Introduction of the new Collateralised Insurer class

ILS BERMUDA INDUSTRY ROUNDTABLE

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Friday August 30, 2019
Hosted by the BDA

Moderator **Kathleen Faries, ILS Bermuda Chair**

Kathleen's career in the industry spans corporate benefits, captives, facultative insurance, reinsurance, and ILS. The past 10 years of her 30-year career have been focused on leading both at Tokio Millennium Re Bermuda (TMR), but also in the Bermuda (re)insurance market. Kathleen's most recent appointment is an advisory position with ChainThat, a UK based Blockchain company.

Panelists

SD - Sarah Demerling, Walkers Global

Sarah Demerling is a Partner in Walkers Bermuda's Corporate, Finance & Funds Group. She co-leads the (Re)insurance and Insurance-linked Securities (ILS) practice and specialises in funds and investment services, ILS, regulatory compliance (including fintech) and mergers and acquisitions.

AP - Andre Perez, Horseshoe Group

Andre Perez is the founder of Horseshoe Group and holds over 25 years of operations and consulting experience in insurance, reinsurance and alternative risk transfer. Prior to setting up Horseshoe Group, he held various positions in both insurance company operations and consulting and is a member of the Insurance Advisory Committee.

BA - Brad Adderley, Appleby

Brad Adderley is a Partner in the Corporate department in Bermuda and has been a member of the Insurance team for over 20 years. He is also a member of Appleby's global Technology & Innovation team, providing comprehensive advice in connection with all aspects of initial coin offerings and the carrying on of digital asset business.

NP - Nicolas Plianthos, Marsh Management Services (Bermuda) Ltd.

Nicolas is the Client Executive on a number of insurance companies comprising captives, commercial insurers and special purpose insurers. In this role, he is responsible for coordinating the delivery of all Marsh resources to his clients, supervising the client team, serving his clients as a trusted advisor, and ensuring the performance of the deliverables as agreed to in his client's management agreements. Nicolas leads Marsh's Insurance Linked Securities (ILS) administration services.

Panelists

RE - Robert Eastham, Artex Risk Solutions (Bermuda) Ltd.

Rob Eastham is the Managing Director for Artex Risk Solutions (Bermuda) Limited, leading its Bermuda office in insurance-linked securities (ILS), structured transactions and captives. Rob has over 35 years' experience in the reinsurance and ILS market and is also currently an Executive Committee Member of the Bermuda Insurance Management Association.

PL - Paul Larrett, Securis ILS Management Ltd.

Paul is the Chief Underwriting Officer for Securis, whose role includes transaction analytics, underwriting and non-life transactions and has included insurance origination, reinsurance and retrocession transactions emanating from the U.S. and Bermuda market. Paul is a Partner and sits on the Securis Management Committee and attends both the Non-Life Origination and Investment Committees.

In Attendance

Andy Burrows, Bermuda Business Development Agency

Andy joined the BDA as CEO in December 2018. He was appointed by the Board after serving four-and-a-half years as chief investment officer for the Bermuda Tourism Authority, where he was responsible for cultivating investment via hotel development and other tourism related infrastructure. He worked to stimulate capital investment, facilitate immigration, permits and tax issues, and helped create investor-friendly legislation to increase Bermuda's competitiveness to attract inward hospitality investment.

Previously, Andy spent 25 years in the financial services industry, including a decade at HSBC Bermuda, where he served as head of commercial banking. He has also been a director on numerous boards, including HSBC Cayman Islands, and currently serves as director of Bermuda Chamber of Commerce, Raleigh Bermuda and Pathways Bermuda.

Kyle Rogers, Bermuda Business Development Agency

Anna Pereira, ILS Bermuda Ltd.

Gemma Godfrey, Whitfield Group

Foreword

Andy Burrows, CEO, Bermuda Business Development Agency

Bermuda Business Development Agency CEO Andy Burrows welcomed panelists and applauded the work of ILS Bermuda in its efforts to support the promotion of the jurisdiction and its world-leading (re)insurance market.

He said: "The BDA has enjoyed a fruitful partnership with the ILS Bermuda team for many years, and we're delighted to be able to host you here today. The Bermuda insurance market continues to set the standard for the global industry. The recent amendments to Bermuda's Insurance Act, which introduce two new classes of insurer and a new category of insurance intermediary, have been made with a view to facilitating innovation and growth.

