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Life Reinsurance in Bermuda: A Closer Look at the Drivers Behind This Rapidly Growing Sector

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Bermuda is already a well-known and well-respected global hub for insurance capacity. Although this market has traditionally focused on general insurance risks, life insurance and reinsurance has been one of the fastest growing sectors in recent years. A diverse range of business models have emerged in this sector, providing new options and opportunities to manage long-term insurance risk.

DRIVERS OF GROWTH

The number of licensed long-term (i.e., life and annuity) companies has grown to be almost 15 percent of total licensed insurers and, in terms of assets under management, the long-term sector now makes up over 30 percent of Bermuda's insurance market.

We have seen many new startups over the past several years due to a few reasons. One reason is the increased demand for life reinsurance, primarily driven by low interest rates and growth in the market for retirement products. Interest rates have been declining since the early 1980s and this has put a lot of pressure on investment yields. As a result, spreads are compressed on legacy blocks of business that typically have higher crediting rates. Insurers also have a harder time selling new business, because of lower crediting rates. Thus, companies are looking for solutions to these issues, and many companies are looking to exit legacy blocks or non-core lines of business to manage their capital and resources more efficiently.

Another reason is that stricter regulatory environments in the U.S., Canada, and the EU with Solvency II, have increased the demand for reinsurance globally. If you look at where the EU is in terms of its demographics, with an aging population and ever-growing retirement funding gap, you have a pronounced issue (which is also true in other jurisdictions around the world). If you overlay that with Solvency II, which increases both regulatory workload and capital required to back certain retirement and life savings plans, you end up with an environment that gives you a push and a pull. There is a push from insurers to review their portfolios and a pull factor to Bermuda for these types of businesses.

All these factors are driving the increased demand for reinsurance. In terms of capital supply, low interest rates are driving institutional investors to look for yield in non-traditional areas, and in seeking diversified yields they want to invest in the life insurance space which is known to generate a stable earnings profile.

Last but not least, we have to mention the environment of Bermuda. Bermuda is very conducive to startups, and the licensing process is very straightforward and streamlined, so companies can raise capital and deploy it relatively quickly.

WHY BERMUDA?

From an EU-facing perspective, we are seeing a lot of decision-making and review around portfolios that are either sub-scale or capital-intensive under the new Solvency II regime. Insurers are looking to take various management actions and have done so over the past two years, including reinsurance and divestiture.

With the specific provisions that Solvency II equivalence gives, Bermuda provides an ideal base for EU-facing reinsurers, essentially levelling the playing field with their EU-based peers. When you put that together, along with the Bermuda Monetary Authority's (BMA) pragmatic and collaborative approach, it makes Bermuda a very compelling choice of jurisdiction.

From a U.S.-facing perspective, Bermuda offers advantages in terms of capital efficiency; there are certain structures when compared to internal targets or U.S. standards that are more compelling in Bermuda. Also, the regulator in Bermuda is very accessible and is available to discuss regulatory approvals for large transactions, customized approaches for non-standard products or transactions, and similar issues. It will give you a decision in a matter of weeks, which is a lot more efficient than some other domiciles. Additionally, proximity to the U.S. is certainly a factor, and the ease of establishing a new company in Bermuda is also an advantage as you're dealing with one regulator as opposed to 50 different state regulators.

WHAT ABOUT TAX?

First, it's important to recognize that any reinsurance premium that's ceded from a U.S. company to a company in a jurisdiction that does not have a tax treaty with the U.S., or has a limited tax treaty like Bermuda, is subject to U.S. Federal

Excise Tax (FET) which is currently 1 percent for reinsurance premiums. On an in-force transaction, where the reserve transfer is considered the reinsurance premium, that can be a substantial amount. So, to make a ceding company neutral from their perspective, a reinsurer in these jurisdictions would often offer a ceding commission to offset that tax expense.

The FET can be expensive for different structures, so there are some companies in Bermuda that elect to be a U.S. taxpayer under the U.S. Internal Revenue Code Section 953d. The fact that there are several of these companies existing in Bermuda gives further evidence that tax is not the only reason why companies are in Bermuda.

The EU tries to harmonize its approach across a number of areas but does not do that with respect to taxation, so you get a range of treatments. As a reinsurer or acquirer, there are implications for us to think about. Some territories levy something similar to the FET called an insurance premium tax on reinsurance. For acquisitions, some territories levy withholding taxes on the payment of dividends from that country to Bermuda. So, tax is quite an important feature in terms of selecting and working with a domicile, and structuring the reinsurance or acquisition arrangement.

SOLVENCY FRAMEWORK

Bermuda has put a lot of effort over the last decade into achieving and maintaining Solvency II equivalence. It is one of only two jurisdictions worldwide, along with Switzerland, to have this distinction. Bermuda is also one of seven National Association of Insurance Commissioners (NAIC) qualified jurisdictions. These two attributes have really differentiated Bermuda among other international jurisdictions. Prior to these initiatives, Bermuda had a relatively limited solvency framework so these developments have really set Bermuda apart and reaffirmed its position as a robust and reputable insurance market.

