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The Bermuda Monetary Authority's Approach to Private Equity-Owned (Re)insurers

Market Background

In recent years, demographic changes and macroeconomic factors have led to significant growth in insurance markets. Within insurance markets, a much more active market in trading "back-books" of insurance liabilities has developed, allowing insurers to optimise their capital allocation and write more new business. In addition, primary insurers have needed to use asset-intensive reinsurance to a far greater degree to support market growth and maximise the amount of premium they can write, fulfilling the needs of the broader economy.

To help satisfy the consequential increased demand for reinsurance from a diversified range of counterparties, new reinsurers have been established, particularly in Bermuda. Bermuda has long sought to make itself an attractive home for reinsurance businesses. In recent years, there has been a transformational increase in the value of life liabilities reinsured to Bermuda. Many of the new reinsurers (or upscaled existing reinsurers) are associated with alternative asset managers, particularly those of a private equity heritage. A key proposition of many of these insurers is to adopt a more diverse approach to strategic asset allocation (**SAA**) and to include a greater proportion of alternatives, such as private credit, in their portfolios.

This relatively new form of association, at scale as part of alternative asset combinations and their approach to SAA, has led to an international debate on how regulatory regimes should respond to these developments. Naturally the Bermuda Monetary Authority (**BMA**) is participating in this debate.

The BMA's Approach

The BMA published a now much-discussed paper in December 2023, "Supervision and Regulation of PE Insurers in Bermuda" (the **December Paper**), clarifying the authority's position on oversight of (re)insurers operating and licensed in Bermuda that are owned or supported by private equity and alternative asset managers (**PE Insurers**).

In July 2023, the BMA released a consultation paper, "Proposed Enhancements to the Regulatory Regime for Commercial Insurers" (**CP2**), which led to legislation. CP2 is an important package of regulatory reforms that will play a key role in strengthening the (re)insurance sector. The practical effect of CP2 will depend on the company concerned, but for many PE Insurers writing life insurance liabilities, the reforms will have significant effects. We have previously discussed the CP reforms in *The Standard Formula* alert released on 30 August 2023.

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In the December Paper, the BMA shifted its focus to identify specific risks that it views as more prevalent in PE Insurer transactions, and outlined how it seeks to address those risks, which include:

- Complex structures.
- Conflicts of interest.
- Higher proportions of investments in illiquid assets.
- Perceived misalignment of timelines between shareholder investment horizons and the duration of insurance liabilities.

As alluded to above, the December Paper reforms emerge against a backdrop of recent global regulatory focus on PE Insurers. The European Insurance and Occupational Pensions Authority (**EIOPA**) Supervisory Convergence Plan for 2024 included a commitment to create a tool to aggregate and share the knowledge of various regulatory authorities within the European Union in order to develop best supervisory practices for PE Insurers. Similarly, since the National Association of Insurance Commissioners (**NAIC**) published its paper on the regulatory considerations for PE Insurers, the association has been concerned with the supposed lack of transparency and the focus on short-term results by PE Insurers and, as a result, has turned its attention to the supervision of investment management agreements.

The BMA's regulatory focus on PE Insurers is notable due to the potential impact on transaction timelines, deal and group structures, capital and collateral requirements, costs and potentially increased administrative responsibilities. Further, as the industry continues to digest the December Paper, a closer focus on financial/regulatory capital models has led the BMA to scrutinise whether the regulatory capital of PE Insurers has been appropriately calculated and whether credit rating agencies and insurers align on the categorisation of the insurers' share capital.

We understand that the BMA has since communicated to some industry executives that the measures outlined in the December Paper do not apply exclusively to PE Insurers but to all firms under the BMA's regulatory remit.

