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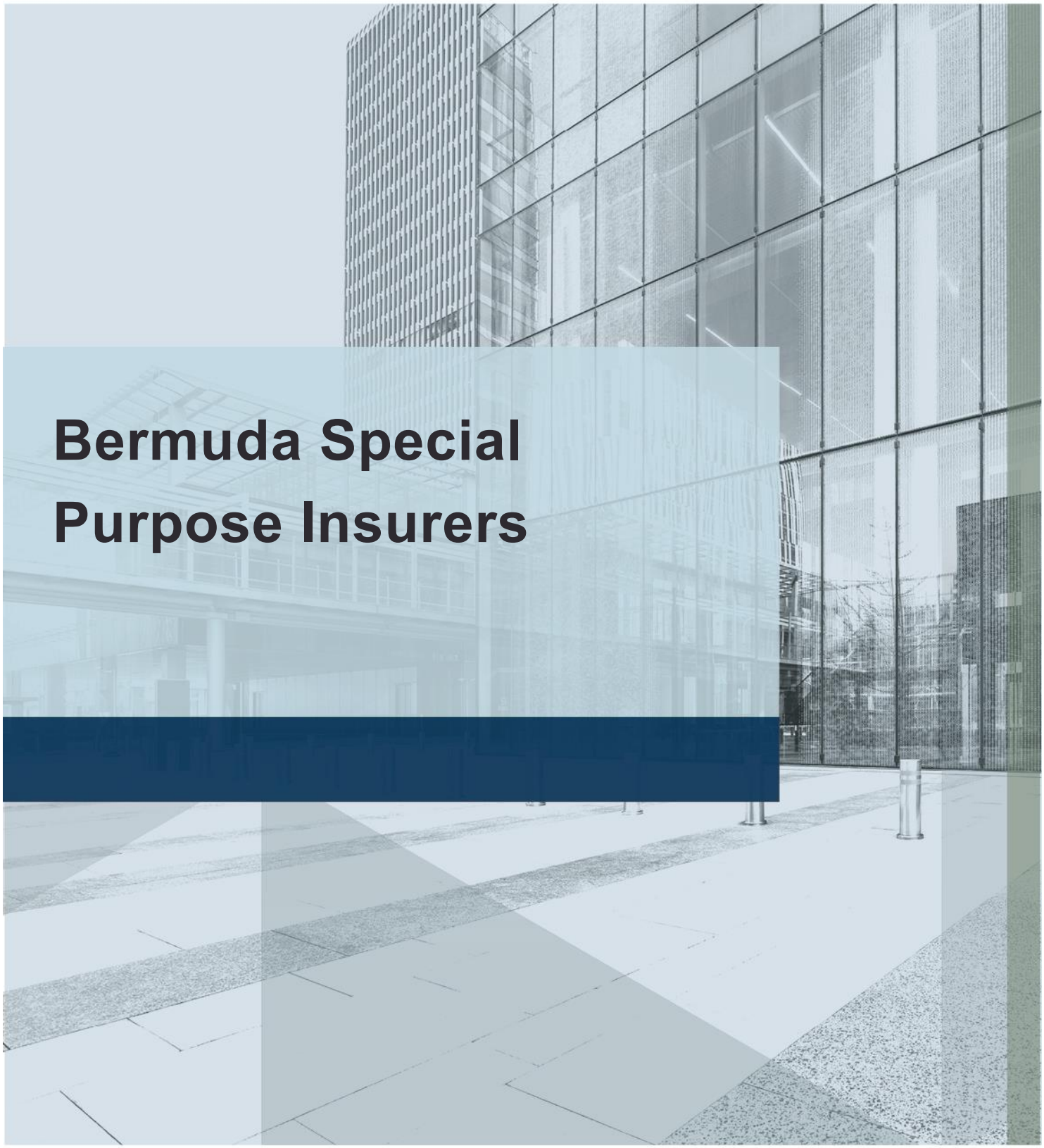

Bermuda Special Purpose Insurers

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Preface

This publication has been prepared for the assistance of those who are considering the formation of a "special purpose insurer" in Bermuda. It deals in broad terms with the requirements of Bermuda law for the establishment and operation of such companies under the Insurance Act 1978. It is not intended to be exhaustive but merely to provide brief details and information on the topic. We recommend that persons seek legal advice in Bermuda on any specific proposals they may have before taking steps to implement them. In addition, before proceeding with any such proposals, persons are advised to consult with their tax, legal and other professional advisers in their respective home jurisdictions.

