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The Bermuda Monetary Authority Consults Further on Enhancing Its Insurance Regulatory Regime

This edition of *The Standard Formula* looks at the updated proposals set out in the consultation paper published by the Bermuda Monetary Authority (BMA) on July 28, 2023, which relate to the BMA's plan to enhance the regulatory and supervisory regime for commercial insurers and insurance groups. These amendments follow on from the BMA's prior consultation paper published on February 24, 2023. (For more information about the significance of the supervisor role, see our June 26, 2023, podcast episode "International Association of Insurance Supervisors: Who They Are and Their Industry Impact.") The proposals draw on the BMA's review of evolving business models and industry practices since the authority published a first set of guidance notes for commercial insurers and insurance groups on November 30, 2016.

The BMA's proposals are intended to ensure that the regulatory regime for commercial insurers regulated in Bermuda continues to be sound and that the rules both protect policyholders and help maintain financial stability. The changes would make the Bermuda regime more closely resemble the Solvency II framework, which is the prudential regime for insurance and reinsurance undertakings in the EU.

Given the amount of business reinsured in Bermuda, the changes are of interest to the entire insurance market. Any bolstering of the Bermuda regime may have consequences for insurers and reinsurers worldwide, particularly regarding pricing.

BMA Proposals

The proposed enhancements cover four main areas:

- Changes to the calculation of the technical provisions of insurers and insurance groups.
- Amendments to the computation and flexibility of the Bermuda Solvency Capital Requirement (BSCR).
- Updates to the prudential rules and reporting forms set out in the BMA's Section 6D framework to modify capital requirements.
- Revisions to the fees charged to life insurers regulated by the BMA.

The BMA intends for the enhanced regime to enter into force on March 31, 2024, subject to certain transitional and grandfathering arrangements. The BMA expects to publish the associated draft bill, revised draft rules and guidance notes imminently for consultation.

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I. Technical Provisions

The BMA's first proposed enhancement relates to technical provisions: These proposals appear to address the need to update the technical provisions framework to better suit the current market environment and developments in insurer practices. The proposals fall into three main categories: updates to the risk margin, scenario-based approach and discount curves.

Risk Margin

First, the BMA is proposing to change the risk margin calculation of insurance groups to be on an unconsolidated basis. This is intended to align the risk margin calculation with the principles behind risk margin construction, where the transfer scenario on which the risk margin determination is conceptually based assumes a separate transfer of the insurance group's liabilities on a carrier-by-carrier basis, *i.e.*, in the transfer scenario, no diversification benefits between the entities exist. This adjustment would align this element of the BSCR with the Solvency II framework.

Scenario-Based Approach

Second, the BMA is proposing changes to its scenario-based approach (SBA), which is similar in concept to the matching adjustment under Solvency II. The SBA reflects the illiquidity premium embedded in an insurer's asset yields in discounting liabilities, if the liabilities can be demonstrated to have predictable and stable cash flows across a range of scenarios and are matched with suitable fixed-income assets that also produce predictable and stable cash flows. The SBA assumes a high degree of matching between the asset and liability cash flows. To the extent that matching liability cash flows with asset cash flows is not possible, the BMA will apply a mismatching cost process that calculates eight alternative interest rate scenarios and will select the worst scenario in order to determine the best estimate liability (BEL) designed to mirror the most extreme potential economic realities while also recognising more conservative, practical guardrails.

The SBA therefore offers a highly tailored and dynamic approach. It requires significant investment from the insurer to ensure adequate governance, risk management and modelling systems are in place. The BMA's proposals to enhance the SBA are driven by its observation that insurers will benefit from having greater clarity and guidance on the SBA requirements. While the changes do not conform the BSCR with the Solvency II matching adjustment, they do bring the BSCR materially closer to Solvency II adjustment.

The SBA enhancement proposals set out in the BMA's consultation are detailed, but in summary, they include the following:

- The BMA's original proposals required entities already using the SBA to obtain prior approval from the BMA to cover all new insurance policies drafted after implementation of the proposed updates, while the revised proposals require BMA prior approval where there are material changes to the existing SBA model — and the BMA has outlined in greater detail the information to include in the application package.
- SBA models that are in existing use are currently, and will continue to be, subjected to appropriately tailored in-depth supervisory review processes.
- Insurers are required to implement a liquidity risk management programme.
- In the updated proposals, the BMA has renamed the Base Lapse Adjustment (BLA) as the Lapse Cost (LapC), in order to better assign a specific cost to lapsable products within the SBA.
  - The new proposals provide a methodology to calculate the LapC, which will be required to meet SBA eligibility.
  - The proposals note that insurers may use other calculation 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 the original proposals.)
- For insurers seeking to use assets for which the BMA has not published the default and downgrade costs, the BMA has provided examples of limited cases where the authority will 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).

