BMA
BERMUDA MONETARY AUTHORITY

BMA House
43 Victoria Street
Hamilton HM 12 Bermuda

P.O. Box 2447
Hamilton HM JX Bermuda

tel: (441) 295 5278 fax: (441) 292 7471
email: info@bma.bm website: www.bma.bm

BERMUDA MONETARY AUTHORITY

CONSULTATION PAPER ON ELIGIBLE CAPITAL

SEPTEMBER 2009

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0. INTRODUCTION

1. This Consultation Paper outlines the Bermuda Monetary Authority's ("the Authority") proposed approach to determining capital resources eligible to meet regulatory capital requirement levels.

2. For the purposes of this paper,

"ancillary capital" means other fixed capital approved for statutory capital purposes;

"available capital" means the aggregate sum of the basic capital and the ancillary capital;

"available statutory capital and surplus", under the Act, refers to the total statutory capital and surplus (Form 1A or 1, statutory balance sheet, Line 40) reported by an insurer at the end of its reporting year, plus adjustments, if applicable, made under Section 6D of the Act;

"basic capital" means the sum of the capital stock (Line 1(a)), contributed surplus (Line 1(b)), and statutory surplus (Line 2(h)) of Form 8, statutory statement of capital and surplus, plus adjustments, if applicable, made under Section 6D of the Act;

"insurers" includes "reinsurers" and "insurance" also refers to "reinsurance";

"other fixed capital" means the other fixed capital (Line 1(c)) of Form 8, statutory statement of capital and surplus;

"the Act" refers to the Insurance Act 1978; and

"the Regulations" refers to the Insurance Accounts Regulations 1980 and the Insurance Returns and Solvency Regulations 1980.

3. The views of the insurance industry and other interested persons on the proposals set out in this paper are invited. Comments should be sent to the Authority addressed to policy@bma.bm no later than November 30th 2009.

1. EXECUTIVE SUMMARY

4. The Authority is proposing to introduce a three-tiered capital system ("the tiered capital system") as a critical component of its solvency regime. The tiered capital system is designed to assess the quality of insurers' capital resources eligible to satisfy their regulatory capital requirement levels. Initially, the regime would be introduced to the Class 3B and 4 insurers effective on December 31st 2011. Following further consultation, the Authority anticipates extending the tiered capital system to Class 3A licence holders, in accordance with the proportionality principle.

5. The existing captive regime is considered appropriate and consistent with international regulatory standards. Therefore, the Authority is not proposing changes to the current regime, but will regularly review it in light of international developments.

6. The Long-term solvency regime is currently under development. A discussion paper on proposals specific to Long-term insurers is anticipated in the last quarter of 2009 followed by a consultation paper in 2010. While proposals in this paper are not anticipated to differ for Long-term insurers, the Authority encourages Long-term insurers to participate in the Long-term solvency consultation process to ensure the adoption of an effective and efficient Long-term solvency regime.

7. The Authority is also proposing to implement the tiered capital system to groups when it is the appointed group-wide supervisor (upon adoption of the group-wide supervisory regime). A consultation paper on the implementation of group-wide supervision is anticipated in early 2010. With minor exceptions outlined in Section 5, it is anticipated that the proposals in this paper would be applied to both solo entities and groups.

8. A key objective of insurance supervision is to protect both existing and prospective policyholders. Insurers are often faced with uncertainty as to the timing and magnitude of policyholder obligations. To minimise these uncertainties, it is important that insurers hold not

only sufficient capital but capital of an appropriate quality to act as a shock absorber against adverse developments.

9. The tiered capital system (Tiers 1, 2, and 3) classifies capital instruments into a given tier based on their loss absorbency characteristics. Eligibility limits will then be applied to each tier in determining the amounts eligible to cover regulatory capital requirement levels.

10. The highest quality capital is eligible for Tier 1: able to absorb losses under all circumstances, including on a going-concern, run-off, winding-up, and insolvency. Tier 2, while providing full protection to policyholders in a winding-up or insolvency, has moderate loss absorbency on a going-concern basis. Tier 3 meets, on a limited basis, some of the characteristics exhibited in Tiers 1 and 2 (e.g. protection to policyholders in a winding-up or insolvency).

