BERMUDA MONETARY AUTHORITY

GUIDANCE NOTE

SPECIAL PURPOSE INSURERS

31 OCTOBER 2019

TABLE OF CONTENTS

I. INTRODUCTION

1. The Special Purpose Insurer (SPI) class was introduced by the passage of the Insurance Amendment Act 2008 on 30 July 2009.

2. This Guidance Note (Note) is a revision to the Guidance Note issued in October 2009 and sets out updated guidance in relation to the Authority's regulatory regime for SPIs. The Authority invites the insurance industry and other interested stakeholders to send us their views on this Note. Comments should be sent to the Authority, addressed to SPInsurers@bma.bm, no later than Friday 29 November 2019.

3. A primary focus of this Note is to outline the Authority's approach to the licensing and ongoing supervision of SPIs. This involves setting out robust prudential requirements that SPIs must meet in order to comply with the Insurance Act 1978 and its related rules, codes and guidance (the Act)[1].

4. If Bermuda's regulatory system is to command the confidence of (re)insurers, cedants/policyholders, regulators, investors and other key stakeholders, the Authority recognises the need for clarity as to the scope and implementation of the provisions of the Act. The Authority therefore seeks to ensure that relevant stakeholders have a sound understanding of the Authority's approach to implementing the Act in the context of SPIs.

5. SPIs typically facilitate the transfer of specific insurance risks to the capital markets through the issuance of Insurance-Linked Securities (ILS). The Authority may register an SPI as restricted or unrestricted. A restricted SPI may conduct special purpose business with specific insureds approved by the Authority. On the other hand, unrestricted SPIs may transact with any insured, if the insured is rated A- or higher, in terms of its financial strength, by AM Best or an equivalent rating from a rating agency recognized by the Authority (refer to paragraph 21 below). Otherwise, the Authority's approval is required. The (re)insurance arrangement must be fully collateralized which generally reduces exposure to counter-party default.

6. Clear contractual arrangements must be established to govern the operations of the SPI such as a reinsurance contract, arrangement for safekeeping of collateral and funding documentation. The Authority considers SPI arrangements appropriate for sophisticated cedants and investors only.

7. While the Authority aims to provide clarity as to its approach, this Note cannot be exhaustive. The Authority endeavours, through this Note, to set out information regarding its regulatory and supervisory approach and expectations of the activities associated with SPIs. Ultimately, it is the responsibility of the Board of Directors of the SPI to ensure the SPI complies with the Act.

[1] The insurance legislation is comprised of the Insurance Act 1978 (as amended) and the rules promulgated under that Act (the Rules). The Rules are Special Purpose Insurer Accounts, Return and Solvency Rules 2019 (currently under development). The codes include the Insurance Code of Conduct, July 2015.

II. APPLICATION AND REGISTRATION PROCESS

8. SPIs are subject to an application, registration and ongoing supervisory review process, commensurate with its risk profile. SPI applications are expected to include all relevant documentation required of (re)insurance applications[2].

9. The SPI application requires the inclusion of an accurately completed SPI Checklist, which aids in the review process and which includes a series of questions directed to the most pertinent details of the SPI transaction[3].

10. The Authority endeavours to process approval of a vetted, compliant and complete SPI application within one week. To make the process more efficient, applicants are encouraged to discuss their proposals with the Authority prior to formal application.

11. Once approved, the applicant should make further application to the Authority to be registered as a licenced SPI. Provided the registration documentation is thoroughly completed, a licence is generally issued within three business days.

III. FULLY COLLATERALIZED STRUCTURE & CONTRACT CERTAINTY

12. The Authority recognises there may be numerous interpretations of the term "fully collateralized" in evaluating the financial position and contractual arrangements inherent to SPI vehicles. For the purposes of interpreting the provisions in the Act in the context of an SPI's fully collateralized position, the following conditions shall apply to an SPI's available assets and liabilities and its contractual arrangements:
    a) To be fully collateralized in accordance with the Act, an SPI will be expected to:
        i. Provide collateral to its insured(s) to cover the full aggregate limit(s) of potential claims that could arise from its (re)insurance contract(s);
        ii. Establish the effective date of the associated (re)insurance contract(s) concurrently or subsequent to the required collateral being fully paid-in to the associated SPI account. Generally, the Authority expects collateral shall be provided on or before the inception date of the (re)insurance contract. However, the (re)insurance contract may expressly allow collateral to be provided within a specified grace period, not exceeding 15 business days, after the later of:
            - The execution date of the (re)insurance contract by the SPI; and
            - The inception date of the (re)insurance contract

[2] Where final transaction details and documentation are not available at the time of application, draft transaction documentation, utilising estimates of final agreed terms, are deemed acceptable.