Permanent Solvency II equivalence means the BMA needs to maintain an equivalent, albeit not equal, framework that is subject to periodic review. This is a key reason for a number of other life reinsurers to be based in Bermuda. It's no coincidence that Switzerland and Bermuda are the first jurisdictions to achieve equivalence—they are both recognized reinsurance hubs.

There are three specific articles that equivalence grants:

1. All Bermuda-based reinsurers are treated as if they are EU-based. In practice, this has a significant commercial benefit. We have an unfettered right to reinsure in EU markets.
2. The BMA is recognized as the group supervisor. Some Bermuda reinsurers are a group of companies, and the BMA would lead the college of supervisors and be recognized as an EU-standing supervisor.
3. The capital regime in Bermuda can be used instead of the Solvency II capital regime for a Bermudian subsidiary of an EU insurance group.

Moreover, even for U.S.-facing reinsurers, Solvency II equivalence is a positive in that it gives ceding companies a sense of comfort that the Bermuda regulator is experienced and well-respected, and the solvency framework is credible and consistent with leading practices.

Specifically, on the NAIC qualified jurisdiction, this allows a Bermuda reinsurer to become certified in the ceding company's state of domicile, which allows for more flexibility on the amount of collateral that is required in order for the ceding company to receive reinsurance credit on the transaction. This allows you to hold reduced collateral based on the credit rating of your company.

JOURNEY TO EQUIVALENCE

Around the mid-2000s, the property and casualty (P&C) industry decided they wanted to be equivalent to Solvency II, mainly for their Lloyd's and U.K. businesses. So, Bermuda initiated some changes to the capital framework. At the time, most of the life reinsurers were U.S.-facing and not particularly interested in Solvency II equivalence. We explored bifurcation (i.e., to only apply for equivalence on the P&C side), but the EU said no. The EU did allow us to break off the captives, so captives in Bermuda are not deemed Solvency II equivalent and have different capital requirements.

The BMA formed a long-term (i.e., life) working group with representatives from industry. We collaborated with the BMA on various sub-topics (longevity risk charges, asset risk charges, etc.) as they worked to form a risk-based capital model for the life sector. Around the same time, the life companies banded together to form the Bermuda International Long-Term Insurers and Reinsurers (BILTIR), an association to represent our industry. BILTIR started out with five companies in 2011, and we now have 43 member companies and 17 associate member companies.

If you recall at the beginning of Solvency II, regulators and governments wanted a risk-based regime that reflected market conditions on both sides of the balance sheet as well as greater public disclosure. Those principles still prevail in the Bermuda framework: it has a risk-based capital model through the Bermuda Solvency Capital Requirement (BSCR) (albeit factor-based but reflective of the risks); it is marked-to-market in that the value of assets and liabilities reflect current market conditions through the Economic Balance Sheet (EBS); and public disclosure is made through the Financial Condition Report (FCR).

A key difference is that the BMA did try to take a pragmatic approach to implement all this, recognizing that the full burden of Solvency II for Bermuda companies is onerous. The BMA has achieved the goals it put forth, but sensibly and supportively of Solvency II equivalence going forward.

The BMA has been very clear to the industry that they are committed to maintaining a solvency framework that is consistent with international leading practices and in line with Solvency II. As a result, there are already changes being outlined to be enacted in 2019. Once these were announced, the industry, through BILTIR, initiated dialogue right away with the BMA to agree on appropriate timelines for the phase-in of these changes.

LOOKING AHEAD

What does the future hold for long-term reinsurance in Bermuda, both in terms of regulatory developments as well as responding to global trends?

First, for in-force transactions, there are trillions of dollars of general account reserves in the long-term insurance market globally. Now, not all of that reserve is in spread compression, but the demand for this reinsurance conceivably could be more than the current capacity in the market. Second, everyone wants their new business initiatives to be more competitive and we can help companies through reinsurance make their new products more competitive.

In the short term, a key impact is regulatory change, as these often provide the kinds of opportunities we've discussed and that will continue for some time. In addition the long-term drivers are still going to be there, like the demographic changes, the aging population, the retirement funding gap, etc. That is going to be a source of business for a number of years yet.

With respect to regulatory trends for Bermuda, as we participate in many global transactions, the BMA regularly participates in supervisory colleges, and this puts the BSCR head-to-head with capital requirements worldwide. This highlights areas where Bermuda may be different. As an industry, we have to understand how these capital requirements make sense relative to the risks we have on our books.

We have seen tremendous growth over the past few years in Bermuda's long-term insurance sector and we see this continuing for all the reasons that have been stated, both for companies that are in existence as well as for startups.

If you want to find out more about the issues affecting the Bermuda life reinsurance marketplace, please visit the BILTIR website (www.BILTIR.bm) and consider attending the upcoming Bermuda International Life and Annuity Conference held on Sept. 27, 2018 at the Fairmont Southampton. ■

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