BMA
BERMUDA MONETARY AUTHORITY

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The Evolution of Asset Intensive Insurance

Update to the *Supervision and Regulation of Private Equity (PE) Insurers in Bermuda* White Paper

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Introduction

Reinsurance is a global industry, and it is essential that the regulators work together to ensure effective regulation and supervision of reinsurance arrangements. Transparent and robust cross-border regulatory cooperation and information sharing are essential in the supervision of cross-border asset-intensive reinsurance. As a leading financial services regulator, the BMA (Authority or BMA) often partners with other regulators worldwide and mutually shares its supervisory experiences with our peers. We have also benefited from similar initiatives by our regulatory colleagues in other jurisdictions. We are appreciative of these opportunities as they continually keep the BMA aware of emerging international regulatory developments and trends.

As part of these efforts, the BMA seeks to publish several papers that are beneficial to both the industry and our peer regulators. In 2023 and 2024, the Authority published several papers relevant to Bermuda's asset-intensive and Long-term insurance market. They include the following:

1. *Bermuda Long-Term Insurance Market Analysis and Stress Testing Report*[1]*;*
2. *Supervision and Regulation of Private Equity (PE) Insurers in Bermuda*[2]*;*
3. *Liquidity Risk in the Bermuda Long-term Insurance Market*[3]*;*
4. *Collateral Structures in the Bermuda Long-term Insurance Market*[4]*; and*
5. *Private Credit–Direct Loans, Collateralised Loan Obligations (CLOs), and Private Placements*[5]*.*

This White Paper updates our previous paper dated December 18, 2023 titled *"Supervision and Regulation of Private Equity (PE) Insurers in Bermuda"*. The paper aims to enhance the understanding of these risks and how they manifest in the context of asset-intensive insurance business, including strategic alliances between life and annuity insurers d asset management firms such as PE firms. The paper also highlights current and proposed regulatory practices designed to ensure the sector is appropriately regulated, focusing on the key regulatory objectives of protecting policyholders and maintaining financial stability.

> *Strategic alliances between life and annuity insurers and asset management firms have played a significant role in narrowing the global protection gap, including in asset-intensive businesses. However, these partnerships have led to a notable shift in traditional investment strategies and pose unique risks and supervisory challenges, including potential governance and conflicts and a tendency to invest in higher proportions of illiquid assets. The interplay between these two risk drivers poses challenges to traditional supervisory approaches. The BMA's supervisory experience has shown that a more tailored and agile supervisory and regulatory approach that takes into account the specific characteristics and circumstances of the insurer is needed. Regulatory cooperation and collaboration between cedent and reinsurer regulators are essential for the effective supervision of asset-intensive insurance businesses. This includes joint evaluation of the deals to identify risks and agree on mitigants; supervisory colleges and bilateral engagements; and joint onsite work focussing on key areas such as collateral arrangements.*

[1] Bermuda Long-term Insurance Market Analysis and Stress Testing Report
[2] Supervision and Regulation of PE Insurers in Bermuda
[3] Liquidity Risk in the Bermuda Long-term Insurance Market
[4] Collateral Structures in the Bermuda Long-term Insurance Market
[5] Private Credit — Deep dive on Direct Loans, CLOs and Private Placement

1 | Key Messages

- There is increasing awareness that people and businesses have far less protection than they need. According to the Global Federation of Insurance Associations (GFIA), the global pension protection gap was estimated at USD 51 trillion[6] in 2023. Bermuda is a broad (re)insurance market that has emerged and evolved over the past six decades in response to and to solve various global challenges, including protection gaps. Bermuda has a long-standing track record of successfully attracting investors and reinsurers willing to deploy capital to address protection gaps, including in the aftermath of major natural catastrophe disasters

- The growth in the Bermuda long-term insurance market has emerged in response to a combination of factors, including demographic shifts that have increased the need for life, savings and retirement products, the 2008 economic crisis (economic cat) and the subsequent long period of extraordinarily low interest rates, tight credit spreads and flat yield curves. During the period of low interest rates, traditional life and annuity insurers often faced challenges generating sufficient returns, prompting them to shift their strategies to return capital to shareholders. McKinsey[7] reported that in the last decade, public life and annuity insurers in Canada and the US gave about $275 billion to shareholders through $190 billion in share buybacks and $85 billion in dividends. A significant contributor to the withdrawal of traditional capital was the inability of the life sector to earn the returns needed to honour guarantees within insurance contracts while meeting the required minimum cost of capital. According to Swiss Re[8], the life sector fell short of its cost of capital by almost 5% points per year on average following the global financial crisis

- To tackle these challenges, life and annuity insurers sought new ways to access more capital from varied sources to continue to play their traditional role of delivering solutions to meet the needs of their customers. Insurers in various jurisdictions, including but not limited to Bermuda, responded to these challenges in the life and annuity market by forming strategic relationships with asset management. This gave insurers both new investment management capabilities and an injection of new capital

- Although strategic alliances with asset management firms have reinvigorated the life and annuity sector, they also have significantly altered traditional investment strategies. These shifts pose unique risks and supervisory concerns, including potential conflicts of interest that must be managed and supervised effectively

- The nature of risks associated with asset-intensive business (including its reinsurance) is differentiated. The existing standard supervision and regulations may not be sufficient or appropriate enough to identify and address these risks. A tailored supervisory and regulatory approach that takes into account the nature, specific characteristics and risks of the asset-intensive/non-traditional insurers is needed. Additional regulatory guardrails (including key risk management and governance requirements) for the regulators of both cedents and reinsurers are required to more effectively capture and mitigate risks specific to asset-intensive businesses' reinsurance. The BMA supports cedent regulator initiatives that require ceding entities to demonstrate to their regulators that they have proportionate but adequate risk management strategies to manage the risks to which they are exposed in relation to their asset-intensive reinsurance arrangements

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[6] Report: *Global protection gaps and recommendations for bridging them*

[7] Insurance Practice: Should North American life insurers stop prioritizing share buybacks?