Moreover, with Bermuda serving as a key insurance hub, there is a concern on the island, shared globally, that the failure of an entity or group the BMA supervises could result in onshore regulatory action and a reduction of Bermuda's presence in the global insurance space. The BMA's regulatory framework is likely to continue to evolve as the authority continues to adapt to an ever-changing and dynamic market. In our view, CP2 and the December Paper are milestones, rather than an ultimate policy destination. This article explores the current path of the changes.

The BMA's Regulatory Regime for PE Insurers

Supervisory Enhancements

The BMA requires prior approval of all long-term block reinsurance transactions, which are particularly prevalent among PE Insurers. This approval process addresses the following factors of the transaction and requires companies to submit information explaining and supporting:

1. The rationale for the transaction.
2. Economics and key features of the transaction.
3. Fit to business.
4. Strategy (underwriting and investment).
5. Expertise.
6. Risk and capital management.
7. Information on governance.
8. Risk management and asset-liability matching.
9. Reinsurance.
10. Collateral and investment agreements.
11. Impact on solvency and stress testing.
12. Total asset requirements (technical provisions plus capital requirements under both the BMA and cedant regulatory bases).

If the BMA or the cedant regulator harbours significant concerns**, adjustments such as increased capital requirements, capital add-ons, changes to reserve assumptions, dividend restrictions/prohibition and capital maintenance agreements may be required**. Alternatively, regulators may decline the transaction if these concerns are not addressed.

The December Paper emphasises the crucial position of the BMA, cedant-regulator relationships and the importance of taking cedant regulator concerns into account. We expect the BMA and home-state insurance regulators to maintain regular dialogue regarding material cessions and transactions.

Enhanced Capital Requirements

The Insurance Act 1978 and its related regulations (the **Insurance Act**) grant the BMA authority to establish higher capital requirements, such as the 150% Enhanced Capital Requirement (**ECR**), calculated as the insurer's statutory capital and surplus divided by the regulatory capital requirement from the Bermuda Solvency Capital Requirement (**BSCR**). While the minimum coverage is set at 100%, the BMA expects insurers to maintain a Target Capital Ratio of 120%. Depending on an insurer's risk profile, the BMA may impose capital add-ons and dividend restrictions/prohibitions, require capital maintenance agreements and mandate liquid contingent capital sources, along with appropriate liquidity management tools.

Compared to their counterparts, PE Insurers often hold a higher proportion of illiquid assets due to their expertise, business planning and the previous low-rate environment. **The BMA, however, mandates that insurers (i) allocate a material portion of their portfolio to standard high-grade fixed-income investments, (ii) manage assets through risk-based capital charges and investment and asset-liability management policies, and (iii) adhere to the prudent-person principle**. This approach necessitates a comprehensive market risk framework, including:

- Aligned investment strategies.
- Concentration limits.
- Identification and quantification techniques.
- Performance measurement and stress testing.

The BMA has expressed concern that PE Insurers holding illiquid assets are more likely to be forced sellers of such assets at potentially steep discounts to meet liquidity needs. Insurers must demonstrate sufficient liquidity sources to meet excess liability cash flows even under stressed conditions, with illiquid assets assigned a nil value for stress-testing purposes. Additionally, PE Insurers are mandated to conduct their own risk and solvency assessments (Commercial Insurer Solvency Self-Assessment (CISSA) or Own Risk and Solvency Assessment (ORSA)). Through additional insurer-specific stress tests, PE Insurers must demonstrate that they hold sufficient capital for their illiquid assets and also for the risks they have taken on. An insurer's ORSA is subject to intense and ongoing scrutiny by the BMA. The authority will provide written communication to PE Insurers regarding areas identified for feedback.

We understand that the BMA has also spent time analysing a substantial amount of industry default data to calculate the prescribed costs of various corporate bond assets. For other acceptable asset classes, BMA-authorised reinsurers must have a specific methodology of calculating their own costs, which is approved by the BMA. If approved, the costs are then subject to a floor. The BMA's approach reportedly results in higher assumed default and downgrade costs than those applied to a reinsurer authorised by the UK Prudential Regulation Authority (**PRA**).

