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The Bermuda Monetary Authority Issues Papers on Collateral Structures, Liquidity Risk and Private Credit

Key Points

- The BMA has issued papers on collateral, liquidity and privatecredit that focus on these subjects in the context of asset-intensive (or funded) reinsurance for life and annuity business.
- The papers recognize the dominance of funds withheld/modified coinsurance structures and encourage their use, noting the importance of carefully drafted contractual provisions.
- The recent enhancements to the BMA's approach to the regulation of liquidity are discussed, along with liquidity risks.
- The historic performance of private credit is considered in a positive light alongside the risks that such investments can pose.

Increased strengthening of the global regulatory landscape in the (re)insurance industry has led to a similar increase in engagement between regulators and those they regulate. Specifically, Bermuda continues to be an attractive choice for (re)insurers and investors alike, continuing its transformation into one of the world's largest specialist reinsurance markets.

In order to maintain its status as a leading venue, the Bermuda Monetary Authority (BMA) routinely publishes articles on its guidelines and approaches. Recently, it published papers on collateral structures, liquidity risk and private credit.

The papers can be regarded as a thoughtful strengthening of aspects of the Bermuda regime and another step toward making Bermuda more attractive to cedent jurisdictions against a global backdrop of onshore regulatory caution regarding the volume of asset-intensive reinsurance flows offshore.

In this update, we review the BMA's commentary on:

- Collateralised reinsurance transactions.
- Its updated approach to liquidity risk.
- Private credit considerations for reinsurers.

In keeping with the overall theme of building a stronger regulatory regime, there is a key theme throughout: stability.

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Collateralised transactions and structures are considered an effective safeguard by the BMA, particularly in asset-intensive reinsurance sectors such as life and annuity reinsurance. However, the macroeconomic environment is changing.

Reinsurers must be aware of the need to stress test their liquidity in the face of immediate shocks and access to assets, reinforcing the potential benefits of a properly constructed collateralised policy and warning of the dangers of a sudden policyholder lapse *en masse*.

It is not coincidental that these three papers were published at more or less the same time.

The BMA notes in the papers that despite the risks and rewards of various financing methods, its approach to governance is through the lens of key principles, notably the prudent person principle (PPP), in which (re)insurers must be confident in their internal governance procedures to ensure that unavoidable or unforeseeable events can be risk-managed appropriately.

Collateralised Reinsurance Transactions in the Bermuda Long-Term Insurance Market

For long-term asset-intensive reinsurance for life and annuity business (also known as funded reinsurance), the BMA has noted that collateralised structures may be an effective and significant safeguard for cedents and their underlying policyholders and beneficiaries.

The BMA's Experience With Collateralised Reinsurance Transactions

The BMA's experience has been that the use of contractual mitigation tools in collateralised long-term reinsurance transactions, such as funds withheld (FWH) and modified coinsurance (ModCo) structures, have significantly decreased an insurer's counterparty credit risk exposure to Bermudian reinsurers.

The BMA highlights that where collateral is not ring-fenced into a segregated custody account subject to legal limits or placed in an equivalent structure, the following risks and concerns are more likely to materialise:

- The cedent will have little to no — or limited — legal control, ownership, visibility or influence over the underlying assets.
- The reinsurer will be able to deal with the assets, subject to treaty and regulatory standards, without input from the cedent.
- The cedent will rely on the reinsurer for the receipt of claim payments, even in periods of financial stress.
- The cedent risks a reinsurer default on the value of the assets required to satisfy policyholder obligations.

To mitigate such risks and concerns, the BMA recommends that parties rely on contractual mitigation tools that allow the cedent to exercise control over the collateralised assets. The BMA's approach is in keeping with its findings that FWH and ModCo structures have become increasingly popular in the Bermuda life reinsurance market.

Examples of robust contractual mitigation tools the BMA has encountered include binding and enforceable limits and investment guidelines between the parties, the inclusion of covenants in reinsurance treaties that constrain reinsurers' asset liability management, and the following, which are of particular importance:

- **Retention of legal title to the assets by the cedent:** The BMA notes this as one of the strongest tools to ensure the cedent's participation in asset management decisions taken with respect to the underlying assets. Considering the level of collaboration the BMA expects between cedents and reinsurers in managing collateralised assets, the BMA will, as part of its onsite review process of insurers, survey governance arrangements between the parties and relay its findings to the reinsurer (and, where concerns are identified with an overseas cedent, to the cedent's regulator).
- **Custody or trust accounts:** Policyholder obligations may exceed the value of the assets used as collateral, in which case the reinsurer must "top up" the custody account. Where assets are held in the cedent jurisdiction, the cedent has ease of access to the premiums of its underlying policies and any other collateral assets. The Bermudian reinsurer will assume the risk of "topping up" the relevant collateral account if the assets are insufficient. However, under the custody or trust structure, the cedent's risk of defaulting on policyholder obligations is minimised, as the cedent has recourse to the collateral if the reinsurer fails to "top up" the account and may already be in possession of sufficient assets to fulfil policyholder obligations (if there is overcollateralisation). It should also be noted that the Bermudian reinsurer may conversely benefit where the assets held are more than required and, upon expiry of the reinsurance, there will be a release of assets to the reinsurer — though some would say this is economically inefficient.