[3] The Authority expects that all aspects of the SPI Checklist shall be completed thoroughly. More specifically, applicants are reminded that the "page reference" entries to all documentation including (but not limited to) business plans, (re)insurance contract(s), indenture agreements and private placement memoranda (as applicable) are expected to be identified in full, to facilitate an efficient review of the SPI application.

Where the grace period is relied upon, the (re)insurance contract must clearly define, using explicit contractual language, how the SPI will settle any claim occurring during the grace period. For example, including clear contractual provisions in a funding agreement, which is legally binding on its investors, stating that the funding agreement will be automatically drawn down or enforced by the SPI to settle any claim occurring during the grace period.

b) Collateral may include any net premiums receivable from the cedant provided the (re)insurance contract has appropriate contractual provisions that permits the SPI to offset the losses payable by the SPI against the net premiums due under the (re)insurance contract. The net premiums shall be the gross premium written, less any applicable expenses such as brokerage, tax, etc. Similarly, funds withheld by a cedant may cover the collateral requirements provided this is clearly stated in the (re)insurance contract.

c) The aggregate limit may be a fixed amount or an amount calculated at any point in time by reference to a specific formula, adjustment(s), model or otherwise, provided:
   i. The aggregate limit is clearly defined in the reinsurance contract; and
   ii. The contractual provisions clearly specify when the aggregate limit may change and the mechanics of how full collateralisation to the aggregate limit will be maintained throughout the life of the contract.

d) The reinsurance contract must contain a limited recourse clause stating that the maximum (re)insurance recoverable from the SPI is limited to the lower of:
   i. The explicitly stated, fixed or formulaic, aggregate limit; or
   ii. The available assets provided as collateral.

e) The limited recourse clause should be employed in the context of sound contractual arrangements governing the SPI structure. More specifically, limited recourse cannot substitute the need to have, among other things:
   i. Clear and effective contractual language within the (re)insurance agreement specifying the aggregate limit transferred to the SPI, and confirming this amount to be equal to or less than the collateral;
   ii. A prudent investment strategy; and
   iii. Adequate governance and risk management controls that are consistent with the risk profile of the SPI.

f) The SPI shall ensure that, to the extent it has entered into more than one (re)insurance contract, that, notwithstanding any other requirements:
   i. Each (re)insurance contract and associated collateral is structured so that the SPI at all times meets the full collateralisation requirements individually for each (re)insurance contract; and
   ii. Each (re)insurance contract has a single cedant and/or multiple cedants under common ownership.

g) The SPI shall ensure that, under the terms of any debt issuance or other financing mechanism used to fund its (re)insurance liabilities, the rights of providers of that debt or other financing are fully subordinated to the claims of policyholders under its contracts of (re)insurance.

13. It is the Authority's expectation that:

a) The SPI shall enter into contracts or otherwise assume obligations, which are solely necessary for it to give effect to the special purpose (re)insurance for which it has been established.

b) All documents governing the SPI, including the terms and conditions of ancillary contracts shall be clearly aligned, consistent and not contradictory.

c) If the SPI executes a reinsurance contract which stipulates collateral will be provided within a grace period (not exceeding 15 business days), the SPI shall have entered into a corresponding funding agreement, which is enforceable by the SPI and legally binding on its investors, prior to executing that reinsurance contract.

IV. ROLLOVER / ROLLFORWARD

14. Where all or part of the collateral supporting a (re)insurance contract is used to support a subsequent collateralized (re)insurance contract, for example in the case of renewing a (re)insurance contract, the contractual documentation must clearly state to what extent the collateral supports each (re)insurance contract and the corresponding effect on the aggregate limit of each of the (re)insurance contracts. The Authority expects the aggregate limit(s) of the contract(s) from which the collateral is transferred from, to be simultaneously and commensurately reduced with the associated release of collateral. Similarly, the aggregate limit of the contract to which the collateral is transferred to shall not contractually come in-force until after the associated collateral is fully paid-in to the collateral account.

V. COLLATERAL RELEASE AND CLAWBACK

15. The Authority expects that the release of collateral by the cedant shall reduce the aggregate limit of a (re)insurance contract commensurately. Further, on full release of collateral by the cedant, the cedant shall discharge the SPI of all past, present and future liabilities arising from the (re)insurance contract. The collateral release arrangement should be governed by clear contractual provisions, for example, a commutation clause in the reinsurance contract.