2. BACKGROUND

11. Continuing on its programme of regulatory change, the Authority proposes to enhance its solvency regime with the introduction of the tiered capital system. The proposals outlined in this paper will consider not only the quantity of capital available but equally important its quality (i.e. its ability to provide protection to policyholders over the obligation period) in determining capital eligible to meet regulatory capital requirement levels.

12. The Authority believes that the existing regime for captives is consistent with global regulatory standards and is considered appropriate for the risks inherent in that sector; however, evolving international standards in relation to captives will be continually monitored and reviewed. Should amendments be needed for the regime, the Authority is committed to working with the captive market to achieve an appropriate balance.

13. Initially, the proposals in this paper would be introduced to the Class 3B and 4 insurers. One year following implementation for these classes, the Authority anticipates cascading this regime to the Class 3A insurers in accordance with the proportionality principle. The Authority also appreciates that a separate consultation is crucial to ensure an appropriate result for these licence holders.

14. The Authority is currently working to enhance the Long-term solvency regime. A discussion paper on proposals specific to Long-term insurers is expected in the last quarter of 2009, followed by a consultation paper due in 2010. While the tiered capital system proposed in this paper will be a critical element of the Long-term solvency regime, it will not be applicable to Long-term insurers until the implementation of this enhanced solvency regime.

15. The Authority is also developing a group-wide supervisory regime; a discussion paper was published in March 2009 and a consultation paper is planned for early 2010. The Authority anticipates that the proposals in this paper would be applicable to both solo entities and (upon implementation of a group-wide supervisory regime) groups. Section 5 will also examine instruments and issues specific to groups.

16. Insurance, unlike most financial products, is characterised by the reversal of the production cycle whereby premiums are collected upfront but insurers are only obligated to pay if an event occurs at some future date. Insurers are faced with uncertainties relating to the timing and magnitude of future losses and the risk that the premiums charged and the reserves held will be insufficient to cover the losses. In addressing these uncertainties, sufficient capital of appropriate quality is critical to provide a buffer against adverse losses and ensure that the insurer meets its obligation to policyholders.

17. The current regime requires all insurers to hold available statutory capital and surplus ("the available capital") equal to or exceeding the margin of solvency ("the MSM"), defined under the Act and Regulations. Failure to meet the MSM represents a breach of the regulatory minimum capital requirement and is deemed insolvent under the Act.

18. Effective December 31st 2008, the Authority introduced an additional level of regulatory capital requirement to Class 4 insurers. The second level obliged Class 4 insurers to maintain an available capital equal to or exceeding the enhanced capital requirement ("the ECR"). The ECR is equal to the higher of the MSM and the requirement computed from the standard risk-based capital model or an approved internal capital model.

19. The Authority also established a target capital level ("the TCL") of 120% of the ECR effective December 31st 2008 for all Class 4 insurers. Although this level was not legislated, it acts as an "early warning" system to assist the Authority in the supervision of Class 4 insurers. The Authority proposes to apply the ECR and TCL to Class 3B insurers effective December 31st 2010 and Class 3A insurers from December 31st 2011.

20. The Authority recognises that capital instruments possess different qualities, and vary in the extent of protection provided to policyholders. For instance, capital instruments such as common shares protect the interests of policyholders by absorbing losses under all circumstances (i.e. on a going concern basis, in run off, in winding up, and in the event of insolvency). Conversely, subordinated debt may only protect policyholders by absorbing losses in the event of insolvency or winding up. To enhance policyholder protection, the Authority will consider the

adequateness of capital both from a quantitative perspective and, equally critical, based on the quality of the capital instruments.

21. The Authority's mission and vision embraces protecting and enhancing "Bermuda's reputation and position as a leading international financial centre"[1]. Towards this end, the Authority views protecting existing and prospective policyholders, through effective regulation, as a key objective contributing to its overall mission and vision. The Authority is thereby committed to meeting international regulatory standards while ensuring that the regulation is appropriate for the Bermuda market.