The BMA's Guidance on Bolstering Long-Term Collateral Structures

Despite the BMA's encouragement of contractual mitigation tools for long-term reinsurance, it notes that such tools are not foolproof. The BMA will more readily grant transaction approval for structures that have:

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- **Robust design and contractual safeguards:** Cedents and reinsurers should have strong and mature risk management systems. Those systems must, at a minimum, be capable of identifying and mitigating emergent risks. The BMA will usually withhold transaction approval to reinsurers who have weak management systems or outstanding supervisory or compliance concerns. The BMA views parties with weak or insufficient systems in place as problematic, as it creates problems for the BMA-supervised reinsurer.
- **High-quality assets as collateral:** Collateral should be appropriately liquid. Parties wishing to hold affiliated assets must now obtain BMA approval, which will entail meeting a "significantly high bar." Any assets held must also adhere to long-standing Bermuda regulatory requirements, namely the PPP and the Bermuda Solvency Capital Requirement (BSCR), and the ceding jurisdiction's laws.
- **Effective implementation measures:** Cedents and reinsurers should have specialist in-house compliance teams to monitor and report frequently on their reinsurance obligations. Cedents should not use as collateral assets outside of their internal compliance team's expertise, and a reinsurer should review a cedent's proposed assets to secure compliance with the relevant investment guidelines and regulatory requirements.

In summary, the BMA views collateralised reinsurance structures as an important safeguard insofar as asset-intensive business is concerned. Such systems have proved effective and secure. They are viewed as sufficiently "tried and tested." The BMA recognises that such systems are not without vulnerability, but this can be mitigated by strong governance and improved internal risk identification and management systems. Such measures are viewed as robust and delivering the level of protection for which they were designed.

An Updated Approach to Liquidity Risk

Liquidity risk is the risk that a company may not have sufficient liquid assets to meet its cash flow or collateral obligations as they fall due for payment. As a result of investments in alternative assets, rising interest rates and a regional banking crisis in the United States, the BMA identified liquidity risk management as a key regulatory focus area.

For Bermuda's long-term insurers (BLTIs), liquidity risk typically emerges from mismatches in timing between asset and liability cash flows. Long-term insurers generally hold illiquid liabilities that position them to be more resilient to liquidity risks.

We examine below the BMA's analysis of liquidity risk in the Bermuda long-term insurance market.

Bermuda's Long-Term Insurance Market

BLTIs maintain diversified investment portfolios, including a high proportion of liquid assets such as cash, corporate bonds and sovereign securities. As a result, BLTIs have high liquidity coverage ratios, indicating their ability to meet liability cash flows in stress events.

Similarly, the structure of Bermuda's long-term insurance market itself further supports the industry's resilience toward liquidity risks: The bulk of Bermuda's long-term reinsurance market covers US reinsurers who typically levy substantial surrender charges for policy lapses. Such charges may act as a strong disincentive to policy surrenders and therefore limit the impact on liquidity risk.

The BMA's Approach to Liquidity Risks

The BMA has reviewed its regulatory framework for BLTIs, introducing a holistic framework including higher reporting requirements, increased focus on insurer-specific stress tests (as required in the Commercial Insurers' Solvency Self-Assessment (CISSA), akin to a Solvency II Own Risk and Solvency Assessment, or ORSA) and a renewed commitment to onsite BMA inspections.

The key features of the regulatory framework are as follows:

- **Liquidity targets:** The BMA mandates insurers to maintain a liquidity buffer consisting of sufficient highly liquid assets to cover unexpected cash flows under severe stress conditions. The threshold is set at a 105% liquidity coverage ratio (LCR), which requires insurers to hold a higher proportion of available liquid assets than the potential surrender amount due under a severe stress event.
- **Regulatory stress testing:** Policyholder behaviour is fundamental in determining liquidity risk; insurers are required to conduct stress testing to demonstrate their ability to withstand severe situations in which policyholders surrender where possible *en masse*, causing substantial cash outflows. Insurers must include stress test outcomes to the BMA in their mandatory annual filings.
- **Internal stress testing:** Companies are required to perform internal liquidity stress tests, aimed at assessing the impact of each individual company's specific risk factors.
- **Liquidity risk management programs:** Each insurer's board of directors must approve risk management programs entailing a clear delineation of responsibilities and annual reviews. Insurers are encouraged to continually review economic conditions, interest rates and market sentiment to adjust their liquidity management strategies.

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The Impact of the BMA's Updated Guidance on BLTIs

Despite their overall resilience to liquidity risks, some BLTIs still face liquidity shortages under stress scenarios. The BMA closely manages such insurers through company-specific onsite inspections, targeted sectorwide assessments and the CISSA process.