[8] Report: Life insurance in the higher interest rate era: asset-savvy is the new asset-light

- With Bermuda being a key reinsurance market, the BMA is at the forefront of executing effective regulation of asset-intensive reinsurance business aimed at policyholder protection. The BMA understands the evolving nature of this business and has, over the past two years, implemented several regulatory and supervisory enhancements. These measures are designed to ensure that emerging risks are properly identified and appropriately managed. In addition, the BMA continues to work closely with cedent regulators in the review and approval of asset-intensive reinsurance transactions

2 | Asset-Intensive Insurance

> *Asset-intensive insurance refers to insurance products offered by direct insurers where investment risk is the significant risk, outweighing biometric, lapse, and expense risks. These products include deferred annuities, universal life policies, and pension risk transfers. The term "asset-intensive" is often used in the context of reinsurance, but it is important to note that the nature of being asset-intensive generally originates from the insurance business itself. Reinsurance does not typically transform a non-asset-intensive business into an asset-intensive one.*

The term "asset-intensive" is often used in the context of reinsurance, but it is important to note that the nature of being asset-intensive generally originates from the insurance business itself. Asset-intensive reinsurance is typically first asset-intensive insurance before it can become asset-intensive reinsurance. Reinsurance does not typically transform a non-asset-intensive business into an asset-intensive one; it merely continues the asset-intensive characteristics of the underlying insurance operations. Asset-intensive businesses can be categorised into two main groups:

- Pension products: these are income-providing products designed to provide income during retirement and can be either single premium or regular premium products. Single premium products either provide an income immediately or defer the payout period, allowing investment returns to accumulate until retirement. Regular premium products allow individuals and employers to contribute to retirement that can be accessed in the future. A significant portion of single premium products is pension risk transfer or bulk annuities, whereby pension schemes sell off blocks of their book to remove their exposure to investment and longevity risk

- Savings products: these are investment products sold by insurers, often having an insurance/biometric wrapper, which allows for some tax efficiencies

An example of an asset-intensive business is financial products designed to provide older retired individuals with a steady cash flow in retirement. Typically, the policyholder would have paid premiums for several years or a lump sum payment at the beginning of the policy. In return, the policyholder would receive annuity payments with various terms and guarantees over a lifetime or specific period.

> *Asset-intensive reinsurance typically involves the transfer of all, or some subset, of the inherent risks associated with a block of insurance liabilities from a ceding insurer to a reinsurer. However, the cedent remains in possession of the assets on its balance sheet or through collateral accounts hence the reinsurer does not get unrestricted discretion over the assets.*

Asset-intensive reinsurance, in turn, is an agreement that transfers all, or some subset, of the inherent risks associated with a block of insurance liabilities from a ceding insurer to a reinsurer. Among the inherent risks transferred is the Asset-Liability Management (ALM) risk, including the interdependence between investment risk, policyholder behaviour, biometric risk, expense risk, etc.

This form of reinsurance targets long-term life liabilities, including deferred annuities, universal life policies and bulk purchase annuities or pension risk transfers, as well as other long-term liabilities.

This type of reinsurance typically involves transferring insurance liabilities and the economic risks of the assets backing those liabilities (but not the actual investment assets) to a reinsurer. As the actual investment assets are typically not transferred to the reinsurer, they are either withheld by the cedent on its balance sheet or ring-fenced in a separate collateral account for the benefit of the cedent. The cedent retains direct possession of the assets on its balance sheet or through collateral accounts. Therefore, the reinsurer does not typically gain full, unrestricted discretion over the assets.

3 | Drivers of Asset-intensive Insurance

To understand the role of asset-intensive insurance, it is essential to understand the broader ecosystem in which the life market operates, including its core, namely the protection gaps and broader macroeconomic conditions.

3.1 Protection gaps—a massive global challenge

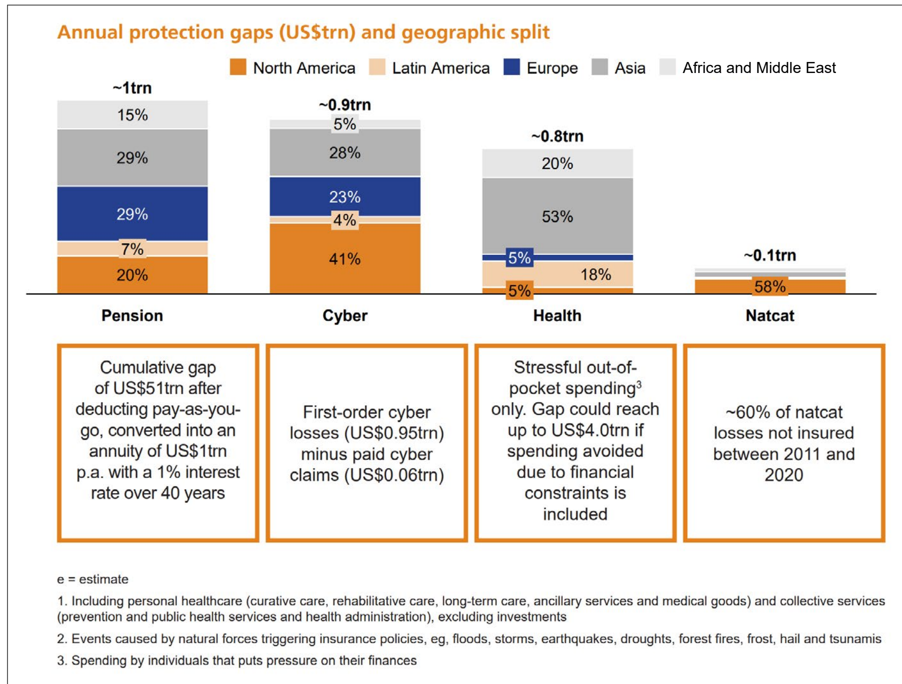
Insurance is a vital tool for managing financial risks and providing financial security to individuals, businesses and communities. However, many people worldwide lack adequate access to insurance products and services. This creates a significant protection gap, which means that many people are exposed to the negative impacts of shocks such as natural disasters, health emergencies, accidents, or loss of a breadwinner, retirement and long-term care without sufficient financial resources to cope with these events.

> *The pension protection gap tops the list of major protection gaps with an estimated gap of USD 51 trillion and is expected to grow due to the ageing population, increased life expectancy and falling birth rates*

The protection gap in the life and annuity sector is a global challenge that affects both developed and emerging markets. There is increasing recognition that people and businesses have far less protection than they need. This gap has significant implications for the well-being and resilience of individuals, households and businesses. According to GFIA, the global pension protection gap was estimated at USD 51 trillion[9] in 2023 and is expected to continue to grow due to the ageing population, increased life expectancy and having fewer people in the workforce to support the inflow of funds into the pension schemes due. This results from falling birth rates, coupled with the increasing number of people receiving disbursements and high living standards that increase the need for higher pensions.

