

## SUMMARY OF THE BMA'S GUIDANCE NOTE ON SPECIAL PURPOSE INSURERS

*Charles Collis & Michael Frith – October 2009*

Last year, in line with its ongoing efforts to enhance the regulation of insurers in Bermuda, the Bermuda Monetary Authority ("BMA") introduced several amendments to the Insurance Act 1978 (the "Act"). Among other matters, the Insurance Amendment Act 2008 (which came into force at the beginning of this year) introduced the concept of "Special Purpose Insurers" in Bermuda. These special purpose insurers ("SPIs") will be licensed to write an entirely new category of insurance business referred to as "special purpose business".

The SPIs will enjoy an expedited application process, overall lighter regulation and only nominal capital requirements, on the basis that such companies are being established to carry out one or a series of fully funded transactions between sophisticated participants. The nature of the underlying risk is irrelevant when determining whether the business is special purpose business. Accordingly, both long-term (life) and general business transactions may be carried out through SPIs.

The legislative changes that created the SPI and special purpose business concepts are intentionally drafted to allow the BMA maximum flexibility in determining the type of transactions and circumstances in which the use of an SPI would be appropriate. In order to provide some guidance to the insurance industry as to the manner in which the legislation is likely to be interpreted in practice, the BMA recently issued its Guidance Note #20 – Special Purpose Insurers (the "SPI Guidance Note"). The SPI Guidance Note, in accordance with the BMA's customary practice, has been developed in close consultation with leading industry participants, and aims to reflect the needs of those industry participants while maintaining an appropriate level of regulatory oversight.

In essence, in order to be deemed to be writing "special purpose business", and to be licensed as an SPI, the applicant will be required to evidence that the business it intends to write will be fully-funded and that the parties to the proposed transaction are sufficiently sophisticated. The question of what is meant by "fully-funded" and "sufficiently sophisticated" has been intentionally left to the discretion of the BMA, in order to allow maximum structural flexibility. However, the SPI Guidance Note does outline some examples of factors that the applicant will be required to evidence in order to meet these essential criteria.

### **Fully-funded**

The Act states that special purpose business may be fully-funded by way of cash, time deposits, subordinated debt and "...*some other financing mechanism approved by the [BMA]*". This latter element allows for maximum flexibility for parties to use funding mechanisms such as reinsurance, derivatives, etc. and to create novel funding mechanisms. Indeed, rather than prescribing the types of transaction that will qualify as "fully-funded" the SPI Guidance Note simply sets out certain key characteristics that an applicant will need to evidence in order to be deemed to be writing fully-funded business. These include matters such as ensuring that full disclosure has been made to the cedant as to the fact that their claims will be limited to the assets held by the SPI and that the terms of the financing make clear that repayment rights will be subordinated to claims of policyholders.

With regard to the nature of assets to be held by the SPI, the applicant will be required to evidence full disclosure to all parties of investment guidelines and asset quality but there is otherwise no specific restriction on the types of assets that may be held. In appropriate circumstances an SPI may fund with contingent assets (eg. reinsurance and/or letters of credit), provided that the issuer of such contingent asset is suitably regulated and of sound financial quality.

### **Sophisticated Participant**

In creating the new concept of special purpose business and SPIs, the BMA has recognized that in transactions that qualify for licensing as such, the need for regulation differs from that of traditional (re)insurance business. The transactions contemplated are necessarily very sophisticated and technically advanced, and as such, the participants in such business are also necessarily sophisticated. In recognition of this fact, SPIs are subject to a lighter form of regulation. The BMA retains broad discretion to determine, on a case by case basis, whether or not a particular party is deemed to be sufficiently sophisticated, but will have regard to factors such as net worth (either of individuals or entities) and levels of skill and experience in business or financial matters.

### **Regulatory Requirements**

Where an applicant satisfies the above criteria and is licensed as an SPI, it will be subject to a lighter regulatory regime than that of general or long-term business insurers. Notably:

- (i) the minimum issued share capital of an SPI is \$1, and the margin of solvency for an SPI (ie. amount by which the SPI's assets must exceed its liabilities) is also \$1.
- (ii) the usual restrictions on the amount by which an insurer's capital may be reduced, will not apply to SPIs.
- (iii) the BMA may entertain applications by SPIs to modify or waive the usual annual account filing requirements applicable to insurers, and in appropriate circumstances may agree to accept unaudited management accounts (prepared in accordance with GAAP, IFRS or other appropriate accounting standard) in lieu of audited or statutory accounts.
- (iv) the requirement to appoint a loss reserve specialist does not apply to SPIs.

### **Application Process**

The SPI Guidance Note makes clear that application for approval of SPIs will be streamlined relative to the approval process for general business or long-term business insurers. An SPI application form will need to be completed and signed by the applicant, and submitted to the Authority, together with any relevant supporting information. The BMA has indicated that SPI applications will be reviewed on an expedited basis, but at a minimum will be reviewed at the BMA's usual weekly Admissions and Licensing Committee meeting (held on the Friday morning of any given week).

These legislative changes, and the BMA's policy in respect of the application of the changes will serve to facilitate the continued development of sophisticated insurance transactions in Bermuda. Cat bonds, Sidecars, Life Securitisations and Transformer vehicles are just some of the possible users of the SPI concept, with the built-in flexibility of the legislation and the continued accessibility of the BMA allowing the industry to develop new concepts and uses as needs warrant.

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*This article is not intended to be a substitute for legal advice or a legal opinion. It deals in broad terms only and is intended to merely provide a brief overview and give general information.*

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