Additionally, commencing 1 January 2025, Bermuda Internationally Active Insurance Groups (**IAIGs**) will need to comply with the global regulatory framework, the International Capital Standard (**ICS**), developed by the International Association of Insurance Supervisors (**IAIS**). The ICS aims to establish a harmonised method for measuring the capital required to cover an insurer's risks, including underwriting, credit, market and operational risks. We expect the BMA to consider adopting the Common Framework for the Supervision of Internationally Active Insurance Groups (**ComFrame**) and to seek to designate the Bermuda insurance regulatory framework as ComFrame-compliant. IAIGs will welcome a harmonised approach.

As outlined above, the rules surrounding capital requirements are dynamic and an area to which PE Insurers must pay due care and attention. Coping with dynamic change and increased regulation is likely to involve increased staffing and compliance costs.

Licencing

The BMA will conduct a thorough review of PE Insurers before considering them for licencing. The BMA scrutinises:

- Shareholder structures and key/executive personnel within these classes.
- An insurer's business model and rationale.
- Conflicts of interest between shareholders.
- The influence over management of investment managers and especially of related parties.
- Reinsurance and collateral agreements.
- The asset portfolio.
- Capital management policies.
- Liquidity management.
- Financial and solvency projections.
- Total asset requirements under both the cedant's and the BMA's bases.

The BMA will of course not approve applications where its licencing requirements have not been met; however, the authority commonly places conditions on approval, imposing investment limits, liquidity management, dividend restrictions, target capitalisation levels **and requirements for access to capital, board compensation, executive and senior management composition, and overall staffing levels**.

Supervisory Collaboration

Given the BMA's view that PE Insurers pose a unique supervisory challenge, the BMA implements intensified supervision measures. Key aspects include:

- Oversight of Bermuda groups.
- Participation in supervisory colleges hosted by other jurisdictions.
- Bilateral discussion with cedant supervisors on applications
- Capital fungibility simulation exercises.
- Internal supervisory quasi groups.
- Crisis management groups.
- Recovery plans.

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The BMA engages regularly with boards and management through substantive quarterly or monthly meetings to focus on key risks. Furthermore, **the BMA is empowered to conduct in-depth on-site reviews, with a focus on investment strategy, liquidity and asset-liability management (ALM), risk management, governance and solvency**.

Insurance regulation in Bermuda is primarily governed by the Insurance Act. It was amended to require certain PE Insurers to produce recovery and/or resolution plans. The BMA is currently in the process of finalising these rules. **PE Insurers in Bermuda should expect to integrate recovery plans into their overall enterprise risk management**. The BMA may request for an insurer to execute its recovery plan and may direct the insurer to address any deficiencies within the recovery plan.

Insurance Liabilities Discounts

In Bermuda, life and annuity insurers may discount their insurance liabilities using the discount curves prescribed by the BMA or an alternative ALM approach called the scenario-based approach (**SBA**). At a minimum, the liabilities should be shown to have predictable and stable cash flows across a range of scenarios and be matched with suitable fixed-income assets that produce predictable and stable cash flows. Where a mismatch exists, the SBA assigns an explicit cost by running the calculation through eight alternative interest rate scenarios and selecting the worst of the eight scenarios to determine the Best Estimate Liability (**BEL**).

To mitigate lapse risk, the BMA has implemented a more intrusive supervisory approach and standard, similar to the UK's matching adjustment regime**. The BMA has noted that the recent enhancements to the SBA, which approach is commonly used by PE firms, will likely have a significant quantitative impact on the Bermuda market**. To be approved to use and or continue to use the SBA, firms must meet specific conditions, such as demonstrating that their liquidity risk management plans align with BMA specifications and conducting detailed liquidity stress tests.