16. Given the requirement that an SPI must fully collateralize all of its obligations under a (re)insurance contract and that the liability of an SPI under a (re)insurance contract must ultimately be limited to the assets provided as collateral supporting the (re)insurance contract, an SPI may not as part of a (re)insurance contract (or contract

ancillary thereto) include an obligation to return collateral released by the cedant as that would potentially leave the SPI with an unfunded liability.

VI. TOP-UP PROVISIONS TO MANAGE ASSET IMPAIRMENT

17. The Authority neither requires nor prohibits the use of contractual top-up provisions to mitigate and manage the risk of loss of value of assets backing the collateral. The following conditions apply if top-up provisions are included in the (re)insurance contract:
    a) The (re)insurance contract must clarify that the top-up provision is to specifically manage the impairment risk of assets supporting the collateral. As a result, this provision cannot be relied upon to:
        i. Clawback or facilitate the return of collateral previously released by the cedant, (refer to paragraph 15 above);
        ii. Undermine the need for the SPI to be fully collateralized in accordance with the Act (refer to paragraph 12 (a) above); or
        iii. Justify an inappropriate investment strategy that is not in accordance with this Note (refer to paragraph 22 below).

    b) The (re)insurance contract must clearly define, using explicit contractual language, specific mechanisms and arrangements demonstrating how the top- up provision will be executed in the event it is triggered. Such arrangements could, for example, be in the form of off-balance sheet support or funding agreement and other hedging arrangements.

18. The Principal Representative of the SPI shall forthwith notify the Authority on reaching the view or on coming to the knowledge that an impairment of assets backing the collateral has occurred and the SPI is liable to top-up the collateral account(s) in accordance with explicit provisions of its (re)insurance contract(s). The Principal Representative shall furnish the Authority with a report in writing outlining all the relevant particulars including how the top-up has been or shall be satisfied.

VII. GOVERNANCE, BOARD COMPOSITION AND RISK MANAGEMENT

19. In accordance with the Insurance Code of Conduct, an SPI must establish sound and effective governance and risk management frameworks that are proportional to its risk profile. The frameworks should facilitate effective and efficient operations and address the organisational structure of the SPI, including the segregation of duties and the management of conflicts of interest.

20. In particular, unrestricted SPIs should organise their governance arrangements and Board composition in a manner that mitigates conflict of interest including by eliminating situations whereby:
    a) All of the Board positions are filled by one service provider;
    b) One service provider is satisfying a majority of key roles such as the insurance manager, principal representative and a majority of Board positions.

VIII. SOPHISTICATED PARTICIPANTS

21. The Authority expects that only sufficiently fit and proper sophisticated participants will engage in this highly specialised form of business, which in the context of this Note means a knowledgeable person who satisfies one or more of the below criteria:
    a) Investors
        i. High income private investors;
        ii. High net worth private investors;
        iii. Sophisticated private investors;[4]
        iv. Eligible investment funds approved by the Authority;
        v. Bodies corporate, each of which has total assets of not less than five million dollars, where such assets are held solely by the body corporate or held partly by the body corporate and partly by one or more members of a group of which it is a member;
        vi. Unincorporated associations, partnerships or trusts, each of which has total assets of not less than five million dollars, where such assets are held solely by such association, partnership or trust or held partly by it and partly by one or more members of a group of which it is a member;
        vii. Bodies corporate, all of whose shareholders fall within one or more of the subparagraphs of this paragraph, except subparagraph (iv);
        viii. Partnerships, all of whose members fall within one or more of the subparagraphs of this paragraph, except subparagraph (iv);
        ix. Trusts, all of whose beneficiaries fall within one or more of the subparagraphs of this paragraph, except subparagraph (iv);
        x. Any company quoted on a recognised stock exchange;
        xi. Any party deemed to have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment; and
        xii. Other persons approved by the Authority as suitable investors on a case-by-case basis.

    b) Cedants:
        i. Restricted SPI - specified licenced (re)insurance entity(ies) typically listed in the SPI's certificate of registration;
        ii. Unrestricted SPI - licenced (re)insurance entity(ies) rated A- or higher by AM Best or equivalent rating by Fitch, Standard & Poor's, Moody's, Demotech, Inc., Dominion Bond Rating Service, Egan Jones Rating Company, Japan Credit Rating Agency, Kroll Bond Rating Agency, Morningstar Credit Ratings or other recognized rating agencies as approved by the Authority;

[4]Private investor means an individual who has such knowledge of, and experience in, financial and business matters as would enable him/her to properly evaluate the merits and risks of a prospective purchase of investments.

iii. Entities in possession of a legislative mandate (e.g. government insurance pools) to provide insurance coverage; and
iv. Entities with demonstrated ability, the necessary risk management capabilities and infrastructure to engage as a party to SPI business as determined by the Authority.

c) Insurance Managers:
   i. Insurance managers licenced by the Authority who are deemed fit and proper to manage SPI vehicles.

