

# *Countdown to Equivalence*

The road to proportionate  
supervision

*A roundtable discussion  
exploring the key challenges  
and opportunities  
surrounding the countdown  
to Solvency II equivalence*

*May 2011*





*“The arguments raised by captives and life companies have struck at some of the fundamentals of Bermuda’s make-up”*

**Arthur Wightman**

*As the Bermuda Monetary Authority (BMA) adds the finishing touches to regulatory changes that are expected to result in Solvency II equivalence, companies are starting to get to grips with compliance. PwC Bermuda’s Regulatory Advisory team, led by Arthur Wightman, discusses some of the more demanding changes ahead.*

**Arthur Wightman (AW):** *Solvency II rules have mandated a big shift in the robustness of companies’ risk management frameworks. How is the BMA responding?*

**David Thompson (DT):** The BMA’s stance all along has been to establish a pragmatic set of regulations that allow for proportional supervision and that reflect the nature of the Bermuda market. That isn’t to say that their expectations of the large commercial companies (most of the Class 4 community) won’t be very similar to those currently being set, for example, by the UK’s Financial Services Authority (FSA). Even given the perceived strength of the reinsurance industry when it comes to risk management techniques, one of the fundamental aims of Solvency II regulation is to raise the bar for those near the weaker end of the spectrum.

**Tim Landick (TL):** We think that the BMA will start to apply their Code of Conduct guidance in a measured fashion. This may mean initially that having a plan to identify and address risk management weaknesses will be sufficient. However, if you look forward a couple of years, I would be surprised if we don’t see a much stronger stance being taken with those companies that have made limited progress against that plan.

**AW:** *In view of the rating agencies’ views on ERM, should a rating of ‘Strong’ or better indicate that a company has little left to accomplish?*

**Andrew Smith (AS):** Not necessarily. The perspectives of the rating agencies and the regulators often differ when it comes to risk management, especially in terms of how conservative a company may be in protecting their policyholders. Regulators, whether under Solvency II or not, are making it quite clear that policyholder protection is paramount and will want to see a risk management framework that is established and operates with that in mind. However, many of the risk management elements viewed as good practice by the rating agencies would be endorsed by the regulators. So, for those companies looking at strengthening their rating, now is a good time to focus on enhancements to ERM programs.

**DT:** Many companies have put ERM programs in place at a group level, with little focus on how risks are translated and then managed at a legal entity level. Despite the problems that are often involved in reconciling group and legal entity views of risk, regulators are asking those involved in legal entity governance to play a more active oversight role.

**DT: How are companies addressing the legal entity requirements, especially those groups who manage risk at a more aggregated level?**

**AW:** We've seen two distinct changes to try and address these requirements. The first is to increase the role played by legal entity boards and senior management teams. For some this has involved adding board members, including independent directors where there previously were none. It has also involved these boards meeting more frequently and playing a much more active role in terms of reviewing risk identification, mitigation and reporting, generally as a precursor to group boards reviewing aggregated data.

**TL:** The second change has involved restructuring how risks are managed and reported. We've seen adjustments being made to both the data being captured and the reporting process to make identification of where the risk resides much clearer. This will also help group boards better understand where risks may be inappropriately aggregated in a particular legal entity, especially if the capital retained in that entity has not been set with that aggregation in mind.

**AW: Given the weight that the BMA is placing on independent oversight, how will the roles and responsibilities of directors and management change?**

**AS:** It's a little early to say, but we've already seen the changes Arthur and Tim noted and I suspect that more will follow as the BMA starts to build its view of good practice. One of the key issues that companies are wrestling with is how to demonstrate the 'right' level of independent oversight. There's no doubt that regulators

generally expect a level of review, understanding and challenge from an entity's board. In addition, compliance officers should be thinking through what constitutes a 'material deficiency' in a risk management framework, and be providing the board (or a committee) with evidence that supports an assessment of whether any such deficiencies exist on a regular basis.

**TL:** Directors that we've spoken with are already starting to take regulatory filings more seriously, especially those with experience of some of the European regulators. Although the Bermuda Solvency Capital Requirement (BSCR) and Commercial Insurer's Solvency Self Assessment (CISSA) filings are not under the umbrella of the external audit, the BMA is mandating a regular, independent verification of the processes supporting the CISSA filings. For boards and senior management teams this exercise, particularly where it brings a flavour of what peer group companies are doing, should help to provide the level of comfort that they seek.

**DT: I've heard different views from companies over whether or not the BSCR is a relevant measure for how they manage their business. Do you see genuine benefits to obtaining approval for the use of an internal capital model?**

**TL:** In my experience there remains a significant part of the Bermuda insurance community that manages capital to regulatory requirements. Although not generally within the Class 4 community, these companies, including those in the long-term sector, are likely to feel some pain from the proposals in the latest versions of the BSCR. There are a number of intricacies around



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the quantification of risk in the standard formula, many of which were less apparent when the BSCR was only being completed by Class 4 entities. On the other hand, the ability for the BMA to read across the industry through the application of a standard formula does provide the BMA with a very useful perspective.

**AS:** Having just come from the UK, I can certainly understand some of the scepticism around internal model approval. However, I think ultimately the benefits will outweigh the drawbacks. Why wouldn't a company want a regulator to be looking at risk in the same way as management and its board does? Then to go a step further, most companies appreciate that trying to regulate using a standard formula is too much of a 'cookie-cutter' approach to providing the right level of oversight. So, although there is some up-front investment, having the regulator aligned with how you view risk is definitely the best long-term solution.