Copies of the Insurance Act 1978 together with the regulations promulgated thereunder are available on request.

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1. INTRODUCTION

Bermuda has long been an important global insurance and reinsurance centre, and is regarded as one of the most sophisticated markets in the world. With a reputation for innovation and speed to market, the island's industry began with the development of the captive insurer concept in the 1960s, quickly followed by the growth of the now well established commercial market. Bermuda has also led the development of sophisticated insurance-linked security ("ILS") products such as cat-bonds, sidecars, transformers and other fully-funded insurance and reinsurance vehicles.

In 2009, having recognised the sophistication of the ILS market, the Bermuda Monetary Authority ("BMA") introduced amendments to the Insurance Act 1978 ("Insurance Act") to create a new class of "Special Purpose Insurer" ("SPI"), specifically to write sophisticated, fully-funded insurance and reinsurance transactions (see below for definition of "fully-funded" and "sophisticated" for these purposes). In recognition of the inherently lower regulatory risk profile of such insurers and reinsurers, SPIs enjoy a lighter, more efficient regulatory regime. Minimum capital requirements of just $1, no return of capital restrictions, the ability to waive the requirement for an audit, no investment restrictions (subject to appropriate disclosure – see below), and low licensing fees are just some of the more popular regulatory features of the new legislation.

Flexibility is also a key feature of the SPIs. The nature of the underlying risk - ie. whether long term or general business[1] - is not relevant to an SPI. Provided that the risk is fully-funded and the parties involved are sufficiently sophisticated, any risk may be written, and the BMA has broad discretion to determine whether or not those two key characteristics are met.

Since the introduction of the SPI concept in 2009, there has been an extraordinary growth in both the number of companies and diversity of transactions availing themselves of the SPI licence. Cat bonds and sidecars are two of the more common uses, both as one-off transactions and with multiple tranches and series. SPIs have also been formed to act as transformer vehicles, to provide reinsurance to Lloyd's corporate members, and to write embedded value life and "triple-X" securitisation transactions. They are commonly used to write collateralised retrocession business, in certain circumstances for multiple cedants, and in that capacity have also been used as a key component of ILS-specialised investment funds. In short, their inherent flexibility and efficiency make them an ideal vehicle for a broad array of transactions, and they have proven to be extremely popular. Experience to date has been that, provided that the company is able to evidence that the contract(s) to be written by it is(are) fully-funded and that the participants to such transaction(s) are sufficiently sophisticated (see below for description of how this may be achieved), that transaction will be deemed by the BMA to be "special purpose business" and they will register the company as an SPI.

2. KEY CRITERIA FOR LICENSING AS AN SPI

In order to be deemed to be writing "special purpose business", and therefore to be licensed as an SPI, the applicant will be required to evidence two key criteria, namely that:

[1] For a detailed discussion of the regulatory regime applicable to long term and general business insurers, including information on the classes of each such category of business, please refer to our general publication titled "Bermuda Insurance Companies".

(i) the business it intends to write will be fully-funded; and

(ii) 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. The BMA has developed a Guidance Note outlining its interpretation of these principles and the regulation of SPIs generally, a copy of which is appended hereto. A summary of the concepts, and the practical application of them, follows.

2.1. Fully-funded

Under the Insurance Act, special purpose business may be fully-funded, in short, by any "*…financing mechanism approved by the [BMA]*". This might be (and often is) in the form of cash collateral or subordinated debt, but can also be achieved by any number of other financing mechanisms, including contingent assets such as letters of credit, reinsurance, derivatives, etc.

In many cases, the transaction documents will contain "limited recourse" provisions, such that it is made expressly clear that the liability of the SPI will be limited to the value of the assets (actual or contingent) held as collateral from time to time. However, this is not a requirement, and collateral "top-up" mechanisms may be permitted in certain circumstances.

Broadly speaking, the nature of the assets being used to fund the liabilities of the SPI can take whatever form the parties may agree, provided that the details are adequately disclosed both prior to and during the life of the transaction in question (and provided that the parties are able to evidence sufficient sophistication – see below). Likewise, there is no restriction on the nature of investments that an SPI may make, again provided adequate disclosure of such investments is made to participants. In transactions where a collateral top-up may be required, the manner in which the top-up mechanism is to operate and the credit-worthiness of the party providing the additional collateral should also be disclosed to all relevant parties. Provided that such disclosure can be made, it will generally be left to the parties to determine the collateral tolerances within which they are willing to operate.