To take full advantage of these legislative changes, it's important to discuss how they impact the sector, and to address any questions that may arise – questions to which the panel assembled here today will have highly valuable insights. What is clear is that Bermuda is continuing to cement its position as a leader in the rapidly evolving world of ILS and collateralised (re)insurance, by responding and catering to increasingly sophisticated providers and investors.

We are leading the way in volume, expertise and regulatory maturity. This is in part thanks to groups such as yourselves who volunteer their time and knowledge to ensure we maintain our position as a global (re)insurance powerhouse. Open and constructive dialogue with all stakeholders is key to our ongoing success.

We value our relationship with ILS Bermuda and I look forward to hearing your views."

Introduction

Kathleen Faries, ILS Bermuda Chair

On August 5th of this year the Bermuda Monetary Authority (BMA) introduced a new Collateralised Insurer (CI) class. In a consultation document, the BMA explained that the new class of Collateralised Insurance and Limited Purpose Insurer (LPI) is the result of the increasing scope and sophistication of the Insurance Linked Securities (ILS) and collateralised (re)insurance market. Following the introduction of Special Purpose Insurers (SPIs) in 2009, Bermuda has seen incredible growth in ILS with excess of 80% of outstanding global issuance listed on the Bermuda Stock Exchange (BSX). The BSX is the world's leading exchange for the listing of ILS with 379 listed issuers and US$34.3 billion in market capital outstanding.

The BMA said the new classes of LPIs is to cater to the evolving market which involves more complex structures and deals including using leverage and transacting with a greater variety of cedants including unrated non-affiliated cedants. The BMA also explained that Segregated Account Companies had traditionally been classified as Class 3 insurers and as a result, a number of insurers providing collateralised property catastrophe insurance have been identified in this insurer class. The BMA is of the view that these new insurer activities are not as appropriate for the SPI or Class 3 regulatory frameworks and a more appropriate regime than the standard commercial regimes (Classes 3A, 3B and 4) appears to be required to respond to an evolving and mature market.

ILS Bermuda gathered leading local market executives to discuss the ins and outs of the new classes and how this can help keep Bermuda at the forefront of a rapidly evolving, and competitive, risk landscape.

List of questions

- More and more asset managers have set-up “captives” and rated reinsurers who are setting up offices in Bermuda. Is this a result of the new BMA’s Home Office requirements?
- Are you seeing certain classes of clients interested in the new class of license? 3As or SPIs?
- What are the benefits of the new Collateralised Insurer (CI) class for (re)insureds?
- Could proposed annual fees for Collateralised Insurers be a competitive disadvantage for Bermuda? What is the market saying with regard to competitive fees in differing jurisdictions?
- Operational Risk Capital Charges for Collateralised Insurers - what has been the market response?
- Permanent Regulatory Capital for operational, market and reinsurance credit risk. How are clients responding to this? Is it similar to requirements of commercial insurers?

See FAQs on page 17 for useful information and dates for implementation.

"What are the main differences between a restricted and an unrestricted SPI? Are there any changes proposed to existing SPI legislation?"

Kathleen Faries

BA: Unrestricted means there are no conditions. But please remember, every license has two conditions: be solvent, or you can't write life business. Be solvent, or you can't write SPI business. So, regardless of whether it is restricted or unrestricted, there are no material changes. These have been here since the beginning of time, it is status quo, and it's normal. So, what we are talking about is how do the guidance notes change now for SPIs and restricted/ unrestricted and a new collateralised insurer? How does it affect existing carriers, like existing class 3s and how does it affect 3As and is there an advantage now to being a collateralised reinsurer over being a 3A? Or is there a disadvantage? And depending on who you are talking to, there are individuals who are going to want to be a 3A and others who will want to be a collateralised insurer. There are clients who say, 'I want to be a 3A' and there are also clients who say, 'I want to be a collateralised insurer.' Finding the best solution for each client is my primary focus.

KF: So, we don't have the guidance notes, but based on what we know today, what do you think the benefits of being the new Collateralised Insurer class might be?