**AW:** It will also give companies an opportunity to evaluate the appropriateness of their model and the robustness of the related governance, processes and documentation. One of the benefits that going through a validation exercise can provide is for the company to get an independent view in all these areas. Often the capital model has been built over time and has not been subject to a genuine health check, despite being used to drive significant business decisions. Having the confidence in the systems and processes behind the model should help management teams fully realize the benefits of embedding it within their business.

**TL:** *How will the current proposals from the Financial Accounting Standards Board and International Accounting Standards Board on accounting for insurance contracts potentially change the way that regulators view available capital?*

**AS:** It's slightly unfortunate that the Solvency II rules have got ahead of the accounting standard setters, although the latest transitional guidance in Omnibus II provides an opportunity for them to line up. It would be in everyone's best interest for the accounting and regulatory balance sheets to be as closely aligned as possible, especially in the more complex areas such as reserves. The way that Solvency II looks at technical provisions is fairly similar to the proposal of the IASB, and therefore I'm hopeful that there is convergence in this area in the near future.

**DT:** An added complication for Bermuda is the pace at which the FASB may or may not converge with the IASB in this area. Since the vast majority of Bermuda's commercial insurance sector report under US generally accepted accounting principles, the BMA is currently in the difficult position of trying to introduce an economic view of a balance sheet that would look markedly different from existing US GAAP. These differences may have a substantial impact on companies' reporting processes.

**AW: You noted that Bermuda is a little behind its European counterparts in determining how a balance sheet will be looked at; it also seems to be true for the level of disclosures, especially those that will be released into the public domain. Is there a problem with promoting an increased level of transparency in a wholesale market?**

**AS:** There will be an increase in the level of public disclosures in the future. The issue for the moment is how extensive these will be and need to be. It could be argued that the nature of the wholesale market is such that the level of transparency doesn't need to be at the level you might need for the direct market. However, that isn't to say that an expanded understanding of companies' risk assessment and management isn't a positive thing in terms of policyholder protection.

**DT:** The comment from Andrew on policyholders is an interesting one. Many conversations I've had with risk management teams have been around the types of disclosures currently made in public filings, particularly in SEC documents such as 10-Ks and 10-Qs. The issue here is that these documents are primarily designed from an investor perspective, which is significantly different to that of a policyholder. Therefore the potential disclosures would be focused on material risks and how companies manage and mitigate these risks. The question is how extensive these types of disclosure get and whether they could start to erode competitive advantages.

**TL: It seems that all the changes we're discussing will result in substantial increases in the amount of data that the BMA will collect. Can the BMA deal effectively with all this additional information?**

**AS:** The increase in data and the relatively short period of time available to prepare would significantly challenge any regulator. However, based on the changes that I see the BMA making, I generally feel comfortable that within a couple of years they will have the technology, resources and internal processes to deal efficiently and effectively with the data being collected. Having said that, clearly the substantially greater responsibilities that both group supervision and enhanced entity supervision will bring are going to stretch the BMA in the near term.

**DT: The BMA will work with the European Insurance & Occupational Pensions Authority as part of the equivalence process. How will the relationship be changed by the release of Omnibus II?**

**AS:** Omnibus II is potentially the most significant Solvency II document issued to date. The equivalence process is just one of a number of areas where final implementation essentially could be delayed for a number of years. In addition, for countries that state their intention to work with EIOPA, a decision could be made to treat that country as equivalent for up to five years, starting in 2013. Looking forward, it would appear very difficult for EIOPA to decide in 2018 that a country should no longer be considered equivalent, after having been treated as such for so long.



*“The next couple of years are critical for setting up the process for group supervision.”*

**Tim Landick**



**AW:** There are often problems with being an ‘early adopter’, as Bermuda is seeking to be here. However, the arguments raised by captives and life companies, such as the speed and extent of changes and the application of proportionality, have struck at some of the fundamentals of Bermuda’s make-up. It would be disappointing if other countries get a ‘back door’ version of equivalence that doesn’t have the technical strength that exists in Bermuda’s bid.

**TL:** I would add that the next couple of years are also critical in deciding on and setting up the process for group supervision. Those decisions and their ramifications could look very different depending on whether a potential group supervisor is in a country deemed equivalent or not. Therefore it would appear that the European Commission has created a headache for itself, should it choose to use some of the transitional provisions in Omnibus II.

**AW:** *We’ve raised the possibility of problems ahead for the long-term sector and for captive insurance companies. What sort of resolution do you see in the short and longer term?*

**DT:** It’s difficult to see the BMA backing off its position for the long-term sector, or any reasons why they would want to. Supervision should be risk-based, so for those life companies assuming significant third party risks, the level of governance, risk management, capital requirements and reporting should mirror what is required by companies in the property-casualty sector.

**TL:** The situation for the captive sector is a little harder to predict. It will remain important for the BMA to apply a risk-based approach; therefore the current classification continues to pose problems since it is not entirely aligned with a view of policyholder risk. In addition, the Solvency II guidance continues to treat captives with only a moderate degree of proportionality - far less than the BMA have proposed.

It will therefore be critical for the BMA to present a compelling case as to why their approach is appropriate for the Bermuda market.

***Can you provide a concise and cohesive explanation of your risk framework?***

***Have you built a plan to obtain independent verification of your CISSA processes and reporting?***

***Is your ability to manage risk supported by an effective means of measuring risk?***

***Are your risk, actuarial, finance and compliance teams sufficiently connected to deliver the CISSA?***

***Are you confident that your Board understands their role and responsibilities with respect to regulatory requirements?***

***Is your entity governance structure robust enough when compared to your peer group?***

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