

NEW CAPITAL REQUIREMENTS FOR BERMUDA COMMERCIAL INSURERS

David Doyle & Kent Smith – February 2010

The Bermuda Monetary Authority ("BMA") has published a consultation paper (and draft legislation) outlining its plans to introduce a 3-tiered capital system designed to assess the quality of capital resources eligible to meet the capital requirements of certain classes of Bermuda general business insurers. The new system is broadly based on the Basel II framework introduced last year to the regulation of Bermuda's banking sector.

The BMA intends to introduce the new regime for Class 4 and Class 3B general business insurers in the fourth quarter of 2010 with a transitional period of a year and, following further consultation, the system will be extended to Class 3A general business insurers in accordance with the "proportionality principle". The extension of the new system to Class 3A insurers is tentatively scheduled to become effective as from the fourth quarter 2011 also with a transitional period of a year.

Background

The current statutory regime requires all Bermuda general business insurers to maintain their statutory capital and surplus at a level equal to or exceeding each company's respective minimum solvency margin ("MSM"), as defined in the Insurance Act 1978 ("Act"). Failure by a general business insurer to meet its MSM represents a breach of its minimum statutory capital requirements and results in the company being deemed insolvent under the Act.

Currently Class 4 general business insurers are also required to maintain available statutory capital and surplus at a level equal to or in excess of its enhanced capital requirement ("ECR") which is the higher of the MSM and the figure derived from the company's standard risk-based capital requirement model or its BMA-approved internal capital model.

While not specifically dealt with in the Act, the BMA has also established a target capital level ("TCL") for each Class 4 insurer equal to 120% of its ECR. While a Class 4 insurer is not currently required to maintain its statutory capital and surplus at this level, the TCL serves as an early warning tool for the BMA and failure to maintain statutory capital at least equal to the TCL will likely result in increased BMA regulatory oversight.

At the present time, the ECR and TCL requirements apply only to Class 4 insurers; however beginning in fourth quarter 2010, the BMA intends to apply the ECR and TCL to Class 3B insurers and this new regime is expected over time to be extended to Class 3A insurers.

The 3-tiered Capital System

Under the proposed new 3-tiered capital system, the available capital eligible to support an insurer's statutory capital requirements is the aggregate of its "Basic Capital" and its "Ancillary Capital".

Basic Capital is made up of a company's capital stock (paid in share capital and share premium), contributed surplus (sometimes referred to as additional paid in share capital or "APIC") and its statutory surplus (as stated in the company's statutory statement of capital and surplus), together with any adjustments thereto. Preference shares may be included as capital stock but their availability as Tier 1 or Tier 2 Capital depends on the degree to which they satisfy applicable Tier Classification Criteria as set forth in the consultation paper.

Ancillary Capital will consist of any other off-balance sheet financial instruments (including unpaid or callable capital and debt instruments) which are approved by the BMA for statutory capital

purposes (examples of such off-balance sheet instruments include letters of credit, loan notes and unpaid share capital). When approving such off-balance sheet instruments, the BMA will consider a counterparty's ability to honour its commitment, the counterparty's credit risk (including past behaviour) and the existence of contractual limitations contained in the instrument itself (eg. duration, subordination provisions etc.). Depending on the instrument, the BMA may impose restrictions on the amount and/or duration that such assets may qualify as Ancillary Capital.

It is recognised that the capital instruments making up the insurer's Basic and Ancillary Capital possess different qualities and vary in the protection they offer to policyholders. For instance, capital instruments such as common shares are able to protect the interests of policyholders by absorbing losses in all circumstances (ie. on a going-concern basis, in a run off situation, where the company is insolvent and in a winding up) whereas debt instruments containing subordination provisions may not be available to absorb losses until the company becomes insolvent or is wound up and, as such, do not qualify as the highest quality capital.

The BMA therefore proposes to classify all capital instruments into a given tier based on their "loss absorbency" and other characteristics, pursuant to the Tier Classification Criteria.

Tier 1 Capital will be comprised of the highest quality capital meaning that it is able to absorb or respond to losses under all circumstances. Tier 2 Capital will generally provide full protection to policyholders in a winding-up or insolvency scenario but which will have moderate loss absorbency on a going-concern basis. Tier 3 Capital will meet, on a limited basis, some of the characteristics exhibited in Tiers 1 and 2 but will otherwise be regarded as the lowest quality capital available to meet the company's regulatory capital requirements.