RE: One of the things that confuse me, Brad, is that it says in the legislation that you can't be a long-term insurance in the same vehicle. Yet they've now started to issue dual licenses for 3As and Cs.

BA: They've been doing that for a couple of years now.

RE: So why can't a collateralised (re)insurer get a dual license?

BA: I think the challenge with collateralised (re)insurance and the life business is – what is collateralised (re)insurance? Meaning, we all agree you have to be collateralised up to an aggregate limit, let's not use the word leverage for a moment, but with life business, what is the aggregate limit? Because with most life limits, you have a life book of business, life companies that we are talking about $2 billion, $3 billion, $4 billion – that's just the reality. No one collateralises a transaction to $4 billion.

BA: Restricted/unrestricted SPIs have existed since the beginning of time. Look at sidecars. Every sidecar is a restricted SPI.

BA: The question is, can a SPI write multiple transactions with multiple parties with multiple forms – that's what you're talking about.

"Does the BMA take a different view now? "

Kathleen Faries

NP: We've had the conversations with the BMA and they won't pre-approve various carriers who are not A- rated. So basically, if you're an SPI, an unrestricted SPI, engaging with multiple cedants, the license restriction is if you're A- rated by AM Best, or equivalent rating agency you're good to go.

AP: What if I do a transaction with Securis and they are not rated and they're fully collateralised, what is it to the BMA? I said look, we do transactions between ILS platforms and it's fully collateralised and don't care if they are not rated.

RE: If fully collateralised then they are fully secured.

AP: If you look at a sidecar, especially if it's a quota share, technically it's not fully collateralised, because some of them may ask you to do a multiple of PML, some will explicitly take the tail back, which is fine. But it's really your interpretation of what collateralised is. From their standpoint if the limit is a million then I'm expecting a million in collateral.

BA: If you're a collateralised (re)insurer, there are no restrictions.

NP: Correct, and that's one of the benefits of being a collateralised insurer is that you can engage unrestricted cedants but obviously the caveat is that you've got to have capital.

PL: The BMA are not saying they are going to re-write all the rules and push SPI's into the new Collateralised Insurer class. They are sort of hinting that they want to limit SPIs a bit more and push more of the business that involves multiple counterparties into the Collateralised Insurer framework.

BA: Class 3 insurers will not need to change from a Class 3 to either a Collateralised Insurer, or a 3A.

RE: We need guidelines, don't we? Until you get the guidelines we just don't know.

SD: We're showing the evolution of the market place, that we're taking the lead in creating a dedicated framework for this, which other people aren't. We are making clear what that category is without having it fall in the commercial regime, so it's a proportional approach, it's recognising where the marketplace is moving. The fact that we're taking steps and we're including everyone in it – in that discussion, we don't have the final details yet but we're saying it's coming, and highlighting again the fact that we're collaborating with the BMA and industry to have something that's fit for purpose.

"What I'm hearing everybody saying is that it's not so much that there is a new class, it's a lack of consistency and potentially lack of transparency around how the BMA are going to handle that new class, right?"

Kathleen Faries

BA: Or we don't know yet.

AP: I think that in all of this I'm going to narrow it down to two things: permanent capital and the reporting requirement. That's basically what it comes down to.

RE: The liquidity ratio, because it's a segregated structure, the liquidity ratio won't be on the segregated account, it will be just on the general account.
And so effectively there is no liquidity requirement.

BA: So, to my clients in December, I said, how much cash are you keeping in the fund? How much funds do you keep which you don't actually invest in a collateralised reinsurance transaction? Is it more than the capital that the BMA is requiring? Yes, it is. The difference is whether you keep the money in the fund level or you keep the money in the

insurance company. But at the end of the day it is semantics. So, all my clients, whatever the number is so far, has always been lower than their own investment policy requirement having cash.

BA: I would state the BMA were suggesting to me it was a million for every billion. So, the clients were like, well I write $4 billion, a million dollars of capital for every billion dollars in collateral.

RE: When does it come in to effect then?

BA: I would estimate it would be sometime next year.

AP: It's passed.

BA: The act has been passed and once the guidance notes are available, the BMA will be able to license companies.