In practice, the necessary disclosure is readily achieved. The offering circular in a cat bond transaction or the private placement memorandum in a sidecar arrangement will often serve this purpose, and where there is no such general disclosure document, simply evidencing the key terms of the transaction documents will generally suffice.

2.2. Sophisticated Participant

As described above, the SPI concept was developed with sophisticated transactions in mind, it being recognised that in such transactions the need for regulation differs from that of traditional insurance or reinsurance business. In short, in order to be satisfied that the SPI's lighter regulatory regime is appropriate to a particular transaction, the BMA must first be satisfied that the participants in the transaction are sufficiently sophisticated to be able to appreciate the nature of the risks involved (see the disclosure requirements described above in the "fully-funded" context). If they are able to evidence that sophistication (and that the liabilities will be fully-funded), the company will be able to avail itself of the SPI regulation.

In its Guidance Note, the BMA sets out specific criteria for determining the appropriate level of sophistication of both individuals and entities. These criteria are broadly based on high net worth/income and/or experience in sophisticated financial matters. In keeping with the theme of flexibility, however, the BMA also retains broad discretion to authorize other persons/entities as being suitably sophisticated for the purposes of the SPI requirements.

3. ADVANTAGES

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 "traditional" general or long term business insurers and reinsurers. Notably:

(i) the minimum issued share capital of an SPI is $1, and the margin of solvency for an SPI (ie. amount by which the SPI's assets must exceed its liabilities) is also simply $1;

(ii) no regulatory restrictions on or approvals required in connection with a return of capital;

(iii) in many circumstances it may be possible to waive the requirement to prepare audited financial statements and statutory financial return, and instead file unaudited management accounts (prepared in accordance with GAAP, IFRS or other appropriate accounting standard) in lieu;

(iv) there is no requirement for loss reserve opinion;

(v) there are no investment restrictions (subject to adequate disclosure); and

(vi) low annual registration fee.

In addition, many of the enhancements to Bermuda's insurance/reinsurance regulatory regime introduced as part of the island's quest for Solvency II equivalence are not applicable to SPIs. SPIs, along with captive insurers, are included within the broader "limited purpose insurer" concept, with the effect that the more detailed BSCR and enhanced capital requirements, among other things, are not applicable.

4. APPLICATION PROCESS

The application process for approval of SPIs follows the same track as for "traditional" insurers and reinsurers. The application is filed with the BMA by close of business on any given Monday for review (and possible approval in principle) on the Friday of that same week. The application package will be comprised of the following documents:

- **Business Plan** - generally no more than 5 or 6 pages, describing the fundamental elements of the transaction in question, including details of: investors, cedant(s)/sponsor and directors/senior management/service providers (to evidence sophistication); nature of funding mechanism (to evidence fully-funded); any other pertinent details;

- **SPI Checklist** – this is a BMA standard form, serving to highlight the most pertinent aspects of the business plan and relevant transaction documents;
- Drafts of relevant transaction documents (eg. Reinsurance agreement, collateral trust agreement, offering circular/PPM, if any) – where drafts are not available at the time of application, summary term sheets will often suffice;
- Service provider acceptance letters; and
- Other relevant documents/information (as appropriate)

The nature of SPI transactions is such that the BMA will, in most cases, be in a position to approve the application at its initial Friday review. Following that approval, the company may then apply to obtain its certificate of registration as an SPI.

5. SINGLE SPI – MULTIPLE TRANSACTIONS

In many cases, an SPI will be used to write a single contract or series of contracts. However, it is possible for an SPI to write multiple contracts, even for multiple cedants, provided that each such contract is "separately structured". What this means in essence is that the collateral or other funding supporting the liabilities of a particular contract may be used only to pay claims under that contract and not any others.

In practice, this separate structuring can be and often is achieved contractually (eg. through the use of separate reinsurance trusts or security arrangements for each contract written). It is also possible to register the SPI as a "segregated account company" pursuant to the Segregated Accounts Companies Act 2000 (or by way of a private act), and have each contract written, and the related collateral held, through a distinct segregated account. In either case, it is important that the mechanism to be used is clearly described in the business plan, such that the BMA is satisfied that each contract to be written by the SPI will be "separately structured".