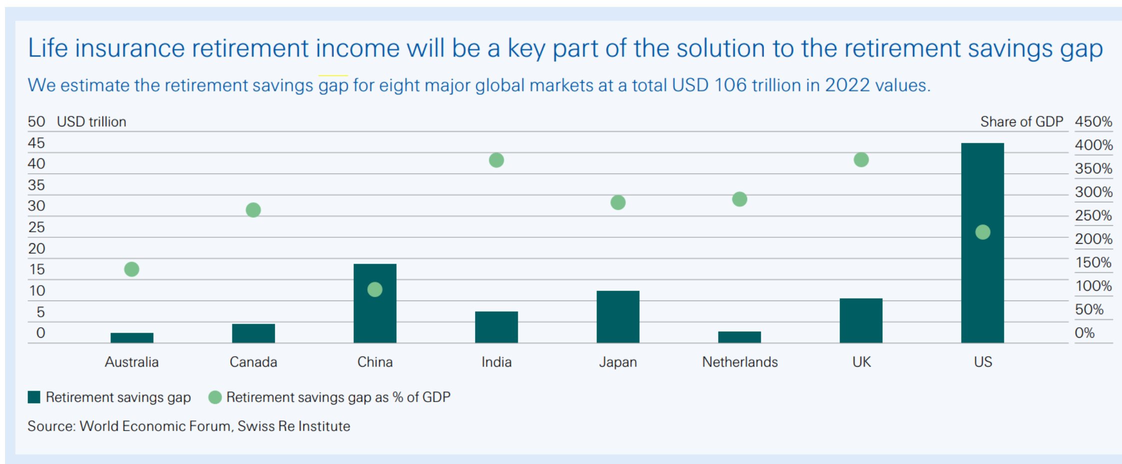
[9] Report: *Global protection gaps and recommendations for bridging them*

The pension protection gap tops the list of major protection gaps



Source: Global Federation of Insurance Associations

Similarly, according to the Swiss Re Institute, the retirement savings gap for eight major global markets is estimated at a total of USD 106 trillion in 2022 value.[10]



[10] sigma 2/2024: Life insurance in the higher interest rate era

3.2 Macro-economic factors and capital depletion due to public insurers' share buybacks

> *A prolonged period of low interest rates, tight credit spread, and flat yield curve led to insurers struggling to earn a sufficient yield to meet guarantees in their books. This was coupled with the withdrawal of traditional capital, resulting in the life sector falling short of its cost of capital. McKinsey reported that in the last decade, public life and annuity insurers in Canada and the US gave about $275 billion to shareholders through $190 billion in share buybacks and $85 billion in dividends. These macroeconomic factors, combined with demographic factors, contributed to the deterioration of the protection gap, which Governments are not able to address on their own.*

The 2008 economic crisis and the subsequent long period of extraordinarily low interest rates, tight credit spreads and a flat yield curve that followed had the following impacts:

- A combination of low interest rates, tight credit spreads and a flat yield curve caused insurers to struggle to earn adequate risk-adjusted yields. This put life insurance companies under pressure to generate sufficient yield to meet the guarantees in their books. According to the IMF[11], the long period of extraordinarily low interest rates after the global financial crisis pushed life insurers to change their business models. Many large insurance groups altered their business strategies to pivot away from capital-intensive business lines and toward capital-light businesses such as unit-linked products, which leave much of the investment risk with policyholders. The BMA has observed a similar trend

- Low interest rates also put pressure on the value of new guaranteed products to policyholders and made them less attractive to policyholders as investment returns declined

- Life and annuity insurers faced much pressure to buy back shares, which reduced their capital. McKinsey[12] reported that in the last decade, public life and annuity insurers in Canada and the US gave about $275 billion to shareholders through $190 billion in share buybacks and $85 billion in dividends. A major contributor to the withdrawal of traditional capital was the inability of the life sector to earn returns to honour guarantees within insurance contracts while minimally meeting the cost of capital. According to the Swiss Re[13], the life sector fell short of its cost of capital by almost 5ppts per year on average following the global financial crisis

Collectively, the above macro-economic factors, combined with demographic factors as well as other factors (e.g. reduced appetite by traditional capital markets) contribute to the deterioration of protection gaps within the life, savings and annuity sectors that governments are not able to address on their own.

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[11] Private Equity and Life Insurers in: Global Financial Stability Notes Volume 2023 Issue 001 (2023) (imf.org)

[12] Insurance Practice: Should North American life insurers stop prioritizing share buybacks?

[13] sigma 2/2024: Life insurance in the higher interest rate era: asset-savvy is the new asset-light

4 | Life and Annuity Industry Response, Benefits and Risks

4.1 Response: Strategic alliances with asset management firms, new capital, new risks

> *The insurance industry responded to the global challenges in the life and annuity market by raising new capital from diverse sources. Bermuda's long-term statutory capital and surplus grew by approximately $100B from 2016 to 2023. The industry also expanded investment management and origination capabilities, mainly through strategic partnerships with asset management firms.*

To tackle the challenges, insurers sought ways to perform their traditional role i.e., delivering solutions that meet the needs of their customers. One aspect of the solution involved the use of the sector's proven long-standing tools, such as reinsurance, to gain access to more and varied sources of long-term capital, including private capital, that was needed for the insurance sector to continue to service the significant life and savings protection and retirement income. Private capital proved to be essential, as noted above because the public markets were withdrawing capital.

Insurers in various jurisdictions, including but not limited to Bermuda, responded to the global challenges in the life and annuity market by providing solutions that included the following:

- **Raising new capital from diverse sources** — this included PE firms, institutional investors such as endowment funds, sovereign wealth funds, pension funds, specialised asset managers and alternative asset managers, among others. Bermuda's long-term statutory capital and surplus grew by approximately $100B from 2016 to 2023

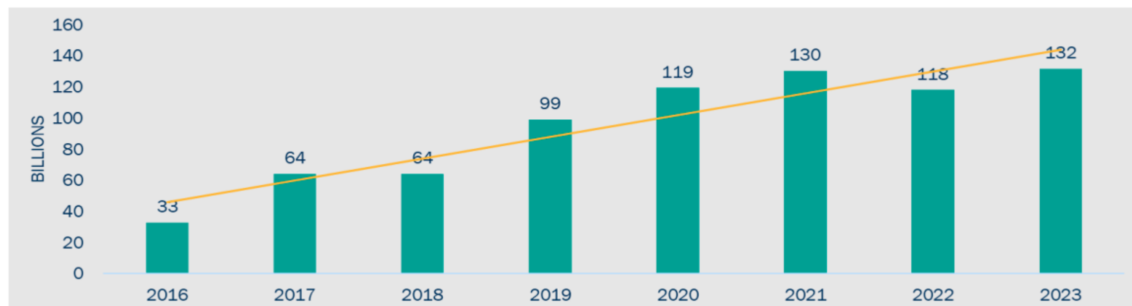

Chart 1: Bermuda Long-term market Statutory Capital and Surplus

- **Injecting or expanding investment management and origination capabilities mainly through different forms of strategic relationships and partnerships with asset management firms (including, but not limited to, PE firms)** — In doing so, insurers sought to earn higher risk-adjusted yields during the challenging economic environment, which (if effectively managed) could benefit the ceding insurers and the customers by offering more attractive and sustainable products and returns

4.2 Benefits to policyholders

The discussed features, actions, and strategic alliances provided capacity, capital, diversification (including sources of capital and a broad range of investments and product types), expertise, and market stability. Insurers also actively contributed to global efforts to narrow the protection gaps, including those created by the change to fee business (e.g., unit-linked) that shifts risks to policyholders. Through these alliances or the expansion of existing investment capabilities, many insurers have broadened and diversified the universe of asset classes invested in and enhanced the sophistication of their ALM capabilities. Better ALM helps insurers identify, measure and manage risks from assets and liabilities in an integrated and holistic manner using advanced analytics and scenario modelling. Practical and robust ALM is also critical for unlocking the illiquidity premia in the insurers' illiquid liabilities. When carefully considering the trade-offs between liquidity needs, yield and risk and executing them correctly, this approach can often lead to higher yields and better risk-adjusted returns. It also results in a more diversified investment portfolio, which benefits policyholders by ensuring they can collect on the financial guarantees promised in their policies. This ultimately contributes to greater economic security for policyholders.