Proposals also include:

- Enhanced modelling of assets that have optionalities or behavioural components to allow for a more granular view of such assets.
- Changes related to unsellable assets, focused on ensuring that unsellable assets are not sold to meet cash flow shortfalls and that SBA projections end with no assets left in the portfolio.
- Increased governance and internal control requirements.
- Expanded reporting requirements.
- Updated guidance on model risk management.

Additionally, the BMA highlights in the new proposals the fact that the SBA uses the actual portfolio of specific assets assigned to back specific liabilities being valued under the SBA. Therefore insurers may only use or pledge assets for the purpose of meeting the policyholder liabilities for which the assets are assigned. 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. Insurers must establish adequate controls to ensure that assets backing SBA liabilities are only exposed to and used to meet payment of the liabilities being valued under the SBA.

The new proposals clarify the responsibilities of the internal audit function for risk management under the SBA model. The BMA outlines its expectation that the chief internal auditor (CIA) will review the SBA model as part of the CIA's regular supervisory exercise of assessing the effectiveness of an insurer's risk management programme. While the BMA will not require an annual attestation from the CIA (unlike the requirement in the equivalent UK regime), the BMA will monitor the activities of the CIA and the internal audit function relating to SBA model risk management. The BMA will require holistic annual regulatory reporting of the SBA model risk management activities, including any activities conducted by internal audit. We note that the most significant remaining difference between the SBA and the Solvency II matching adjustment is an insurer's ability to rely on modelling.

Regarding implementation of the SBA enhancements, the BMA recognises that the proposed changes (which may be amended further) will have a material financial impact on life insurers in Bermuda. Most metrics and triggers of the current SBA regime are locked into the reinsurance treaties that insurers already have in place, so the BMA proposes to grandfather certain limited aspects of the treatment of existing portfolio liabilities until run-off. However, the changes will apply to all new business contracted after the proposed enhancements come into effect.

Discount Curves

Third, the BMA is considering adjusting the Euro-denominated discount curves used in Bermuda's "standard approach," akin to the treatment in the European Standard Formula. The adjustment would eliminate differences between the Euro-denominated rate curves provided by the European Insurance and Occupational Pensions Authority (EIOPA) and those provided by the BMA. This is driven by the BMA's observation that Bermuda insurers with Euro-denominated liabilities often carry out internal calculations using the EIOPA curve. The BMA views the two curves as producing similar results and so it proposes to allow insurers to use the EIOPA Euro-denominated discount curve without seeking separate approval from the BMA.

II. The BSCR Framework

The second proposal involves two sets of more general enhancements to the BSCR framework: The first relates to the introduction of increased risk sensitivity related to lapse and expense risks under the BSCR framework, and the second relates to amendments to "Property and Casualty catastrophe risk charges" intended to better capture man-made risks.

Lapse and Expense Risks

- Lapse and expense risks currently fall within the long-term "other insurance risk" charge of the BSCR framework. There is no explicit identification of these two risk components. The BMA proposes to separate the "other insurance risk" charge into "lapse" and "expense" risk components. This change will better reflect these risks and improve the transparency of the BSCR standard approach.
- For lapse risk, the capital requirement will be equal to the change in net asset value resulting from the applied shocks. This would involve calculating the post-shock BEL and comparing it to the before-shock BEL to determine the impact of the shock.
- The BMA states that breaking down and replacing the long-term "other insurance risk" charge necessitate a new, dedicated charge for expense risk. As with the lapse risk proposals, the aim is to increase risk sensitivity and the transparency of the charges. The proposal takes into account a combination of the following two shocks:
  - a relative increase in all (unit) expense assumptions; and
  - an absolute increase in expense inflation rates per annum.
- These shocks would be applied to the capital requirement and recalculation of the BEL: The difference between the pre-shock and post-shock values will be the capital requirement.
- The BMA proposes applying a ten-year transitional period for implementation of the new lapse and expenses risk charges.

The BMA's updated proposals clarify the application of long-term insurance risk charges within the risk margin calculation. Following a review of feedback and field-testing data, the BMA has further refined its initially proposed approach to lapse risk charges. The BMA recognises that lapse risk has a time-sensitive liquidity dimension. As part of the BMA'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 update resulted from the BMA's recognition that mass lapse is better managed by assessing both the solvency and liquidity resilience of insurers.