APPENDIX A - BMA Guidance Note #20 – Special Purpose Insurers

1. INTRODUCTION

(1) The class of Special Purpose Insurers ("SPIs") was introduced by the passage of the Insurance Amendment Act 2008 on 30th July 2009 (IA(1)).

(2) This note (the "Note") sets out guidance in relation to the Authority's licensing and supervisory regime in relation to SPIs. A primary focus of the Note is to demonstrate the Authority's approach to the supervision of SPIs which involves setting out prudent and robust fundamental requirements that SPIs must meet in order to be licensed under Bermuda law.

(3) The Authority is of the view that once licensing for an SPI has been achieved, regulatory attention should be placed upon the original cedant/insured. This is aligned with the fact that the SPI is by definition fully funded and therefore perpetually solvent. In this regard, the Authority expects that as the ceding entity benefits from capital relief associated with its risk-transfer to the SPI, it shall be adequately capitalised and technically equipped to manage all risk characteristics associated with the SPI cession.

(4) The Authority recognises the need for clarity as to the scope and implementation of the provisions of the Insurance Act 1978 and related regulations ("the Act")[2] if the regulatory system is to command the confidence of both (re)insurers and contract/policyholders. The Authority therefore seeks to ensure that those operating in Bermuda have a sound understanding of the Authority's approach to implementing the Act in the context of SPIs.

(5) While the Authority aims to provide clarity as to its approach, this Note cannot be exhaustive. The Authority will do its best, through this and other guidance notes, to set out information about its regulatory approach and expectations regarding the activities associated with SPIs. Ultimately, it is the responsibility of the legal entity to ensure their compliance with the Act and all queries associated with this guidance should be directed to the Authority.

(6) There is likely to be a need for some modification in the SPI guidance over time as new scenarios emerge. In this context, it is generally the approach of the Authority to pass material changes in process through industry consultation before being published, usually through the issuance of revised versions.

2. THE REGISTRATION PROCESS

(7) SPIs will be subject to a streamlined application and ongoing supervisory process, commensurate with the assumed risk of the venture.

[2] The Act" means the Insurance Act 1978 and its related regulations. The insurance legislation is comprised of the Insurance Act 1978 (as amended by the Insurance Amendment Acts, 1981, 1983, 1985, 1995, 1998, 2001, 2006 and 2008) (IA) and the regulations promulgated under that Act (the "Regulations"). The Regulations are the Insurance Accounts Regulations 1980 (as amended by The Insurance Accounts Amendment Regulations 1981, 1985, 1989 and 2008) and the Insurance Returns and Solvency Regulations 1980 (as amended by The Insurance Returns and Solvency Amendment Regulations 1981, 1985, 1989 and 2008).

(8) The SPI application process will generally require that an SPI application form ("SAF") be completed and signed by the applicant before being submitted to the Authority. The SAF will include a series of questions directed to the most pertinent details of the SPI transaction.

(9) The Authority shall expedite approval of SPI applications when received. At a minimum, applications will be considered at the weekly Admissions and Licensing Committee (ALC) meeting.

3. CHARACTERISTICS OF FULLY FUNDED STRUCTURES

(10) The Authority recognises the numerous interpretations of the term "full funding" in evaluating the financial position and contractual arrangements inherent to SPI vehicles.

(11) For the purposes of interpreting the provisions in the Act in the context of the SPI's fully funded position, the following conditions shall apply to the SPI's available assets and liabilities and its contractual arrangements. To be fully funded, an SPI will generally be expected to:

(a) confirm full disclosure to the cedant or insured of the fact that the maximum reinsurance recovery from the SPI is limited to the lower of the stated contract limit and the available assets of the SPI;[3]

(b) ensure that, under the terms of any debt issues or other financing mechanism used to fund its (re)insurance liabilities, the rights of providers of that debt or other financing are fully subordinated to the claims of creditors under its contracts of (re)insurance;

(c) enter into contracts or otherwise assume obligations which are solely necessary for it to give effect to the (re)insurance special purpose for which it has been established; and

(d) ensure that, to the extent that more than one (re)insurance contract is in place within the SPI, each of the (re)insurance contracts is structured so that the SPI meets the fully funded requirements individually for each contract.[4]

4. SOPHISTICATED PARTICIPANT

(12) The Authority expects that only sufficiently Sophisticated Participants will engage in this highly specialised form of business, which in the context of this Note means a person who satisfies one or more of the criterion below:

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[3] Notwithstanding this expectation, to the extent that an SPI reinsurance agreement does not include limited recourse language, the SPI may be required to validate that it has in place adequate financial arrangements for the purpose of funding cedant/insured claims exceeding its available assets. In these circumstances the SPI may be required to demonstrate that any issuing counterparty:

1. Is a regulated financial institution subject to regulation by the Authority or equivalent regulation by another regulatory body; and

2. Has achieved a financial rating (counterparty, credit or financial strength as applicable) of at least A- as of the date of application and as determined by a recognised rating agency or,

3. Is of a sound financial quality (in the circumstance of unrated issuers or issuances,).

[4] This provision should not necessarily be deemed to require asset segregation by contract, but rather that that the Authority will at a minimum expect to be provided with assurance that there is clarity of contract obligations via specific contract language.

(a) high income private investors;[5]

(b) high net worth private investors;[6]

(c) sophisticated private investors;[7]

(d) investment funds approved by the Authority under the Investment Funds Act (IFA)

(e) bodies corporate, each of which has total assets of not less than five million dollars, where such assets are held solely by the body corporate or held partly by the body corporate and partly by one or more members of a group of which it is a member;

(f) unincorporated associations, partnerships or trusts, each of which has total assets of not less than five million dollars, where such assets are held solely by such association, partnership or trust or held partly by it and partly by one or more members of a group of which it is a member;

(g) bodies corporate, all of whose shareholders fall within one or more of the subparagraphs of this paragraph, except subparagraph (d);

(h) partnerships, all of whose members fall within one or more of the subparagraphs of this paragraph, except subparagraph (d);

(i) trusts, all of whose beneficiaries fall within one or more of the subparagraphs of this paragraph, except subparagraph (d);

(j) any company quoted on a recognised stock exchange; and

(k) any party deemed to have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment.

(13) On a case by case basis, the Authority may approve other persons as suitable investors (in addition to the list of persons set out in 12 above).

5. ASSET QUALITY AND DISCLOSURES

(14) It is the expectation of the Authority that the SPI provide full disclosure to the cedant/insured(s) and investor/debt-holder(s) and makes available documentation setting out the investment guidelines governing the SPI structure. This documentation is expected to disclose detail such

[5] Means an individual who has had a personal income in excess of $200,000 in each of the two years preceding the current year or has had a joint income with that person's spouse in excess of $300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year - "current year" means the year in which he purchases an investment.

[6] Means an individual whose net worth or joint net worth with that person's spouse in the year in which he purchases an investment exceeds $1,000,000 - "net worth" means the excess of total assets at fair market value over total liabilities.

[7] Means an individual: 1) who has such knowledge of, and experience in, financial and business matters as would enable him to properly evaluate the merits and risks of a prospective purchase of investments; and 2) who, in respect of each investment transaction, deals in amounts of not less than $100,000.

as the types of acceptable instruments (including contingent assets as applicable), issuers and credit ratings of permissible investments.

(15) In addition, it is the expectation of the Authority that the SPI provide full disclosure to the cedant/insured(s) and investor/debt-holder(s) and agrees to make available to the relevant counterparties the following data, (as applicable): 1) the total composition of the assets of the SPI, 2) latest available market value of the assets, and/or 3) the latest available net asset value of such assets: (A) within a maximum of 10 business days after the end of each calendar month, and (B) within 2 business days of the request of any relevant participant where such data may not be aged by more than 30 days unless agreed upon by the relevant parties.

6. CONTINGENT ASSETS[8] AS FORMS OF COLLATERAL

(16) The Authority recognises contingent assets such as reinsurance and/or LOCs from appropriately risk managed and regulated institutions as acceptable instruments for inclusion in the funding structures of SPIs.

(17) In this context, where an SPI is funded through a balance of contingent assets the SPI must demonstrate that any issuer of these contingent assets:

(a) is a regulated financial institution subject to regulation by the Authority or equivalent regulation by another regulatory body; and

(b) has achieved a financial rating (counterparty, credit or financial strength as applicable) of at least A- as of the date of application and as determined by a recognised rating agency, or

(c) is of a sound financial quality (in the circumstance of unrated issuers or issuances,)

(18) To the extent that, as a result of deterioration in the value of contingent assets, the value of the SPI available assets falls below the value of the expected reinsurance recoveries or aggregate liabilities by a specified margin, then the Principal Representative shall forthwith inform the Authority. The quantification of this margin of deterioration will be left to the discretion of the relevant participants but must be fully disclosed at the time of making the SPI application.