22. The international debate on capital has continued for a number of years: in the banking sector with the adoption of the Basel framework; in the European Union ("the EU") with the enactment of the Solvency II Directive; at the International Association of Insurance Supervisors ("the IAIS") with the publication of principles, standards, and guidance on capital; and in the United States with the National Association of Insurance Supervisors' modernisation programme. Although there are differences, there is a general consensus that regulatory regimes must establish adequate capital requirement levels satisfied by capital resources of appropriate quality to protect policyholders in the event of an insurer experiencing unforeseen or adverse circumstances.

23. The IAIS' insurance core principle 23 recommends that solvency regimes establish criteria for assessing the quality and suitability of capital instruments, having regard to their ability to absorb losses on both a going concern and winding up basis[2]. The EU's view is similar, and the Solvency II Directive looks to categorise capital instruments into three tiers and assign limits on the proportions of tiers 1 and 2 applicable for capital requirement levels.

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[1] http://www.bma.bm/about-us/mission-vision.html.
[2] IAIS – "International Association of Insurance Supervisors – Insurance Core Principles and Methodology", October 2003.

24. Bermuda's solvency regime will likely be a critical component of jurisdictional equivalence assessments. Where the Authority is assessed as being broadly equivalent with key jurisdictions, potential benefits to Bermuda insurers include:

- Ability to compete in global markets on a non-discriminatory basis;
- Reducing the risk of multiple capital requirements;
- Removing the need for group solvency calculations on a number of different regulatory bases; and
- Improved ability to optimise group capital, including increased fungibility.[3]

25. Presently, this paper outlines the Authority's proposed tiered capital system. Given that capital remains a key topic amongst international regulators and standard setting bodies, the Authority will also closely monitor and, where possible, participate in these debates to ensure Bermuda continues to adopt internationally recognised standards that are appropriate for its insurers.

3. PURPOSE OF A TIERED STRUCTURE

26. The Authority recognises that capital instruments behave differently by design to support insurers' business objectives and strategies. In determining the capital adequate to protect policyholders, the Authority must also be mindful of the uniqueness of capital instruments in their ability to protect policyholders on a going concern basis or run-off and during times of distress such as in a winding-up or insolvency. However, a balance between the cost of capital to each insurer and the level of policyholder protection required by the Authority is necessary.

27. Accordingly, the Authority proposes to introduce the tiered capital system to complement the regulatory capital requirement levels (the MSM and the ECR) previously introduced. The MSM is the minimum regulatory capital requirement level and breach of the MSM may trigger mandatory winding-up. Therefore, the highest quality capital must be available to support the

[3] "Bermuda's Insurance Solvency Framework - The Roadmap to Mutual Recognition", March 2009, Pg 1.

MSM. The ECR (if different from the MSM), on the other hand, is a second level capital requirement and thereby allows for greater flexibility.

28. It should be noted that while Bermuda currently does not have a tiered capital system, its regulations surrounding "non-admitted assets" have conservatively compelled high quality capital be held by Bermuda insurers. A review of the statutory financial statements for the reporting year ending December 31st 2008 of Class 4 insurers revealed that approximately:

- 83% of available capital is in the form of common shares, preference shares (less than 1%), and contributed surplus;
- 16% of available capital is the excess of assets over liabilities ***excluding*** common shares, contributed surplus, and other fixed capital (e.g. letters of credit, parental guarantees); and
- 1% of available capital is other fixed capital approved for statutory capital purposes.

29. Consequently, approximately 98% of the current available capital held by Class 4 insurers would be capital meeting Tier 1 requirements (i.e. the highest quality capital). The proposals outlined in this paper are merely codifying existing practices in the marketplace, and may allow certain insurers to more efficiently allocate capital.

30. Though the tiered capital system is new to the Bermuda insurance market, as mentioned above, it exists under Basel II. In January 2009, the Authority adopted the Basel II framework to further strengthen soundness and stability in the banking sector. Under this framework, the Authority attaches great importance to the quality of banking capital and requires banks to categorise their capital into three tiers based on quality and ability to absorb losses. The growing linkages between the insurance and banking sectors support the need to more closely align capital rules across sectors.

4. ELIGIBLE CAPITAL

31. The Authority is proposing to introduce the tiered capital system, Tiers 1, 2, and 3. The examples of capital or qualifying debt instruments outlined in Appendix A are not exhaustive; where an insurer is uncertain of the application of a capital or debt instrument, it should consult with the Authority.