4.3 Resulting prudential risks

> *The strategic alliances between life and annuity insurers and asset management firms have played a significant role in narrowing the global protection gap but have also created some unique challenges mainly potential conflict of interest and risks from increased investment in illiquid assets.*

Strategic alliances between life and annuity insurers and asset management firms have played a significant role in narrowing the global protection gap. This was particularly crucial during a critical period when according to McKinsey[14], 17 of North America's top 20 public life insurers returned at least half of their market value to shareholders through buybacks alone. However, these partnerships have led to a notable shift in traditional investment strategies and pose unique risks and supervisory challenges that must be effectively managed. These risks primarily arise from two main risk drivers:

a) Potential governance, conflict and risk management challenges; and

b) A tendency to invest in higher proportions of illiquid assets, which are subject to valuation, concentration and complexity risks (and may be subject to elevated spread risk, particularly in stressed conditions).

The interplay between these two risk drivers poses significant supervisory challenges as it amplifies the vulnerability of the insurers to potential shocks and stresses.

See Appendix 1 for more details about these risks and associated regulatory responses.

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[14] Insurance blog: Should North American life insurers stop prioritizing share buybacks?

4.3.1 Culture clash, undue influence and conflict of interest

The evolution of the long-term insurance market has seen the introduction of new market participants, including private equity firms, alternative asset managers and traditional asset managers, among others. The BMA's supervisory experience has shown that asset managers may influence the insurers' strategy, asset allocation, growth and capital management. While there are potential benefits, this influence typically presents unique supervisory challenges and may exist regardless of the level or structure of ownership.

4.3.2 Impermanency of capital and focus on the short term

A potential focus on short-term outcomes or on returning capital to investors could undermine policyholder protection. Where this may be the case, supervisors may need to exercise enhanced supervisory scrutiny and reporting and tailor supervisory interventions, such as dividend restrictions, liquidity and capital maintenance agreements, higher levels of solvency, etc.

4.3.3 Misaligned incentives and value extraction via asset fees (among others)

While the insurer is on the hook to meet policyholder obligations for the entire life of the liabilities, the asset manager is typically not. Yet, the asset manager may influence the choice of investments and would have already collected the Assets Under Management (AUM) fees. The periodic payment of AUM fees presents another challenge. The main problem is that a significant portion of the AUM fees are typically paid quarterly, while the performance of liabilities unfolds over the long term. This allows the asset manager to benefit in the short to medium term (through quarterly asset management fees) while policyholders lose out in the long term. Considering these challenges, the BMA sees an opportunity for further research and the development of concrete solutions relating to the appropriateness of asset management fees in the context of asset manager-owned or influenced insurers. For example, some Bermuda reinsurers retain a portion of the asset management fees that are only paid out when liabilities run off (e.g., after 10 years).

4.3.4 Risks from increased competition

Competition has become elevated under the recent high-interest rate environment where other non-insurance institutions, including banks, offer competing products. This raises concerns that crediting rates offered by insurers may be unsustainable. Competition also exists between reinsurers. Underwriting and risk management standards may weaken as reinsurers compete for business deals. As a result, the BMA began to require regulatory approval for block transactions to assess whether these deals present excessive risk to policyholders. The BMA believes that this work (i.e. approval at the reinsurer level) could be complemented by reviews of crediting and guaranteed rates by the ceding regulators. Additionally, increased competition in the private credit market may weaken underwriting standards and relaxation of covenant terms, raising the risk of credit losses in the future. The Authority sees this as a significant risk on a forward-looking basis. The BMA has enhanced investment reporting by insurers and is exercising more rigorous supervision of private credit. Other regulatory measures include clarifying expectations on compliance with the Prudent Person Principle (PPP). The BMA also plans to consult on a proposal to publicly disclose the assets of commercial long-term insurers.

4.3.5 Concentration risk to BBB and specific asset classes

While most insurers' investments remain investment grade, insurers have reached for greater yields by increasing their allocation to lower-rated investment-grade assets i.e., BBB-rated assets. Companies with material concentrations, including in specific asset classes, are typically required to implement measures to mitigate risk to policyholders e.g., de-risk and/or hold additional capital. The BMA has required some insurers to meet a target solvency ratio post-downgrade stress to cushion against concentration risk.

4.3.6 Susceptibility to investment in affiliated assets

There is the risk that policyholder money may be used to fund affiliates' operations, whether of the asset manager, the cedent or the reinsurer. The BMA introduced a requirement for insurers to secure approval for affiliated assets. This establishes a high bar for insurers, requiring them to demonstrate that investment affiliates of the asset manager, the cedent or the reinsurer are appropriate for covering policyholder liabilities.

4.3.7 Lack of transparency around value extracted by the asset manager

The scope of services provided may not be clear, and there is a risk that pricing may not be set on an arms-length basis. The BMA's supervisory experience shows that insurers could enhance public disclosure of the extraction and flow of cash and non-cash value between them and affiliated asset managers.

4.3.8 Poor design and execution of contractual mitigations by cedent and/or reinsurer

Asset-intensive reinsurance is an institutional market with established best practices for conducting business and executing transactions. Through our supervisory work, the BMA has seen evidence of sound market practices but also practices that need improvement. For example, regarding collateral assets, the BMA does not believe it is enough for the cedent to set investment guidelines and approve assets that go into the collateral account. Cedents should also have the capability to independently verify that the assets are in the best interests of its policyholders on an ongoing basis. Cedents also need to consider the possibility of being required to recapture the collateralised assets and the potential implications regarding their ability to understand and manage them, their fit into the cedent's balance sheet and solvency implications arising from recaptured assets. The BMA would encourage cedents to disclose to their regulators their assessment of the assets in the collateral account and whether or not these align with the insurer's policyholder obligations.

4.3.9 Unique and complex transactions may require more than standard supervision and regulations

The BMA's supervisory experience has shown that a more tailored and agile supervisory and regulatory approach that considers the specific characteristics and circumstances of asset-intensive/non-traditional insurers is needed to identify and address the differentiated risks associated with the asset-intensive business.