IX. ASSET QUALITY AND DISCLOSURES

22. It is the expectation of the Authority that the SPI will generally carry minimal investment risk with respect to the collateral in the collateral account. The SPI should provide full disclosure of the investment guidelines governing the collateral to the cedant and its investor/debt-holder(s). The associated documentation is expected to disclose detail such as the types, issuers and target credit ratings of permissible investments.

23. In addition, it is the expectation of the Authority that the SPI provide full disclosure to the cedant and investor/debt-holder(s) and agrees to make available to the relevant counterparties the following data, (as applicable):
    a) The total composition of the assets of the collateral; and

    b) The latest available market value of the assets, and/or the latest available net asset value of such assets:
       i. As soon as commercially practicable after the end of each calendar month or such other times as agreed between the parties; and
       ii. As soon as commercially practicable after the request of any relevant participant where such data may not be aged by more than 30 days unless agreed upon by the relevant parties.

X. LETTERS OF CREDIT AND OUTWARDS REINSURANCE

24. The Authority recognises letters of credit as acceptable instruments for inclusion in the collateral structure of SPIs. The SPI must demonstrate that the issuer of the letter of credit:
    a) Is a regulated financial institution subject to regulation by the Authority or equivalent regulation by another regulatory body; and

    b) Either:
       i. Has achieved a financial rating (counterparty, credit or financial strength as applicable) of at least A- (or equivalent) as of the date of application and as determined by a recognised rating agency; or
       ii. Is of a sound financial quality (in the circumstance of unrated issuers or issuances) as deemed by the Authority.

25. The Authority does not generally recognise outwards reinsurance as a form of funding acceptable to collateralize the aggregate limit (re)insured by an SPI under a (re)insurance contract. However, the Authority may approve the use of suitable reinsurance arrangements by an SPI, for example where the reinsured limit is fully collateralized with high-quality assets.

XI. MATERIAL CHANGE IN BUSINESS

26. If during the lifetime of the SPI it intends to:
    a) (Re)insure any additional risks that were not contemplated in the initial transaction and/or business plan;

    b) Make any material changes to any of the ancillary contracts to the (re)insurance contract;

    c) Make any modifications to the material disclosures included in the original application;

    d) Raise additional capital from investors and/or debt-holders not identified or contemplated in the original documentation approved by the Authority;

    e) Make any other changes pertinent to its business where these changes would be deemed by a reasonable and knowledgeable person to be material; and/or

    f) Make any material change as outlined in Section 30JA of the Act,

    then these changes are subject to prior supervisory approval as required by Section 30JB of the Act.

27. The approval process for any material change in an SPI's business shall take into account the nature, scale and complexity of those changes as determined by the Authority.

28. In its deliberations, the Authority shall consider whether the changes constitute a change in the objectives of the SPI, and to the extent that they do, the Authority may require a more exhaustive authorisation process.

XII. EXEMPTION FROM PRIOR APPROVAL OF CAPITAL RELEASE

29. Section 31C of the Act – "Restrictions as to reduction of capital" is not applicable to SPIs. This is consistent with the Authority's risk based approach to regulation, and the Sophisticated Participant requirements associated with these entities.

XIII. FILING REQUIREMENTS FOR SPIs

30. Statutory Financial Returns shall be prepared and filed in accordance with the requirements of the Special Purpose Insurer's Accounts, Returns and Solvency Rules 2019 (the Rules). The Rules require each SPI to submit a Statutory Financial Return (SFR) populated from the corresponding values in its GAAP financial statements.

31. SPI's are required to have their GAAP financial statements audited unless they write only restricted special purpose business (as defined in the Act) or have been granted an audit exemption by the Authority (refer to paragraph 32 below). Where an SPI is not required by the Authority to have its GAAP financial statements audited, but it does so for any other purpose, it shall submit those audited financial statements to the Authority.

32. The Authority shall, on a case-by-case basis, consider applications to modify the GAAP external audit requirement, where appropriate. An SPI must be in good standing with the Authority for its application to be considered by the Authority. Additionally, audit waivers shall be considered on an annual basis and shall relate to the relevant financial period.

XIV. IMPLEMENTATION

33. This Note will come into force on 1 July 2020.