4.1 Tier Classification

32. Tier 1 capital is the highest quality capital; it is available when required and can fully absorb losses at all times. Capital instruments included in Tier 1 should fully satisfy the following characteristics (see Appendix A):

- Full loss absorbency in going concern, run-off, insolvency, and winding-up;
- Subordination in going concern, run-off, insolvency, and winding-up;
- Permanency (free from requirements / incentives to redeem);
- Perpetuality (undated / adequate duration); and
- Absence of mandatory fixed charges and encumbrances.

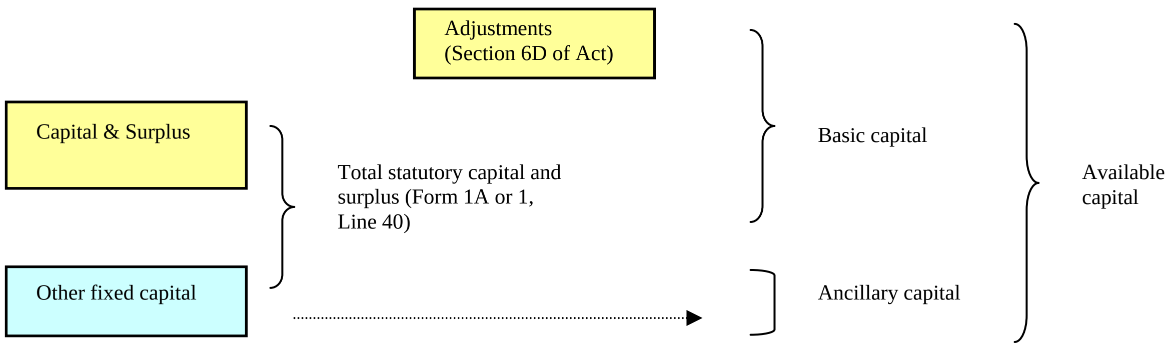
33. Tier 2 capital includes other capital instruments that, to varying degrees fall short of the quality of Tier 1 capital, but nonetheless provide protection to policyholders (see Appendix A). Tier 3 consists of capital instruments not meeting all of the characteristics of Tier 1 or Tier 2 but have full subordination on winding-up (see Appendix A).

4.2 Capital Eligible for Tiers 1, 2, and 3

4.2.1 Available Capital

34. The available capital eligible to support regulatory capital requirement levels is equal to the aggregate sum of the basic capital and the ancillary capital. The ancillary capital includes off-balance sheet financial instruments approved by the Authority for statutory capital purposes.

Insurers must examine and classify each capital and qualified debt instrument into the three tiers based on the criteria established for each tier (see Section 4.1 and Appendix A). The eligible limit of each tier will determine its ability to cover the MSM and the ECR (see Section 4.3).



4.2.1.1 <u>Basic capital</u>

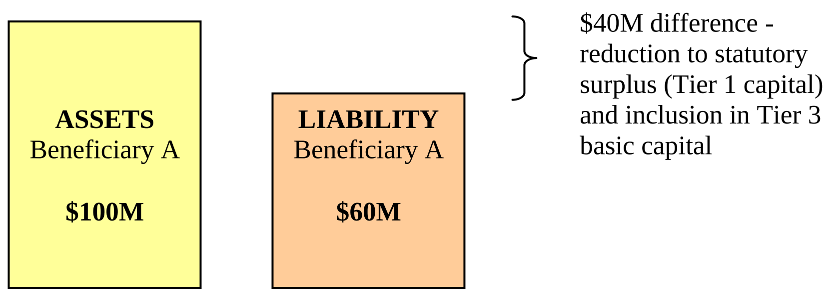
35. The basic capital is equal to the capital stock (Line 1(a)), contributed surplus (Line 1(b)), and statutory surplus (Line 2(h)) of Form 8, statutory statement of capital and surplus, <u>*plus*</u> adjustments, if applicable, made under Section 6D of the Act. Where an adjustment has been imposed under Section 6D of the Act, the amount may form part of the statutory surplus.