NP: So, the BMA, in addition to this Collateralised Insurer project, have been working on updating the SPI guidance notes. So, they will harmonize the release of both of them but the SPI guidance notes are much further down the line than the guidance notes for the collateralised insurer. There are enough people out there that want this license, that's why they are doing it. People want to take investment risk, they want to work with unrestricted cedants, they want to work with modelled limits and that's why they have this new license.

BA: One of the questions is if whether you're going to be 3A or not, the clients who are not looking for Solvency II equivalence, but want to do multiple transactions with multiple cedants with multiple parties in multiple forms, leveraged, unleveraged, modelled, whatever. They will become a Collateralised Insurer. They will be less concerned about a head office. The head office requirements have to be higher for a 3A than for a Collateralised Reinsurer.

"Do you feel like this new class is going to help Bermuda be more competitive, more sophisticated? From a market perspective, what do you think the response is going to be?"

Kathleen Faries

BA: No, you are choosing it because you are choosing flexibility. So, I think it comes down to the flexibility and how much capital. So, the question to me is – how big is that number? If that's a reasonable number then I think clients will choose that unless they want to be Solvency II equivalent.

"So, is the methodology on how much permanent capital is required transparent, clear and specific?"

Kathleen Faries

NP: It's very much a work in progress.

KF: So that's part of the problem. Until we know...

NP: The BMA are actively working with us to try and come up with something that is palatable to everybody.

AP: But realistically, I think the BMA is doing something right. They are recognizing that there are features within the collateralised reinsurance market, which needs to be addressed. Whether it's the claw back or whether it's the investment top-up etc.

KF: Yes. As a regulator, yes, I can see that.

AP: I agree, but to answer your original question, is it going to attract or not attract more business? At the end of the day, I think its going to be up to clients to decide whether there is a benefit, if it's a good proposition for them because remember, this is still not a Solvency II equivalent class. Or they might say we're going to look to another jurisdiction.

RE: A move towards Solvency II equivalence, to be honest, the rated 3A structure is becoming more and more popular.

KA: Is there something they can do with the 3A rather than introducing a new class?

BA: The whole idea was to make it easier. We're a jurisdiction of seamless business. We're trying to give you more certainty. Instead of an SPI to do five thousand things we want an SPI to do one thing, an unrestricted SPI to do three things, and the Collateralised Insurer to do even more. We're trying to give you more certainty, on fees, on disclosure from audit. Actually, we are showing that we are ahead of the market.

> **"So what is it that the regulator could do now to provide more certainty?"**
>
> Kathleen Faries

KF: That's the regulator working with business here correct?

RE: I think that getting the guidelines out quickly is important. There's a question mark really on how it's going to look.

RE: The uncertainty is not good. That stops people from making decisions.

BA: But the message for me is, it's going to be a lower standard than a 3A because otherwise you're just going to become 3A.

KF: So, it has to make sense. The requirements have to make sense.

BA: And so far, what the BMA has done, they have listened to the industry to make it better, which speaks to Bermuda's strength in constantly evolving and finding solutions for our (re)insurance industry.

BA: See most of our big, or should we call them big SPIs, not your plain vanilla SPIs, they have either converted, or are in the midst of converting.

AP: Why are they converting?

BA: They just think that, whether they think they are going to get a rating in the future or not, or write business off the balance sheet or not, or even because, you know some of them have business plans where some of them are not permitted to use trust accounts. So, they say, Brad I'm always going to write collateralised business but I'm going to get a rating.

AP: Well if you're getting a rating, if you mean having leverage.

RE: Having some leverage, yes.

RE: Also, there are some cost advantages as well in managing a trust account. You don't have a hundred trust accounts, you only have one.

BA: Well that depends if you're an SPI, but we have 3As today who are saying, Brad, I'm going to get a rating, I'm not going to put the money in a trust between me and the cedants. I'm going to write the business off by balance sheet. It's still going to be fully collateralised by having collateral on my balance sheet. So, I save on trustee fees, administration fees, but of course, I have a rating fee. And by the way, I need the rating anyway and I'm

going to do the audit and all the things I'm going to do for a 3A I'm going to have to do anyway to get a rating.

KF: And they have to have to put up hard capital for a rating.