4.4 Guardrails mitigating some of the risks in asset-intensive insurance markets

> *Collateral structures in the form of modified coinsurance and funds withheld are a key feature of asset-intensive reinsurance. Potential economic gain of the underlying assets and liabilities is transferred to the reinsurer. In contrast, the assets are held in the cedent balance sheet or a collateral custody account in the cedent's jurisdiction. The cedant retains control and legal title of the assets, significantly reducing counterparty credit risk. In addition, 80% of Bermuda reinsurance business is conducted on a collateralised basis.*

The Authority has observed several important guardrails in the insurance market for asset-intensive products. The guardrails are structured to mitigate the risks for the cedant and policyholder and, in doing so, are contributing to ensuring that the asset-intensive reinsurance market continues to operate in a prudent and effective manner.

4.4.1 Counterparty guardrails implemented by cedents and reinsurers

Modified Coinsurance (ModCo), Funds Withheld (FWH) and other forms of collateral arrangements play a crucial role in mitigating the risks associated with asset-intensive reinsurance. Data gathered by the BMA shows that most of the long-term reinsurance business in Bermuda (80%) is conducted on a collateralised basis, mainly through FWH and ModCo. The collateral arrangements enable cedents to identify, measure, monitor and manage the risks to which they are exposed in relation to their asset-intensive reinsurance arrangements. In the case of collateral structures such as FWH, ModCo and collateral trusts, the potential economic gain or loss of the underlying assets and liabilities is transferred to the reinsurer. The assets themselves are not transferred and the cedent retains the assets either on their balance sheet or in a collateral account ringfenced for that specific cedent. The collateral custody account is typically maintained in the cedent's jurisdiction. FWH and ModCo do not legally transfer assets to the reinsurer or physically transfer assets to Bermuda. This means the reinsurer assumes the asset and liability risks on the reinsured business, while the cedent retains control of and legal title to the assets. As a result, the reinsurer counterparty credit risk is significantly reduced.

The following are additional benefits of collateral structures:

- The ceding insurer can set investment guidelines, including asset allocation, currency, single issuer counterparty and credit quality/rating limits for each type of asset

- The cedent can directly monitor, on a real-time basis or as desired, the assets' performance during both stress and normal conditions. Therefore, the cedent has complete visibility on the assets held at any point in time and can monitor them to ensure that investments are following the agreed-upon guidelines

- They provide full transparency to the ceding insurer and its regulator with insight into the nature and value of the specific assets backing the cedents business

- The ceding insurer typically has audit rights over the collateral account that they can exercise for any reason at their discretion

- The cedent can independently value assets and require collateral top-ups if assets are impaired

Some common clauses in the collateral arrangements are as follows:

- **ALM and investment constraints:** nearly all collateralised reinsurance treaties have requirements to maintain certain interest rates and FX hedge ratios. There may also be single-issuer limits or limits on allocations to a certain sector in addition to the reinsurers' own credit and concentration risk limits. Such constraints significantly reduce concentration and systemic risks

- **Cure periods and intervention provisions:** there may be protections that kick-in if there is a deterioration in a measure (e.g. solvency ratio), such as contingent over-collateralisation, cash traps from withdrawing excess collateral or dual authorisations on trades. These often happen before severe scenarios are reached, which provide a further layer of protection for a cedent

- **Collateral risk haircuts and requirements:** this may be applied to expand the proportion of high-quality assets in case of a drop in reinsurers' credit rating

- **Private debt-specific clauses** Many private bonds and loans have strong underlying collateral (e.g. data centres and other infrastructure) and so recoveries on default may be expected to be much higher compared with unsecured loans (including those that are publicly listed)

- **Termination provisions:** These are fairly standardised across treaties and are linked to non-payment, fraud, loss of permissions, etc. Importantly, cedents typically want a solvency ratio trigger that kicks in before a company defaults or the solvency ratio falls below 100%

Aside from collateralisation, cedents also employ other strategies, such as utilisation of financial impairment clauses and limitations on subsequent retrocession.

Case Study

In a recent article, a ceding insurer's Chief Risk Officer (CRO) highlighted the protections inherent within its asset-intensive strategies and rationale for dealing with non-traditional reinsurers to illustrate how the related collateral arrangements function. In the article, the CRO noted that policyholders should not be worried by such deals. The CRO said, "When you look at the traditional reinsurance market, it is actually highly concentrated. You have a handful of top names in the industry. Then you have a lot of smaller firms that arguably are not able to take multi-billion transactions onto their balance sheet or manage it appropriately. So, the fact that there is the alternative to the traditional reinsurance approach through the engagement of private equity firms is a welcome alternative."

In the article, the CRO noted that the CRO's ceding insurer did not just move assets to the reinsurer and exit –it remained active in administering claims and monitoring assets. Similar to the ceding insurer's own book, the CRO said they "pay attention to the diversification and make sure that exposure to single credit or asset class or industry is limited – it's sort of similar here. We (the CRO's ceding insurer) did a super-thorough credit risk analysis, looking at the counterparty risk. And, we (the CRO's ceding insurer) also have the assets in a trust underpinning the transaction where we (the CRO's insurer) agree with the counterparty on investment guidelines, on average rating, duration, and diversification across asset classes and where there is ongoing monitoring of the valuations of those assets. This gives me (the CRO) a lot of comfort."

The CRO noted the apprehension over PE firms in the insurance sector, but believes, “We cannot judge by the ownership. Ownership is not the identifier here,” [...]. “You still have to do your due diligence on the counterparty and then if you have the extra risk mitigations, as I mentioned, this actually makes for a stronger overall execution and transaction.”[15]

4.4.2 Regulatory guardrails implemented by the regulators of the ceding insurer, the reinsurer or both.

> *Collaboration and coordination between cedent and reinsurer regulators are essential in ensuring effective supervision of the asset-intensive business. This includes evaluation of deals, supervisory colleges, bilateral engagements and joint onsite work. Both cedent and reinsurer regulators need to affect key risk management and governance requirements tailored to the risks posed by the transactions*

4.4.2.1 Cross-border supervisory cooperation and coordination

Reinsurance is a global industry, and it is essential that the regulators work together to ensure effective regulation and supervision of reinsurance arrangements. Transparent and robust cross-border regulatory cooperation and information sharing are essential in the supervision of cross-border asset-intensive reinsurance. In particular, the BMA is strongly committed to working with regulators of the cedents through group supervision (supervisory colleges and joint on-site reviews focussing on areas of interest such as collateral) and regulator-to-regulator requests. For example, the BMA requires prior approval of all long-term block transactions. The approval process typically entails cross-border, regulator-to-regulator discussions and collaboration with the supervisor of the cedent to evaluate the deal and jointly come up with mitigants to address arising risks.