36. Preference shares may be included, for the purposes of Form 8, in the capital stock (Line 1(a)); however, in determining instruments eligible for the respective tier, insurers must examine the characteristics of each instrument relative to the criteria specified in Appendix A. Accordingly, basic capital may be adjusted for preference shares not meeting a tier's criteria.

37. Certain debt instruments (e.g. subordinated liabilities) must meet all the criteria of Tier 1 capital to be considered as basic capital. In other words, its behavior on a going-concern basis (i.e. first to absorb losses) or in a winding-up (i.e. highest subordination) must be similar to that of common shares. Further, the debt agreement must include explicit terms relevant to each tier (e.g. duration period, subordination, etc.) and it must receive approval from the Authority (see paragraph 42) in order to qualify for inclusion.

38. The statutory surplus, noted in paragraph 35, is the surplus of assets over liabilities *excluding* capital stock, contributed surplus, and other fixed capital. By way of the "non-admitted assets" (see paragraph 28), elements such as deferred tax assets and intangible assets are excluded from Bermuda's statutory balance sheet and therefore adjustments are not required. However, encumbered assets, as discussed in paragraph 39, will result in the reallocation of the encumbered statutory surplus from Tier 1 capital to Tier 3 basic capital.

39. Collateral requirements are common in the insurance industry; and are designed to protect a specific group of policyholders against their insurer's credit risk. The collateralised assets are not available to all policyholders until the obligations of the underlying policyholders have been satisfied. Thereby, the statutory surplus must be adjusted to recognise the limited accessibility of these assets. It is proposed that this adjustment be calculated as the difference between the encumbered assets and the respective policyholders' obligations recognised in the statutory balance sheet and the difference be transferred to Tier 3 basic capital.



40. The Authority is also mindful of assets potentially losing their value during times of distress. Such assets in most cases are normally "non-admitted assets"; however, in the event that any are included on the statutory balance sheet, adjustments may be required for tier eligibility purposes arising from the reduction in loss absorbency under distressed conditions.

4.2.1.2 Ancillary capital

41. The Authority considers off-balance sheet instruments (e.g. letters of credit, contingent capital, etc.) as potential sources of capital as they may be called upon to absorb losses, albeit

under limited circumstances. In order to determine the eligibility of such instruments, each must receive approval from the Authority before inclusion as ancillary capital.

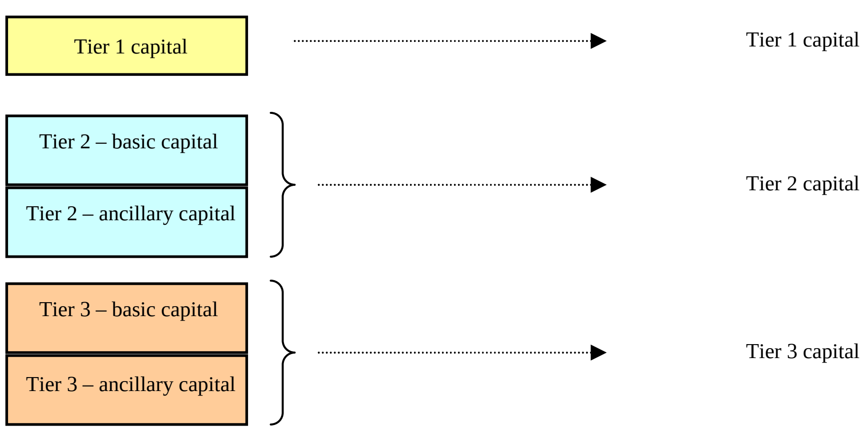
42. In approving these off-balance sheet (see paragraph 41) or debt instruments (see paragraph 37), the Authority will consider the following:

- Ability and willingness of the counterparty to honour their commitment;
- Terms of the instrument (e.g. duration, subordination, etc.);
- Credit risk of the counterparty (e.g. assets held in trust); and
- Any supplementary information, such as past behavior of the counterparty.

43. Depending on the instrument, the approval may restrict the coverage period or amount eligible. The Authority may also issue directions with its approval potentially triggering mandatory regulatory disclosures. In due course, the Authority will be issuing further guidance on its approval process of ancillary capital including transitional provisions (see paragraph 55), as appropriate.