The key drivers of liquidity risk for BLTIs include:

- Holding excessive illiquid assets.
- Adverse market conditions, such as interest rate increases.
- Reinsurer defaults.
- Shortfalls in new business.
- Challenges in meeting urgent short-term liquidity needs.

As policyholders seek to take advantage of high interest rates elsewhere in search of better returns, liquidity risk increases proportionally. In the 2020-2023 period, there was a noted upward trend in surrender payments as a proportion of new premiums. In addition to usual economic penalties, time was also a crucial factor: The more quickly a policyholder could access their funds, the more likely the BLTI would be to need to engage in a rapid distribution of assets to meet its policy obligations.

The BMA highlights the advantage of increasing the time delay in order to ensure that the sale of assets may be spread evenly and appropriately. Nonetheless, a 2023 BMA survey revealed that most BLTIs successfully navigated through this period of rising policy lapses.

In summary, the BMA is satisfied with the resilience of BLTIs in the event of liquidity-related shocks, and the Bermuda industry has demonstrated robustness in recent years in an increasingly uncertain macroeconomic environment.

Insurers are encouraged to continue to stress test their liquidity risk routinely, particularly in light of increasing policy lapses, in order to ensure long-term stability and preparation to navigate liquidity challenges, safeguard policyholder interests and maintain market stability.

An Assessment of Private Credit for (Re)insurers

As a result of an increase in investors (including insurers) turning to private credit in search of higher yield, the BMA has reported on the benefits and risks associated with investments in private credit for BLTIs. In this update, we refer to "private credit" as meaning direct loans (including leveraged loans), collateralised loan obligations (CLOs) and private debt placements.

Despite the allure of higher yields and low rates of credit loss, the BMA notes that prevailing private credit trends create material tradeoffs and potential risks for BLTIs.

Private Credit's Historical Track Record

Private credit's historical track record has been favourable in the low-interest, more high-covenant (although see below) environment since the 2007-09 global financial crisis. However, as the global economy rebounded in the wake of the pandemic and interest rates surged globally, the BMA underscores that in relation to private credit asset classes, there are forward-looking considerations that cannot be accurately captured in the historical data.

Historically, relative to comparable public debt investments, investments in private credit have resulted in:

- **Higher yields:** Private credit allows investors to capture an "illiquidity premium" — the difference between the yield of a private debt investment as compared to the yield of a theoretical, otherwise identical, public debt investment. The illiquidity premium arises from the compensation demanded by investors for taking on risks, such as illiquidity and complexity risks. In the context of insurance in Bermuda, the premium is delivered by insurers' application of discount curves provided by the BMA.
- **Lower rates of credit loss and higher recovery rates:** Direct loans have significantly lower rates of credit loss and higher recovery rates relative to comparable public debt investments, especially throughout macroeconomic periods of financial distress. Similarly, CLOs have yielded minimal credit losses since 2008.

Nonetheless, private credit investments pose inherent risks for (re)insurers, namely:

- **Illiquidity risks:** Private credit investments have long-term horizons that may exceed those of an insurer's corresponding funding sources. Accordingly, mismatched investments may jeopardise an insurer's ability to adhere to capital and liquidity requirements mandated by the BMA.
- **Valuation risk:** The balance sheet value of private credit investments may materially deviate from their fair value, as there are no readily available trading values through which to observe valuation. Overvaluation of private credit investment values on an insurer's balancesheet can compromise their compliance with the BSCR and result in denial of regulatory approvals.

Prevailing Trends and Future Risks

Whereas BLTIs may be attracted to investing in private credit, the BMA's analysis of trends and future risks in the space suggests insurers should be more risk-averse than expected.

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Specifically, the BMA notes that private credit assets may be "untested" in adverse market conditions. For instance, newer CLO structures have not been tested under severe financial crisis conditions. Internationally, various organisations (including the BMA) continue to scrutinise such structures.

In addition, insufficient lender protections may increase credit loss rates and lower recovery rates. Excess demand for leveraged loans has resulted in so-called "covenant-lite" loans that include fewer lender protections. Likewise, such loans include more borrower-friendly terms while the borrowers themselves continue to take on increasing amounts of leverage, exacerbating default risks.

The BMA's Guidance for Insurers Investing in Private Credit

The BMA views (re)insurers' investments in private credit through the prism of the PPP, which provides that an insurer "may only assume investment risks that it can properly identify, measure, respond to, monitor, control and report," taking into account its capital and liquidity requirements.

In order to adhere to the PPP, (re)insurers investing in private credit should conduct regular bottom-up stress testing and scenario analysis.

The BMA further emphasises that, from a liquidity standpoint, long-term insurers with illiquid liabilities are most suited to private credit investments, and liquid liabilities should not be used to fund these investments. The BMA expects that insurers will conduct thorough CISSAs and adhere to the aforementioned liquidity risk management programmes and practices when holding private credit investments.