

# Ready for business

Charles Collis and Michael Frith of Conyers Dill and Pearman clarify the issues raised in the BMA's Guidance Notes on the new 'special purpose insurer' class in Bermuda

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

The SPIs will enjoy an expedited application process, overall lighter regulation and only nominal capital requirements, on the basis that such companies are being established to carry out one or a series of fully funded transactions

between sophisticated participants. The nature of the underlying risk is irrelevant when determining whether the business is special purpose business. Accordingly, both long-term (life) and general business transactions may be carried out through SPIs.

The legislative changes that created the SPI and special purpose business concepts are intentionally drafted to allow the BMA maximum flexibility in determining the type of transactions and circumstances in which the use of an SPI would be appropriate. In order to provide some guidance to the insurance industry as to the manner in which the legislation is likely to be interpreted in practice, the BMA recently issued its Guidance Note #20 – Special Purpose Insurers (the 'SPI Guidance Note').

The SPI Guidance Note, in accordance

with the BMA's customary practice, has been developed in close consultation with leading industry participants, and aims to reflect the needs of those industry participants while maintaining an appropriate level of regulatory oversight.

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

“The SPI Guidance Note has been developed in close consultation with leading industry participants”

#### Fully funded

The Act states that a special purpose business may be fully funded by way of cash, time deposits, subordinated debt and "...some other financing mechanism approved by the [BMA]". This latter element allows for maximum flexibility for parties to use funding mechanisms such as reinsurance, derivatives, and so on,

and to create novel funding mechanisms.

Indeed, rather than prescribing the types of transaction that will qualify as 'fully funded', the SPI Guidance Note simply sets out certain key characteristics that an applicant will need to evidence in order to be deemed to be writing fully funded business. These include matters such as ensuring that full disclosure has been made to the cedant as to the fact that their claims will be limited to the assets held by the SPI and that the terms of the financing make clear that repayment rights will be subordinated to claims of policyholders.

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

#### Sophisticated participant

In creating the new concept of special purpose business and SPIs, the BMA has recognised that in transactions that qualify for licensing as such, the need for regulation differs from that of traditional (re)insurance business. The transactions contemplated are necessarily very sophisticated and technically advanced, and as such, the participants in such business are also necessarily sophisticated.

In recognition of this fact, SPIs are subject to a lighter form of regulation. The BMA retains broad discretion to determine, on a case-by-case basis, whether or not a particular party is deemed to be sufficiently sophisticated, but will have regard to factors such as net worth (either of individuals or entities) and levels of skill and experience in business or financial matters.

#### Regulatory requirements

Where an applicant satisfies the above criteria and is licensed as an SPI, it will

be subject to a lighter regulatory regime than that of general or long-term business insurers. Notably:

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

#### Application process

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

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

## GLOSSARY

### CATASTROPHE (CAT) BONDS

Funding structures designed to raise capital in the event of a catastrophe such as a hurricane or earthquake. Cat bonds are high-yield debt instruments that are usually insurance-linked. Because the insurance risk securitisation of cat bonds shows no correlation with equities or corporate bonds, they provide good risk diversification.

### SIDECARS

Limited purpose reinsurance companies that provide insurers and reinsurers with alternative capital to reduce earnings and capital volatility. The reinsurance sidecar assumes a portion of the ceding company's underwriting risk in exchange for a percentage of the profits. Sidecars are usually set up by an affiliated insurer or reinsurer and capitalised by equity and debt financing.

### LIFE SECURITISATIONS

Securitisation is the process of converting illiquid assets into asset-backed instruments which can be sold in the debt capital markets. In this case a portfolio of life insurance assets, potentially including premiums, charges, commissions and reserve, is packaged into securities and traded in the capital markets. Potential benefits include increased liquidity, lower cost of capital and an improved return on equity.

### TRANSFORMERS

A transformer is an entity (usually a special purpose vehicle) which 'transforms' one type of financial risk into another. Typically this will be risk under an insurance or reinsurance contract transformed into risk under a credit derivative agreement, or vice versa.