44. Ancillary capital (see Appendix A) also includes unpaid or callable capital and debt instruments. In order to qualify for inclusion, they must meet all the Tier 2 or 3 criteria. However, approval would not be necessary for inclusion of unpaid or callable capital instruments in the respective tier.

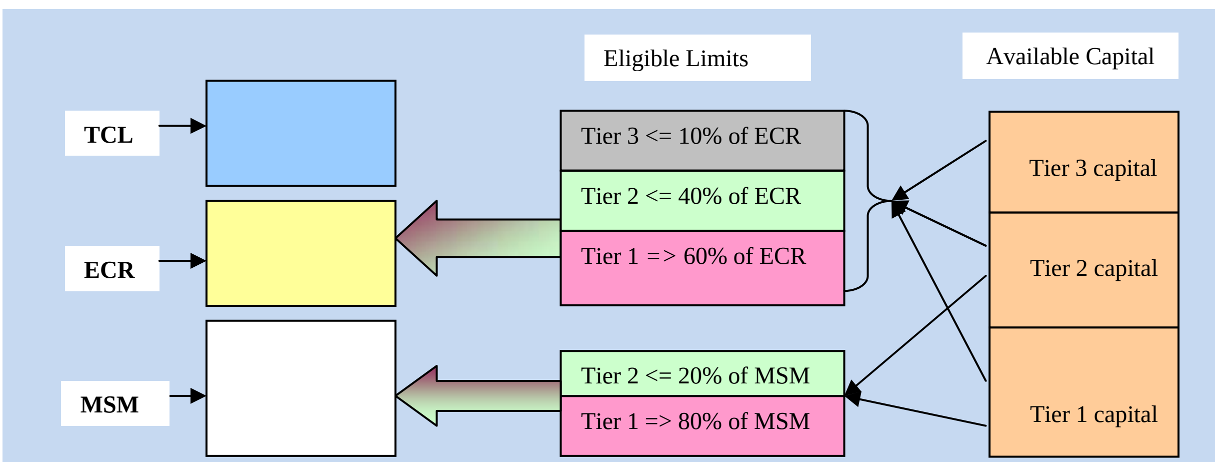
4.3 Eligibility Limits



45. As noted in paragraph 27, only high quality capital of Tiers 1 and 2 should cover the MSM. Further, given that a breach of the MSM would constitute insolvency for regulatory purposes, a higher portion of Tier 1 capital must be available to meet the insurer's MSM. Consequently, the Authority proposes that a minimum of 80% of Tier 1 capital and maximum of 20% of Tier 2 capital are eligible to meet the MSM.

46. The ECR, on the other hand, is a second level of regulatory capital requirement; therefore, the Authority may exercise greater flexibility in determining capital eligible to meet the ECR. The Authority proposes that a minimum of 60% of Tier 1 capital and maximum of 10% Tier 3 capital must be available to cover the ECR. Once the insurer has sufficient capital in Tiers 1, 2, and 3 to meet the MSM and the ECR, any combination of Tiers 1, 2, and 3 capitals may be eligible to meet the TCL.

47. Regulatory capital requirement levels and the eligible tier limits:



48. As noted in paragraph 25, the debate on capital continues, which may result in amendments to the current proposals. While the Authority is committed to adopting international standards, the Authority will also be consulting with the market prior to making amendments to ensure standards are appropriate for the Bermuda market.

5. GROUP-WIDE SUPERVISION

49. The Authority anticipates that the proposals in this paper would also be applicable to groups (upon adoption of the group-wide supervisory regime) where the Authority is the appointed group-wide supervisor. The examples provided in Appendix A are not exhaustive; groups should contact the Authority where they are unclear as to the application of an instrument. Further, some examples included in the Appendix A (e.g. approved parental guarantees, Tier 2 ancillary capital) may not be relevant to groups and should be disregarded.

6. RELATED INITIATIVES

50. The Authority is also working on proposals to enhance its statutory reporting and valuation as it recognises the importance of an economic valuation of balance sheet instruments. These proposals will impact the underlying assets and liabilities used to determine regulatory capital requirements. The IAIS recommends that "insurer management, regulation and supervision need to be firmly rooted in economic valuation. Only a current economic valuation of assets, obligations, and risk exposures related to all balance sheet items can provide sufficiently relevant and reliable information and insight into the financial position of the insurer".[4] Given the complexity and the debates surrounding the topic internationally, the Authority proposes to defer the implementation of the economic balance sheet to a later stage but has begun to conduct discussions with market participants.