4.4.2.2 Enhanced and tailored supervision of asset-intensive reinsurance by the BMA or the regulator of the asset-intensive reinsurer

As mentioned above, asset-intensive reinsurance presents unique risk and supervisory challenges. The BMA has implemented a tailored supervisory regime and has proactively taken actions aimed at ensuring the framework remains fit for purpose in light of the evolving landscape and associated challenges. Examples of the enhanced supervisory regime include:

- Prior regulatory approval for long-term block reinsurance transactions[16] (mentioned above)
- Enhancements of BMA’s capital requirements and insurance liabilities valuation framework. These enhancements had a material impact on the solvency position of Bermuda long-term insurers due to an increase in total asset requirements[17]

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[16] Notice: Prior Approval of New Long-Term Block Reinsurance Transactions

[17] Stakeholder Letter: Re: Consultation Paper — Updated to “Proposed Enhancements to the Regulatory Regime for Commercial Insurers”

- Enhanced supervisory tools, resources and expertise. The BMA has added more staff with diverse industry experiences and expertise in actuarial, models, risk and investments to its bench. To support this, the Authority recently increased the fees charged to long-term insurers to meet the necessary costs of supervision

- Intensified supervisory engagement, including through intrusive joint on-site examinations and collaboration with cedent regulators

- Implemented Recovery Planning Regime

- Enhanced investment reporting to provide visibility of exposure to illiquid and other non-traditional assets

- Implemented targeted prudential measures, including requiring higher solvency, capital add-ons, reserve add-ons, restricting dividends, and imposing liquidity maintenance arrangements

- Enhanced regulatory measures around governance, risk management and conflicts of interest

- Broadened the definition of affiliated investments to capture any relationship that could result in a conflict of interest, implemented approval requirements and established a high hurdle for insurers to demonstrate that affiliated investments are appropriate for covering policyholder liabilities

4.4.2.3 Existing supervision by cedent regulators

Cedant regulators have regulatory practices in place, including a review of treaties focusing on clauses such as recapture and termination. They also focus on various risk management practices, such as counterparty risk limits and stress testing scenarios.

On the investments/asset side, ceding jurisdiction regulators review the entities' liquidity risk management, Asset-Liability Management (ALM) as well as compliance with the Prudent Person Principle. Some conduct entity-level as well as industry-wide stress testing scenarios.

4.4.2.4 Further regulatory enhancements by cedent regulators

Reinsurance is a global business, making it crucial for regulators of both cedents and reinsurers to work together to ensure appropriate and effective regulation and supervision of asset-intensive reinsurance transactions and arrangements. The existing baseline regulatory requirements relating to solvency, liquidity, valuation, reporting, disclosure and other aspects of the cedent and reinsurers, serve as an important guardrail. These measures ensure that insurers and reinsurers have sufficient financial resources and capabilities to withstand severely adverse scenarios and still meet their obligations to policyholders. Related to this, there have been notable enhancements by other regulators, including:

- The NAIC announced a list of 13 considerations that were developed by its Macroprudential Working Group

- The UK Prudential Regulation Authority (PRA) acknowledges that reinsurance is an important part of risk management but sets out its expectations regarding life insurers entering into or holding funded reinsurance arrangements as cedents

The BMA agrees that reinsurance is a proven tool for risk management and can enhance the protection of and access to insurance by increasing the capacity, diversification and stability of the insurance sector and enabling insurers to offer more affordable and suitable products and services to customers. The BMA sees an opportunity for regulators in other jurisdictions to evaluate and, if necessary, improve their current supervisory tools and expectations for insurers. This is necessary to ensure that these tools effectively capture and mitigate risks that are specific to the asset-intensive nature of the insurance business and its activities in the insurer's respective markets. While some of these efforts are still under development, the BMA supports initiatives by cedent regulators that require ceding entities to demonstrate to their regulators that they have proportionate but adequate risk management to identify, measure, monitor, manage, and report the risks to which they are exposed in relation to their asset-intensive reinsurance arrangements.

Appendix 1 | Risks in the long-term market due to strategic partnerships with asset management firms and BMA supervisory responses

1. Culture clash, undue influence and conflict of interest

The evolution in the long-term market has seen the coming in of a range of new market participants, including private equity firms, alternative asset managers and traditional asset managers, among others. For brevity, we use the term 'asset management firm' to broadly refer to these. These players access the long-term insurance market using at least five main methods:

Method	Description	Risk
1.1. Full-controlling interest	Asset management firms obtain full control of the insurer directly or indirectly by owning a company that directly or indirectly owns the insurer	BMA supervisory experience has shown that asset managers may exert influence on the insurers' strategy, asset allocation, growth and capital management. This influence may exist regardless of the level or structure of ownership
1.2. Part-controlling interest	Asset management firm obtains part-controlling interest of the insurer directly or through owning a company that directly or indirectly owns the insurer	
1.3. Non-controlling ownership stake	Asset management firm obtains a non-controlling ownership stake (less than 10% ownership) in the insurer's business through shareholding in a company that directly or indirectly owns the insurer	
1.4. Fund managed by the asset management firm	A fund managed by the asset management firm (or where the asset management firm is the general partner) obtains controlling interest in the insurer	
1.5. Asset manager/ Investment advisor	Asset management firm serves as an asset manager and/or investment advisor with no ownership stake – potential for indirect or hidden influence, including through funding commitments and control of key relationships, such as relationships with investors	

It can be argued that conflict of interest is mitigated where the asset management firm owns 100% of the insurance business and is equally affected by the poor performance of the insurer. However, even where no conflict of interest exists on paper, it does not necessarily follow that the new culture will prioritise policyholders' interests and keep this top-of-mind when making business decisions. The Authority expects insurers to establish adequate governance and corporate culture and look beyond systems and structures (i.e., risk and governance structure). Historical experience has shown that the main cause of failure is not mainly due to inadequate structures but that the behaviour of those who have influence over the insurers (primarily the board and senior management) is below standard. Even when the insurer seems to be performing well, the risk of inadequate behaviour and culture may accumulate. For example, the Authority has identified a concerning trend where asset managers sometimes exert significant influence over the

strategic asset allocation setting process. Management and the board have also, in some instances, failed to create a culture where control functions can challenge and block inappropriate investments, notwithstanding the fact that those assets could be argued to be within board-approved SAA. The Authority has taken regulatory actions to address, protect against and mitigate risks related to policyholders in these circumstances.

Some insurers have taken steps of their own to internally enhance investment risk management capabilities and their ability to challenge and veto individual investments from their asset manager; however, there is much room for improvement across the industry. Additionally, some insurers have enhanced the level of public disclosures relating to their investments and conflicts of interest. In response, the BMA enhanced its scrutiny of insurers' application of the PPP.

2. Impermanency of capital and focus on the short term

If the asset management firms' capital is not fully permanent, they may focus on extracting and returning the capital to the investors rather than protecting policyholders' interests over the full run-off of the obligations. A focus on short-term outcomes could lead to inadequate investment in control systems and heightened risk-taking, particularly in favourable economic conditions, with an intention to divest once short-term return objectives are achieved.