BA: So, people are moving, your question to me is how many $2 billion SPIs are there out there who are still staying as $2 billion, unrestricted, multiple cedant, multiple party SPIs? Either people have moved or are in the process of moving or at least discussing it.

AP: The ones that have been talking about it is to get a rating and eventually leverage their own balance sheet.

PL: There's not much of a market for second tier retro. So, if we're writing a retro deal and we want to hedge it, we hedge it with an ILW. And you get no capital relief obviously with an SPI structure because of the "basis risk".

AP: In a 3A, you have just one fungible capital base, then you become just a regular insurer.

KF: Yes, you're protecting the balance sheet of the whole entire entity.

RE: Yes, you get a credit for the solvency requirements.

PL: We don't on an SPI.

RE: For the reinsurance, yes.

PL: It's a Solvency II thing

AP: If it's non-specific, the nice thing about 3As is it's one slug of capital.

BA: Simply put, I think that it's going to come down to the difference in head office requirements, the difference in capital requirements, and if the fees are a factor.

KF: And what are the head office requirements?

> **"When it comes to the head office factor, there is no clarity and they will need to be reviewed on a case-by-case basis."**
>
> Brad Adderley

SD: Well depending on how large the SPI is as to how you're meeting those head office requirements. Head office is considered based on the nature, scale and complexity of the business, so you don't necessarily have to have premises and employees. You can outsource, but you need to conduct the business in a prudent manner and have mind and management and direction and execution in Bermuda and you also need to be aware of economic substance requirements to make sure that is being met as well.

PL: So, question one...

"More and more asset managers have set-up Bermuda offices and are now looking at setting up rated reinsurers. Is this increase in people located in Bermuda a result of the new BMA's Home Office requirements? if you're a 3A and you're going to become a rated entity, the requirement in Bermuda to meet economic substance and satisfy the ratings agency is?"

Kathleen Faries

RE: Significant

BA: If you were going to have a rating, you're going to get a rating and it has to be A- or better, or you're not going to be in business. You're going to have to hire staff.

KF: Well maybe not necessarily in Bermuda.

BA: You're going to have to have staff, and you're going to have independent directors. So, first question is, it's going to be driven by AM Best.

KF: So, there's no specific requirement that you have so many C-suites executives or specific types of employees in Bermuda?

BA: If you are a 3A collateralised vehicle but you write a large number of collateralised transactions a year, there is greater administration burden, a lot of underwriting, a lot of actuarial support, maybe the BMA is going to tell you, for

example, 3 staff. And you're going to start off with maybe a chief risk officer, a chief underwriting officer, an actuarial assistant or something along these lines.

"So, there's no specific requirement that you have so many C-suites executives or specific types of employees in Bermuda?"

Kathleen Faries

BA: Most new structures you do, unless you're an existing player with existing funds. And this really is the case, at least we're finding the case with our clients, they will form everything in Bermuda.

PL: The answer to question 1, in my view is, no. For a very short answer. Because there are bigger issues at stake.

PL: I know staff is an important cost and so on, but one of the reasons you set up a rated reinsurer is to do with capital efficiency.

PL: By that (a rated carrier) I mean leverage and operation ease. You're not putting money in trust accounts where you're having a hard time getting it back. You're not putting money in trust accounts that's slow coming back. On renewal you can decline a deal or reduce your line without negotiating how much collateral you can roll over.

RE: If there are collateral releases.

PL: The reason why people are creating these rated carriers is primarily due to who controls the capital/collateral, capital efficiency and operational ease. It's not really about having three staff here I think.

RE: Yes, it's about capital efficiency, controlling costs, avoiding fronting. The reliance on fronts as well.

KF: Yes, but now you're a rated reinsurer, which comes with a whole set of expenses and responsibilities.

KF: Yes. It's just been interesting to see that evolution.

KF: I think Rob's point that the quicker the better, in terms of uncertainty for the market.

BA: Except that we want it ensure everything is thought through and makes sense.

BA: So, to me the question is not simply when the guidance notes come out, but when will they become effective, and more importantly will they affect January 1 renewals. The new guidance notes won't be effective until April of next year. They won't affect the January renewals. That's important for everyone to understand.

KF: And then you have time...

