ADVISORY | INDUSTRY INFORMATION

Looking ahead: enhancements to the Bermuda regulatory regime

Overview

In February 2023, the Bermuda Monetary Authority ("**BMA**") issued a consultation paper, Proposed Enhancements to the Regulatory Regime and Fees for Commercial Insurers ("**CP1**"), outlining proposed changes to the regulatory regime for commercial insurers and insurance groups in Bermuda. The changes are designed to ensure the regulatory regime remains sound, protect policyholders and contribute to financial stability. In July 2023, with the benefit of feedback received from industry stakeholders on CP1, the BMA published a second consultation paper ("**CP2**"), outlining some revisions to the changes originally proposed. In September 2023, the BMA published initial draft revisions to the prudential rules for insurance groups and commercial classes, along with Guidance Notes on the statutory reporting regime and applications for adjustments under section 6D of the Insurance Act 1978 ("**Insurance Act**"). The BMA issued Stakeholder Letters in July and November 2023, summarising the substantive feedback received from the industry on the consultation papers and providing its response. The BMA has now published the following revised prudential rules to give effect to the changes, and these will become operative on 31 March 2024:

- Insurance (Prudential Standards) (Class 4 and Class 3B Solvency Requirement) Amendment Rules 2024
- Insurance (Prudential Standards) (Class 3A Solvency Requirement) Amendment Rules 2024
- Insurance (Prudential Standards) (Class C, Class D and Class E Solvency Requirement) Amendment Rules 2024
- Insurance (Prudential Standards) (Insurance Group Solvency Requirement) Amendment Rules 2024.

In this article, we recap on the key changes and their potential implications.

Key changes introduced

The changes to the insurance regulatory regime are to:

- the technical provisions;
- the Bermuda Solvency Capital Requirement ("BSCR") computation; and
- applications under section 6D of the Insurance Act.

These will each be explored in more detail below.

Technical provisions

a) Risk margin

Under the reforms, the risk margin calculation of insurance groups will change to be on an unconsolidated basis. This aligns the calculation to the basis of the risk margin construction, which assumes a separate transfer of each insurance group entity's liabilities in a transfer scenario. The BMA has committed to seeking to ease any resulting operational burden on Bermuda insurance groups.

b) Scenario-based approach ("**SBA**")

Driven by a number of key principles outlined by the BMA, including a desire to keep pace with international standards and enhance policyholder protection, the changes provide clarity on the acceptable use of the SBA and introduce additional rigour in an effort to ensure SBA processes are robust. New uses of the SBA will require pre-approval by the BMA, while existing uses of the SBA will only require approval where there are material changes to the model.

The reforms include changes designed to improve insurers' liquidity risk management ("**LRM**"). Entities using the SBA will need to maintain a LRM programme that meets certain criteria, including maintenance of a pool of highly liquid assets as a liquidity buffer. Insurers that do not use the SBA but are exposed to mass lapse risk will also be required to have a LRM programme in place.

There is also a strong focus on ensuring lapse risk is appropriately accounted for, including via the introduction of a lapse cost.

Restrictions will be introduced on assumed asset sales when using the SBA and, for assets that fund long-term liabilities, regulatory approval will be required where the assets have counterparty credit exposure to certain affiliated parties. Standardisation of default and downgrade costs for certain asset types, as well as caps on spreads of assets that are generally not acceptable, will be introduced and, while ring-fencing will be required for assets backing liabilities valued under the SBA, insurers will retain some flexibility in the approach used to assign the liabilities. Some additional reporting requirements will also apply in relation to the assignment of assets. The reforms seek to clarify expectations for setting prudent assumptions where assets contain optionality or behavioural components, principles to be observed as part of insurers' investment and divestment strategies, and ensuring transaction costs are reflected in SBA projections.

Enhancements to documentation and data practices are also being introduced, and there is a focus on ensuring robust governance and internal controls are in place, with clarification provided on accountability for the appropriateness of the SBA model and its use. The BMA will monitor SBA model risk management practices and insurers will have enhanced reporting obligations, which will support the BMA's supervisory efforts.

Certain limited existing liabilities that use SBA will be grandfathered, with the BMA recognising that most metrics and triggers are locked in at the outset of life reinsurance arrangements.

c) Standard approach

For liabilities denominated in Euros, insurers using the standard approach will have the option to use the discount curves provided by the European Insurance and Occupational Pensions Authority ("**EIOPA**") or those provided by the BMA without seeking separate approval from the BMA. This change is in recognition of Bermuda insurers often using the EIOPA EUR-curve for internal calculations, with the BMA being satisfied that the EIOPA and BMA curves produce results that are not materially different.

BSCR computation

Under the changes, long-term "other insurance risk" will be broken down into separate lapse and expense risk components, with explicit diversification incorporated. This is intended to aid in clarity and facilitate the BMA's supervisory efforts. The new lapse and expense risk charges will be transitioned in over a ten-year period, with weightings to apply during this period. To improve risk sensitivity and more accurately reflect product characteristics, lapse and expense shocks will replace the current factor-based calculation. In its November 2023 Stakeholder Letter, the BMA indicated that it will issue further instructions on the application of the lapse and expense stresses, following some feedback from the industry over the potential increased volatility of the lapse-risk capital requirements, particularly as regards mass-lapse.

The BSCR Catastrophe Risk module will also be enhanced through the introduction of a man-made catastrophe risk sub-module, covering terrorism, credit and surety, marine and aviation. The charges for the new catastrophe scenarios will be phased in over a period of three years.

Section 6D

The section 6D framework allows insurers to make adjustments to specific BSCR parameters where the BSCR does not adequately reflect the insurer's risk profile. The BMA is seeking to make the framework more clearly defined, standardised and transparent by setting out three different routes, depending on the type of adjustment sought: Simple adjustments, simple-complex adjustments, and complex adjustments. A set of pre-defined adjustments and the application requirements is provided for each category. Certain transitional arrangements are available for adjustments already granted that fall outside of the revised section 6D framework.

Increased regulatory fees

To ensure the BMA has appropriate resourcing for its supervisory activities, annual business fees and registration fees for long-term insurers have, of necessity, been increased. The higher annual business fee increases are to be phased in over a three year transition period. Individual fee amendments will also be considered on a case-by-case basis.

Implications

While commercial insurers in Bermuda will likely benefit from greater clarity in key regulatory processes, the BMA has acknowledged that the changes will result in some impacts on the solvency position and capital requirements of long-term insurers, and a lesser impact on other commercial insurers. More generally, for insurers who use SBA, additional resources will likely need to be deployed to cater for the process changes and the increased governance, documentation and reporting requirements.

The BMA intends for the changes to result in an increase in the effectiveness of insurance regulation and supervision in Bermuda, ultimately enhancing policyholder protection. The enhanced regime will also assist Bermuda in maintaining its Solvency II equivalence, which is critical to enabling Bermuda commercial insurers to compete effectively for European insurance business and to support Bermuda's status as the World's Risk Capital and a leading insurance market globally.

What next?

The BMA has now issued revised prudential rules to give effect to the enhancements from 31 March 2024. Commercial insurers and insurance groups should ensure they are familiar with the new rules and the associated guidance notes, and update processes and practices within their organisations to ensure alignment. For assistance with understanding how these changes will impact your organisation, please get in touch with our team.

Further information

For further information please speak with your usual contact or contact:

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