Where this is the case, tailored supervisory interventions such as dividend restrictions, liquidity and capital maintenance agreements, higher levels of solvency, etc., are typically imposed. Additional measures include enhanced supervisory scrutiny and reporting.

3. Misaligned incentives and value extraction via asset fees (among others)

3.1. As Assets Under Management (AUM) grow, the asset management firm benefits from increased AUM fees. There is, therefore, an inherent risk that the asset management firm will continue to push for more business growth, which may encourage excessive risk-taking by the insurer through aggressive underwriting and risk management practices. For example, the insurer may under-invest in personnel and infrastructure resources, which overexposes them to complex or illiquid assets, or they may concentrate on only a few asset classes or maintain a low solvency target that leaves no headroom to absorb shocks under adverse conditions. The asset management firm may also be unable or unwilling to inject capital should the insurer become troubled.

The BMA requires approval for all block transactions. This approval allows the BMA to evaluate the factors behind growth and whether the deal aligns with policyholders' interests. In the past, some deals have been rejected or subjected to additional conditions.

3.2. The periodic payment of asset management fees presents another challenge. While the insurer is on the hook to meet policyholder obligations for the full life of the liabilities, the asset manager typically is not. However, the asset manager may influence the choice of investments and would have already collected the AUM fees. The main problem is that a significant portion of the asset management fees are typically paid quarterly while the performance of insurance liabilities unfolds over the long term. Because of this, it creates the possibility that the asset manager could benefit in the short to medium term (through quarterly asset management fees), while policyholders lose out in the long term. The board of directors is responsible for demonstrating that the fee structure incentivises prudent investment behaviour. Considering these challenges, the BMA sees an opportunity for greater accountability by the boards and management of insurers to further research and develop

concrete solutions relating to the appropriateness of asset management fees in the context of asset manager-owned or influenced insurers. For example, some insurers retain a portion of the asset management fees that are only paid out when liabilities run off.

3.3. The BMA supervisory experience has shown that some asset manager firms' influence and discretion are often significant. While insurers may have a Chief Investment Officer (CIO), the CIO function typically has little influence in practice and is not empowered to assess, challenge or veto investment decisions independently. Control functions such as risk management may also lack the ability to challenge the investment decision-making process. This may be due to a lack of full financial independence (including compensation and performance incentives) or a lack of suitable expertise (which might be caused by a lack of operational and budgetary independence).

Overall, this is an area of continued supervisory review and interest for the BMA, and a consultation on PPP is due to be released in due course. The BMA would like to see a robust and properly capacitated CIO function that is empowered to 'own' and challenge investment decisions.

4. Risks from increased competition:

4.1. **Crediting rates:** the life insurance market is competitive. This competition has become elevated under the high-interest rate environment where other non-insurance institutions, including banks, offer competing products. Unsustainable crediting rates may drive aggressive risk-taking on the asset side that can expose policyholders to heightened risk.

4.2. **Reinsurance deals:** competition also exists between reinsurers. Reinsurers' underwriting and risk management standards may weaken as they compete for business deals. The BMA requires approval of block transactions to assess whether these deals present excessive risk to policyholders. The BMA believes that this work (i.e., approval at the reinsurer level) could be complemented by reviews of crediting and guaranteed rates by the ceding regulators. For example, the BMA recently learned about a ceding insurer seeking a reinsurer for a three-year guaranteed annuity. A Bermuda reinsurer looking to set the crediting rate would realise it would have to invest heavily in longer-duration, illiquid assets to meet the necessary guaranteed rate. The regulators of both the cedent and the reinsurers need to understand how this kind of short-term product can match with such a portfolio. There is a need for the regulators of cedents and reinsurers to challenge and understand how the crediting rate is earned and the economics behind the product offering.

4.3. **Private credit market:** increased competition in the private credit market may result in weakening underwriting standards and relaxation of covenant terms that may raise the risk of credit losses in the future. As prime borrowers secure funding easily, insurers may be forced to invest in lower-tier borrowers to deploy their capital in a bid to generate the return promised to policyholders. In response, the BMA has enhanced investment reporting by insurers and is exercising more intrusive supervision of private credit to address micro and macro-prudential risks. We have seen similar measures by cedent regulators. Other regulatory measures include clarifying its expectations on compliance with PPP. The BMA also plans to consult on a proposal to publicly disclose the assets of commercial long-term insurers.

Standard supervision and regulations may not be sufficient or appropriate to identify and address the differentiated risks associated with asset-intensive business. The BMA's supervisory experience has shown that a more tailored and agile supervisory and regulatory approach is needed to take into account the insurer's specific characteristics and circumstances. For example, to gain a comprehensive understanding of the risk profile (including liquidity risk), a range of tools are needed.

These include more frequent and detailed on-site inspections, off-site reviews, data requests, interviews with key functions and persons, closer engagement regarding material transactions and bespoke stress tests and associated recovery plans. Enhanced cross-border supervisory cooperation is also needed. Additional customised regulatory reporting is also needed to help closely monitor and address liquidity risks. This includes identifying liquidity risk indicators, such as assets that are paid in kind, poor ALM and maturity transformations, leverage, investment commitments, insurance product design and distribution channels, etc. The BMA report entitles *Liquidity Risk in the Bermuda Long-term Insurance Market*[18] contains more details on the recently enhanced BMA liquidity framework.

5. Concentration risk to "BBB-" and asset class

Tables 1.0 and 1.1 below provide details on the overall rating distribution of Bermuda commercial long-term insurers in scope. While most insurers' investments remain investment grade, with 85% of fixed income securities rated as such on a weighted average basis, some insurers have sought higher yields by increasing their allocation to lower-rated investment-grade assets, especially those rated "BBB-". The tables indicate that insurers had a relatively high allocation with 28% BBB-rated fixed-income securities. The BBB rating encompasses BBB+ to BBB-. The BMA's on-site inspections, ongoing monitoring and customised data requests have revealed that some insurers are disproportionately invested in "BBB-", which is the lowest rating within the BBB rating category. To further illustrate this point, the 75th and 90th percentile of the distribution of fixed income ratings are 38% and 46%, respectively. This demonstrates the potential concentration and exposure to credit migration and its associated transformations. This risk will continue to attract significant supervisory attention from the BMA. For example, insurers have been required to meet a target liquidity coverage ratio and solvency ratio post-downgrade stress. By setting this requirement, the BMA aims to provide a cushion against concentration risk, ensuring that even in times of a downgrade or credit stress, insurers have enough liquidity and capital to cover their liabilities.