AP: The SPI regulation we have at the moment is still applicable. One win that we have was that the BMA has agreed that they will release the new SPI notes concurrently with the new class of business. So, it's business as usual,

provided that's the case. There is no change in the guidance notes that will affect January 1, but as always, the BMA may have discretion to modify some business.

> **"So, we are in a position where we, as an industry, continue to work with the BMA to understand and adhere to the guidance notes."**
>
> Kathleen Faries

BA: We very rarely have clients that have come to us that are jurisdictional shopping. I think years ago they would consider different jurisdictions, before they even chose lawyers and managers. We do see that on the funds side, with the ILS funds behind us. But when it comes to insurance companies, they know they want to be in Bermuda so it's not even a question.

BA: Slightly different to the collateralised market because there has been less commercial business.

PL: Let's not forget the softer thing, of why people locate in Bermuda: the size of the (re)insurance industry here. US cedants come here, brokers come here. There's a market.

BA: Think of all the brokers we've formed this year in Bermuda. There have been 3 or 4 new brokers.

AP: Well, I think Bermuda, in that sense, is always the first port of entry. No doubt about it.

PL: Time zones do help.

KF: What I am hearing is that business leaders and the regulator continue to have a dialogue in Bermuda as is historically the case.

RE: Every few years, you examine the regulator.

KF: It's also very hard, like we said to compare Bermuda to any other jurisdiction because of all these other key factors.

SD: And we are looking forward to what is coming in the evolving and increasingly sophisticated marketplace rather than looking at what historically we've had to try to pre-empt and respond to where the market is going.

Frequently Asked Questions - FAQs

How does the new Collateralised Insurer (CI) fit into the Bermuda Monetary Authority (BMA) regulatory framework for the Insurance Linked Securities (ILS) sector?

Bermuda has been at the forefront of providing innovative solutions to the insurance industry, in part by adapting its regulatory regimes to align with industry developments such as the ongoing evolution and transformation of ILS. The CI class is primarily driven by need to introduce a dedicated ILS insurance vehicle with operational flexibility to cater for the continuing evolution and transformation of the ILS product, structures, origination models, etc. There is still a fair share of simple ILS transactions such as catastrophe bonds etc., which will continue to be registered as Special Purpose Insurers (SPI). The new CI class will cater for complex ILS structures and deals including:

- Desire to fund part of the collateral by purchasing high quality outward reinsurance
- Take on more investment risk than is otherwise allowed in an SPI
- Trade on a primary/direct basis including unrated policyholder/cedants
- Engage in more complex ILS deals e.g. retroactive legacy covers, structured casualty-ILS

What are the effective dates of the revised SPI Guidance Notes and detailed Rules relating to CI?

- CI class was introduced by the passage of the Insurance Amendment Act 2019 on **5th August 2019**.

- Detailed CI-Rules outlining: (i) the capital framework and (ii) reporting requirements will be consulted upon in **September – November 2019**.

- Subject to the outcome of the consultation process, the BMA expects the new CI-Rules will come into effect on **1st of January 2020.**

- The effective date of 1st of January 2020 is intended to ensure that any CIs that register between 5th August and 31st December 2019 (with a December 31st year-end date or prior) will have the necessary legislative framework to facilitate its first filing (due by 30th April 2019).

- The SPI Guidance Note will be consulted simultaneously with the CI-Rules. The Consultation Paper for the SPI Guidance Note will propose an effective date of 1 July 2020 to give the market sufficient time to comply without disrupting the ongoing 1/1, and April 2020 renewal seasons.

In the past, the BMA registered a number of class 3 insurers, whose structure, business model and risk profile are now more closely aligned to the new CI. Will these be allowed to reclassify to CI and when?

Following the introduction of the new CI class, new insurers and existing ILS-insurers currently registered as class 3s may apply to the BMA to be reclassified to the new CI with effect from 5th August 2019.
However, most might want to wait until the detailed CI-Rules, defining the capital framework and reporting requirements, are published (September to November 2019). While a number of ILS-insurers appear eager to take advantage of operational flexibility afforded by the new CI class, the BMA encourages stakeholders to engage the BMA in the customary pre-application discussions to facilitate efficient reclassification.

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