(19) The SPI must fully disclose, within the notes to its accounts, the existence of all contingent assets and similar funding vehicles. The SPI must be prepared to demonstrate, through documentation or otherwise, how the issuer(s) of the said contingent assets has satisfied the SPI that any concentration risks underwritten by the issuer(s) are within the risk appetite of the SPI. This evaluation, at a minimum, should involve standard credit risk analyses.

[8] The Authority defines a “contingent asset” as an asset in which, at the time of its purchase, the possibility of an economic benefit from the asset depends solely upon future events, where these events are fortuitous and therefore cannot be controlled by the company. (e.g. reinsurance, LOCs or other financial mechanisms such as swaps, contracts for differences etc.)

7. MULTIPLE CEDANT/INSURED AND/OR INVESTOR/DEBT-HOLDER GROUPS

(20) The Authority shall review SPI structures on a case by case basis, generally only authorising structures established by one or more entities within the same group and not by a number of unrelated entities from different groups.

(21) Where the SPI anticipates that multiple cedants/insureds will utilise the SPI, the Authority may require either special reporting responsibilities or separately incorporated SPI cells for each unrelated transaction.

(22) On a case by case basis, the Authority may register SPIs where the SPI discloses that more than one (re)insurance agreement is in place, however it is the expectation of the Authority that, a) each of the (re)insurance contracts is individually structured; and b) that the SPI can individually meet the fully funded requirements for each contract.[9]

8. PROGRAMME BUSINESS AND PRIOR APPROVAL FOR RE-USE OF AN SPI

(23) Any reuse of an SPI needs prior approval from the Authority, either at the time of initial application or upon reapplication, where, at the time of (re)approval, the Authority shall take into account any actual or anticipated changes to the original contractual terms.

9. MATERIAL CHANGE IN BUSINESS

(24) If during the lifetime of the SPI it: 1) has any additional risks reinsured into it that were not contemplated in the initial transaction, or 2) has any material changes made to the contracts involved, or 3) makes any modifications to the material disclosures included in the original application, or 4) has further capital raised from investors and/or debt-holders after authorisation, or 5) makes any other changes pertinent to its business where these changes would be deemed by a reasonable and knowledgeable person to be material, then these changes are subject to prior supervisory approval.

(25) The approval process for any material change in an SPI's business shall take into account the nature, scale and complexity of those changes as determined by the Authority through consultation with the applicant and may not require a full authorisation process as would be needed at the original establishment of the SPI.

(26) In its deliberations, the Authority shall consider whether the changes constitute a change in the objectives of the SPI, and to the extent that they do, the Authority may require a more exhaustive authorisation process.

10. EXEMPTION FROM PRIOR APPROVAL FOR CAPITAL RELEASE

(27) Section 31C of the Act – "Restrictions as to reduction of capital" is not applicable to SPIs. This is consistent with the Authority's risk based approach to regulation, and the Sophisticated Participant requirements associated with these entities.

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[9] This provision should not necessarily be deemed to require asset segregation by contract, but rather that that the Authority will, at a minimum, expect to be provided with assurance that there is clarity of contract obligations via specific contract language.

11. FILING AND EXTERNAL AUDIT REQUIREMENTS FOR SPIS

(28) The Authority shall, on a case by case basis, exercise its powers under section 56 to modify the annual accounting provisions in respect of an SPI, subjecting it to more streamlined filing requirements.

(29) In this context, and for the purposes of an SPI's registration process and ongoing reporting, and where the appropriate Section 56 request has been granted, the Authority will accept unaudited management accounts from the SPI prepared in accordance with any one of the following standards or principles

(a) International Financial Reporting Standards ('IFRS');

(b) generally accepted accounting principles ('GAAP') that apply in Bermuda, Canada, the United Kingdom or the United States of America; or

(c) such other accounting standard as the Authority may recognise.

(30) Where management accounts are deemed to be acceptable to the Authority for the purposes of regulatory reporting, the SPI is required to provide to the Authority a copy of those accounts as soon as practicable after such management accounts have been submitted to participants and at a minimum within four months of the end of each financial year.

(31) Notwithstanding the above, financial statements will be due in accordance with the requirements under the Act.[10]

[10] However, upon the completion of a stub period, and the appropriate Section 56 directive, no annual accounts will be required. A "stub period," is a one- time incomplete accounting period that covers the time frame from the beginning of the last fiscal year to the time at which business activities are considered to effectively cease.