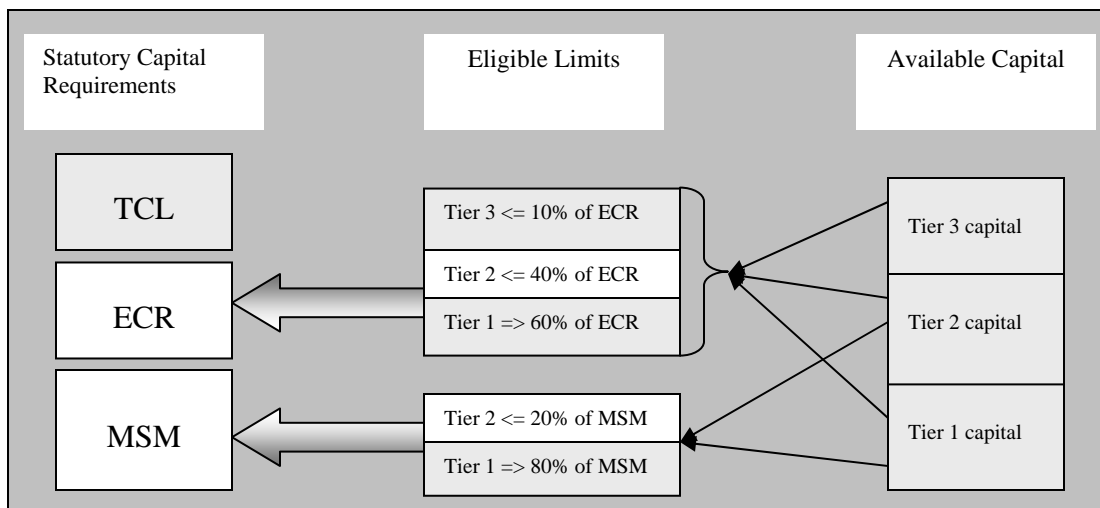
Satisfaction of statutory capital requirements

Under the proposed regime, only the highest quality capital will be permitted to be used to support the MSM which is the minimum statutory capital requirement that must be maintained by all Bermuda insurers. Given that a breach of the MSM constitutes insolvency for regulatory purposes, the BMA proposes that a minimum of 80% of Tier 1 Capital and a maximum of 20% of Tier 2 Capital be eligible to meet the MSM.

The ECR, on the other hand, represents a secondary level capital requirement and, as such, the BMA is prepared to be more flexible in determining what capital is eligible to satisfy the ECR. The BMA initially proposes that a minimum of 60% of Tier 1 Capital and a maximum of 10% of Tier 3 Capital be eligible to meet the ECR.

Once the insurer has sufficient capital in Tiers 1, 2 and 3 to satisfy its MSM and ECR, any combination of Tier 1, 2 and 3 Capital may be used to satisfy its TCL.

The chart below sets out in diagrammatic form how the proposed 3-tiered capital system is proposed to operate with respect to the Class 4 and Class 3B insurers.



A similar approach is expected to apply with respect to Class 3A insurers; however based on the outcome of further consultation, it is likely that the percentages of eligible capital available to meet a Class 3A insurer's MSM, ECR and TCL requirements may be varied from those set out above but the Tier Classification Criteria are expected to remain the same.

Timing

In order to effect this proposal, it is expected that an Insurance Amendment Bill, along with amendments to the Insurance Returns and Solvency Regulations 1980, will be presented to the Bermuda Legislature in early 2010 and, assuming approval, will become effective for Class 4 and Class 3B insurers from fourth quarter 2010 with a one year transitional period.

Conclusion

A review of the statutory financial statements of Class 4 insurers for the period to December 31st, 2008, indicates that 83% of available capital was in the form of common shares, preference shares (less than 1%) and contributed surplus; 16% was the excess of assets over liabilities, excluding common shares, contributed surplus, preferred shares and other fixed capital; and 1% comprised other fixed capital approved for statutory capital purposes, e.g. letters of credit and parental guarantees. Thus, based on these figures, about 98% of the current available capital held by Class 4 insurers would qualify as Tier 1 Capital.

David Doyle, Partner, Conyers Dill & Pearman
Kent Smith, Associate, Conyers Dill & Pearman

This article deals in broad terms only with the expected changes to the capital requirements for Bermuda commercial insurers. It is based on the consultation paper published by the Bermuda Monetary Authority and follow-up discussions with members of the BMA implementation team. It is intended solely to provide a brief overview and general information on the proposed enhanced requirements and is not intended nor is it a substitute for legal advice or a legal opinion.

The complete text of the consultation paper and the draft legislation can be found at www.bma.bm or can be requested from us. Please contact David Doyle (david.doyle@conyersdillandpearman.com) or Kent Smith (kent.smith@conyersdillandpearman.com) for further information.

Notes to Editors

Conyers Dill & Pearman is a multi-jurisdictional law firm that advises on the laws of the Cayman Islands, British Virgin Islands, Bermuda, Mauritius and Cyprus. The firm specialises in company and commercial law, commercial litigation and private client matters. Conyers' structure, culture and expertise enable the firm to consistently deliver on its promise of responsive, timely and thorough service. Conyers provides clients with the highest quality legal advice from strategic global locations including offices in the world's leading financial centres in Europe, Asia, the Middle East and South America. Founded in 1928, Conyers comprises 600 staff including more than 150 lawyers. Affiliated companies (Codan) provide a range of trust, corporate secretarial, accounting and management services.

Conyers Dill & Pearman was named Offshore Law Firm of the Year 2009 by *The Lawyer*.

For further information please contact:

Naomi J. Little

+1 441 298 7828

naomi.little@conyersdillandpearman.com

www.conyersdillandpearman.com