional arrangements will be offered for any adjustments already granted but that fall outside the revised section 6D regime, so long as there are no material changes that affect the adjustment. The following transitional arrangements will be used:

a. For insurers with a liability duration of < (less than) five years[5], a five-year transition will apply where the adjustment will continue to be renewed for the first two years and then be phased out using a linear formula over the subsequent three years;

b. For insurers with a liability duration of >= (greater or equal to) five years[6], a transition period equal to their liability duration will apply but will be subject to a cap of ten years. The adjustment will continue to be renewed for the first five years and subsequently phased out using a linear formula over a number of years that equals the insurers' liability duration less five years and will be subject to a cap of five years.

[5] Based on the 2024 yearend BSCR submission

[6] Rounded to the nearest whole year