Property and Casualty Catastrophe Risk Charges

For Property and Casualty catastrophe risks, the BMA proposes amending the BSCR catastrophe risk module to include a dedicated man-made catastrophe risk submodule. This submodule will comprise catastrophe scenarios for (i) terrorism, (ii) credit and surety, (iii) marine situations and (iv) aviation, reflecting market developments.

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The BMA expects that the introduction of this submodule will:

- Enable the BMA to adopt the approach followed by other internationally recognised insurance capital models.
- Offer greater industry certainty as it reduces the need for *ad hoc* capital adjustments for non-modelled catastrophe perils.
- Promote good risk management, as the scenarios are all risk-sensitive.

The BMA's updated proposals revised the Terrorism Catastrophe scenario to align with the Solvency II SCR fire scenario and introduces the Solvency II Credit and Surety scenario as an alternative option to the already proposed ICS Credit and Surety scenario. Additionally, in line with market feedback, the BMA would extend the time horizon of the ICS Mortgage Stress scenario and permit an explicit allowance for outward reinsurance for the ICS Trade Credit stress scenario.

III. Adjustments to the BSCR

The third proposal relates to amendments to the BMA's Section 6D framework (referring to Section 6D of the Bermuda Insurance Act 1978 (the Insurance Act)). This involves the adjustments that regulated entities can apply to make to their BSCR.

These updates are intended to allow the BMA to revise its framework for the application process that insurers and reinsurers use to modify specific parameters related to their BSCRs, particularly in situations where the BSCR framework may not adequately reflect the insurer's risk profile.

The revised Section 6D regime will allow for a certain predefined set of adjustments that fall under one of three different routes, ranging from the simplest to the most complex adjustments. The BMA states that the proposed revisions will ensure that the Section 6D framework is more clearly defined, standardised and transparent in its scope and requirements.

In addition, the BMA hopes that the revised framework will help insurers better understand the areas and circumstances where an application for adjustment to their BSCRs may be allowed if the existing BSCR framework does not fully reflect their risk profiles. An adjustment will then be possible without requiring approval of a full or partial internal model for regulatory capital purposes.

IV. Regulatory Fees

The BMA's fourth and final proposal would increase the fees it charges to long-term commercial insurers. The BMA justifies the increase as necessary to enable the authority to cover the costs of effectively resourcing its supervisory activities. The BMA cites an increase in new market entrants as well as increases in the size and complexity of existing regulated entities as driving factors behind the increased cost of supervision.

The BMA's updated proposals state that it is agreeable to a three-year transitional/phase-in period for the updates to annual business fees. In addition, it 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 will be provided). Generally, however, the BMA is not reconsulting on the fee proposals.

Market Impact

In its new consultation paper, the BMA reported that it received nearly 50 trial-run submissions across different classes of insurers and business models. The authority stated that the quality of the submissions was generally acceptable, indicating that industry participants understood the main aspects of the proposals being tested. The BMA noted that it regards the sample submissions as representative and able to generate meaningful conclusions, notwithstanding the normal limitations associated with these exercises.

The BMA reported that the results of the most recent consultation were broadly in line with the authority's expectations about the main drivers and impact of the proposed updates. The BMA concluded that:

- The 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 property and casualty insurers.
- In the BMA's opinion, the changes are unlikely to cause significant market solvency issues given the healthy capitalisation levels of the Bermuda market.
- The stand-alone impact of the changes to 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 stand-alone impact of the changes to the property and casualty capital charges is expected to be moderate, but the impact on overall capital requirements will be small, again as risks are aggregated and diversification benefits are applied.
- The changes appear to have a small to moderate negative impact on capital and surplus — although the "best efforts" nature of the sample submission may have led insurers to assume simplifying and/or optimistic conditions, so the BMA expects the actual (negative) impact to be higher.
- The benefit of the transitional arrangements is more material for long-term insurers due to the longer phasing-in period for those insurers.

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Our View

The BMA's proposals come at a time when other insurance supervisory authorities are also revisiting their frameworks and considering how to enhance their regimes to better serve the insurance and reinsurance sector (with the reform of the UK Solvency II regime as one example). The Bermuda International Long-Term Insurers and Reinsurers Association has welcomed the proposals.

The BSCR is sometimes referred to as an economic framework rather than a set of prescriptive regulatory rules. In our view, that remains the case, but the proposed updates would increase the detailed instructions contained in the solvency capital requirement. Many would argue that this shift is a price worth paying for Bermuda to retain its Solvency II equivalence and its privileged access to the US market.

What will happen to reinsurance pricing as a consequence of the reforms is hard to forecast. But, particularly for life insurance businesses, it would be logical to conclude that the reforms will play an incremental role in further driving increases in life reinsurance pricing, and that knock-on effects for nonlife reinsurance pricing will follow.