Further regime enhancements include (i) the requirement for insurers to seek approval to use nonpublicly traded assets (included assets rated investment grade by the BMA itself) in the SBA, (ii) the prohibition of affiliated transactions and connected assets in the SBA and (iii) the requirement to cap asset yields. The BMA will bolster SBA supervision with additional resources to analyse reported data, ensuring the adequacy of technical provisions set up by supervised firms.

Structure of Cross-Border Transactions

Transactions between cedants and cross-border insurers, including PE Insurers, often involve coinsurance or modified coinsurance (**ModCo**) arrangements, which is particularly prevalent for reinsurance involving US cedants. In many transactions, assets remain with the cedant and the cedant directs investment strategy. This means the cedant's regulator is aware of the composition of assets supporting liabilities.

With the BMA seeking to prevent firms from operating in Bermuda to avoid differing levels of regulatory oversight, the BMA will consider the cedant's regulator's level of comfort with a transaction before the BMA exercises its power to approve or prevent a proposed transaction. The BMA can also consider which supervisory and regulatory tools it could utilise to increase the cedant's regulator's level of comfort.

PE Insurers should remember that even when conducting transactions in jurisdictions where the regulator does not have the power to prevent a transaction, the BMA may prevent a transaction on behalf of a cedant's regulator. The BMA maintains an open line of communication with the cedant's regulator by hosting supervisory colleges and meetings.

Governance

Concerns arise regarding transactions with affiliates or when an associated private equity firm or partner invests the assets, potentially compromising arm's-length transactions. The BMA, therefore, requires a PE Insurer to appoint BMA-vetted independent nonexecutive directors (**INEDs**) who chair conflict-of-interest committees and risk and audit committees. The BMA will determine the precise number of INEDs required on a case-by-case basis via discussions with insurers. As noted above, the BMA will carefully check that the proposed INEDs will bring the requisite life experience to the board. **The BMA also regularly holds privileged closed-door sessions with board chairs and INEDs to confirm PE Insurers are protecting policyholders' interests**.

The BMA commonly models its policy updates on those of the UK PRA and the UK Financial Conduct Authority (FCA), so we may see the implementation of a new regime similar to the UK's Senior Manager Regime for insurance executives, in which the FCA or PRA must approve senior personnel who perform key roles within a firm. **Overall, the BMA is committed to regularly testing internal governance and board oversight as part of its intensified supervision of firms**.

Lapse Risk

Lapse risk pertains to policyholders terminating insurance policies prematurely, potentially leading to a loss of future premium income and impacting an insurer's ability to cover claims and sustain profitability. The BMA identifies this risk as particularly relevant for PE Insurers who may need to sell illiquid assets at discounted prices to mitigate losses from mass lapse events.

In response, the BMA has implemented significant changes to lapse and expenses risk charges. The updates include:

- Enhancing risk sensitivity by transitioning from a factor-based approach to using lapse and expense shocks.

- Adopting Solvency II lapse shocks for European and UK business, while employing lapse up and down shocks based on the ICS for other regions. Mass lapse shocks are tailored by product type and features to accommodate Bermuda's diverse business landscape and historical data.
- Aligning expense shocks with ICS specifications.
- Introducing two new submodules into the solvency calculation to replace the long-term "other insurance risk" charge with aggregation based on Solvency II correlations, consistent with the ICS framework.

Conclusion

The Bermudian market has seen a flourishing of involvement of private equity and alternative asset manager-backed (re)insurers. This trend will likely continue. Nonetheless, onshore regulatory worries about that model have resonated in Bermuda. The CP2 reforms and the explicit and implicit policy positions effectively taken by the December Paper may be seen as a reaction to those concerns — and an attempt to address them while nurturing and protecting the Bermudian insurance industry. In any event, the passage of time and the growing sophistication and growth of the market will lead to further regulatory evolution in this space as the BMA responds to new challenges but remains malleable based on feedback from the industry. What is clear is that the changes discussed in this article are unlikely to be an endpoint, and further change will come.