[18] Liquidity Risk in the Bermuda Long-term Insurance Market

Table 1.0: Overall rating distribution of Bermuda Commercial Long-Term insurers

Rating Category	Weighted Average	Average	25th Percentile	50th Percentile	75th Percentile	90th Percentile
AAA	8.8%	15.4%	5.1%	10.4	20.1	31.3
AA	7.6%	9.9%	5.6%	8.3	11.2	17.2
A	33.4%	31.5%	21.9%	30.3	39.1	52.0
BBB	24.8%	28.1%	17.0	27.8	37.2	43.3
BB	2.2%	2.3%	0.0	1.1	3.4	6.3
B	0.4%	0.5%	0.0	0.1	0.6	1.2
CCC	0.1%	0.1%	0.0	0.0	0.0	0.2
CC/C/Unrated	10.9%	5.7%	0.0	1.0	9.2	19.6
EQ	2.2%	2.1%	0.0	0.0	0.7	10.3
PE	4.0%	2.0%	0.0	0.0	0.9	6.3
ALT	5.0%	2.0%	0.0	0.0	2.4	5.9
RE	0.7%	0.3%	0.0	0.0	0.0	1.1
Total	**100.0%**	**100.0%**				

Notes:

1. EQ = Listed equity, PE = Private equity, ALT = Alternatives, RE = Real estate;
2. "Weighted Average" is the dollar-weighted market average, considering the whole industry in the aggregate; "Average" is the simple average across individual insurers (equally weighted); and
3. Rating category "CC/C/Unrated" includes BSCR Rating 8, which includes both investments rated below CCC- and unrated investments, as well as fixed income investments reported as not rated; this, "CC/C/Unrated", is the lowest category and consists mostly of loans and mortgages (and to a lesser extent bonds) that are unrated.

The table below further displays the rating distribution for fixed-income investments (i.e., excluding equity and alternative investments). Of all these investments, ca. 85% are investment-grade on a weighted average basis (at aggregate market level) and 91% are investment-grade on a simple average basis (across insurers).

Table 1.1: Overall rating distribution of fixed income investments of Bermuda Commercial Long-term insurers

Rating Category	Weighted Average	Average	25th Percentile	50th Percentile	75th Percentile	90th Percentile
AAA	10.0	16.4	5.5	10.8	24.9	34.1
AA	8.7	10.7	6.0	8.7	13.3	17.9
A	37.8	33.8	24.9	32.4	40.4	53.8
BBB	28.1	29.9	18.6	30.3	38.3	45.6
BB	2.5	2.5	0.0	1.2	3.7	7.3
B	0.5	0.6	0.0	0.1	0.6	1.2
CCC	0.1	0.1	0.0	0.0	0.0	0.2
CC/C/Unrated	12.4	6.1	0.0	1.0	10.5	21.4
Total	**100.0%**	**100.0%**				

Table 2.0 below shows information on the overall asset allocation of Bermuda Commercial Long-Term insurers. The 75th and 90th percentiles of the distribution show potential concentration in certain asset classes by individual insurers. Concentration in any asset class or group of related asset classes is another point of ongoing supervisory attention as it reduces financial flexibility and exposes the insurer's policyholders to sector-specific deterioration. Companies with material concentrations are typically required to implement measures to mitigate risk to policyholders e.g., de-risk and/or hold additional capital where this is deemed to be an appropriate remedy.

Table 2.0: Overall investment allocation of Bermuda Commercial Long-Term insurers

Rating Category	Weighted Average	Average	25th Percentile	50th Percentile	75th Percentile	90th Percentile
Cash and Cash Equivalents	4.7	6.7	2.4	4.3	8.5	13.9
Sovereign Bonds	6.8	10.8	1.6	5.2	15.6	28.5
Corporate Bonds	46.7	50.1	37.9	48.8	63.2	70.9
RMBS	2.5	3.3	0.0	1.2	5.1	9.4
CMBS	3.4	3.5	0.0	2.6	5.1	9.8
CLO	5.2	4.5	0.0	1.6	6.9	13.0
ABS	5.9	5.2	0.0	2.0	8.2	13.0
Residential Mortgage Loans	2.7	1.1	0.0	0.0	0.0	4.3
Commercial Mortgage Loans	5.0	3.3	0.0	0.0	4.9	11.0
Private Placements and Private Lending	3.6	4.1	0.0	0.1	6.4	12.7
Other Loans and Bonds	1.6	0.9	0.0	0.0	0.0	1.1
Listed Equities and Preferences Shares	2.2	2.1	0.0	0.0	0.7	10.3
Private Equity	4.0	2.0	0.0	0.0	0.9	6.3
Alternatives	5.0	2.0	0.0	0.0	2.4	5.9
Real Estate	0.7	0.3	0.0	0.0	0.0	1.1
Total	**100.0**	**100.0**				

Note: The Corporate Bonds category includes Municipals. Of the RMBS, Agency RMBS make up 24% on a weighted average basis and 43% on a simple average basis.

Refer to the BMA report "*Private Credit — Deep Dive on Direct Loans, CLOs, and Private Placements*" for more details on certain investments by Bermuda asset-intensive (re)insurers.

6. Susceptibility to investment in affiliated assets

There is the risk that policyholder money could be used to fund affiliates' operations, whether of the asset manager, the cedent or the reinsurer. The BMA's supervisory experience has shown that affiliated, related or connected party assets can be complex and are prone to potential conflicts of interest, creating additional risks and governance challenges. In response, the BMA introduced a requirement for approval of affiliated assets that establishes a high bar for insurers to demonstrate that investments in affiliates such as the asset manager, the cedent or the reinsurer are appropriate for covering policyholder liabilities.

7. Lack of transparency around value extracted by the asset manager

It is not always completely clear what services are provided by the asset manager and how such services are priced in a manner that is both arms-length and in the best interest of policyholders. The BMA's supervisory experience shows there is an opportunity for insurers to enhance public disclosure of extraction and cash flow and noncash value between insurers and affiliated asset managers.

8. Poor design and execution of contractual mitigations by cedent and/or reinsurer

Asset-intensive reinsurance is an institutional market with established best practices on the conduct of business and execution of transactions. Through our supervisory work, the BMA has seen evidence of sound market practices and areas that need improvement.

8.1 **Collateral assets**: the PPP requires the reinsurer to ensure that investment decisions have been executed in the best interest of the policyholders. The cedents typically seek to independently confirm this is the case for assets in collateral accounts. However, the BMA does not believe it is enough for the cedent to set investment guidelines and approve assets that go into the collateral account. Cedents should have the capability to independently verify that the assets are in the best interests of its policyholders on an ongoing basis. Such consideration should inform rights in place for the substitution of assets, concentration limits and over-collateralisation. The use of non-publicly traded, complex, unrated and below-investment grade assets should be a key focus of such confirmation reviews. The BMA would encourage cedents to disclose to their regulators their assessment of the assets in the collateral account and whether these align with policyholder obligations.

8.2 **Potential conflicts of interest:** these should be assessed, including how they may affect the integrity of the asset valuation process, the quality of assets and fees and other expenses charged.

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