51. The enhancement to Bermuda's solvency regime includes insurers demonstrating to the Authority their own assessment of the risks they face and the capital required to support those risks. The Authority is publishing a discussion paper on Own Risk Solvency Assessment ("the ORSA") proposals in September 2009 and a consultation paper will follow in 2010. Depending on the results of the ORSA assessment, positive or negative adjustments under Section 6D of the Act may be applied to the available capital; although it is anticipated that adjustments, if required

[4] IAIS – "The IAIS common structure for the assessment of insurer solvency", February 2007, Pg 19 - 20

are likely to be applied to the ECR. This may impact the available capital eligible to support the MSM, ECR, and TCL.

52. Finally, the Authority is working to enhance the supervision and regulation of Long-term insurers, specifically proposals relating to the solvency regime (where eligible capital is a key component). While the proposals outlined in this paper are also relevant to Long-term insurers, the Authority encourages Long-term insurers to participate in the Long-term solvency consultation process (discussion paper in 2009 and the consultation paper in 2010) to gain an understanding of all the elements of the enhanced solvency regime.

7. REPORTING REQUIREMENTS

53. Insurers should retain documents supporting the assessment of their tiered capital for supervisory review. The Authority will seek to enhance the reporting requirement of the Statutory Financial Return (prescribed by the Act and Regulations) and the Capital and Solvency Return (prescribed by the Insurance (Prudential Standards)(Class 4 Solvency Requirement) Order 2008) to include disclosure of all capital instruments eligible for the respective tiers.

8. IMPLEMENTATION PROVISION

54. The Authority is proposing to implement the regime effective on December 31^{st} 2011 for Class 3B, Class 4, Long-term insurers, and groups. Effective on December 31^{st} 2012 proposals on eligible capital, to be determined subject to consultation, would be applicable to Class 3A insurers.

9. TRANSITIONAL PROVISION

55. Upon application, and on a case-by-case basis, the Authority may allow instruments previously approved for capital purposes to be eligible to support the MSM and ECR. As discussed in paragraph 42, the Authority will be issuing further guidance on the approval process of ancillary capital.

Appendix A

Tiers	Criteria	Key Features	Examples Items
Tier 1 capital	 Loss-absorbency Subordination Perpetuality Permanency Absence of mandatory fixed charges Absence of encumbrances	(1) statutory surplus *less* adjustments on encumbered assets (see paragraph 39); and (2) common shares and contributed surplus; and (3) capital instruments that satisfy the following: (a) capable of absorbing losses in a going concern either by way of: (i) write down of the principal amount or until losses cease; or (ii) mandatory conversion to capital stock when losses begin to accumulate; and (b) highest level of subordination in a winding-up; and (c) undated or have estimated maturity of not less than 10 years (approval is needed for shorter maturity instruments held to match significantly lower maturity insurance obligations); and (d) non-redeemable unless approve for redemption (such application would only be considered if the instrument is being restored with an equal or higher quality instrument); and (e) absent of terms incentivising investors or creditors to redeem; and (f) the coupon payment is: (i) cancellable; or (ii) deferrable indefinitely, where settled only with the issuance of an instrument of equal or higher quality; and (g) absent of encumbrances; and	Examples include: ➢ fully paid common shares; ➢ statutory surplus / deficit or retained earnings *less* adjustments on encumbered assets (see paragraph 39); ➢ contributed surplus or share premium; ➢ qualifying undated or with estimated duration of not less than 10 years hybrid capital instruments (e.g. non-cumulative, perpetual or fixed term preference shares); and ➢ perpetual or fixed term subordinated liabilities.

Tiers	Criteria	Key Features	Examples Items
		(h) absent of netting mechanisms designed to off set insurer claims and obligations to the investor or creditor.	
Tier 2 - basic capital		Capital instruments that satisfy the following:	Examples include: ➢ qualifying hybrid capital instruments with estimated duration of not less than 5 years (e.g. cumulative preference shares); and ➢ subordinated liabilities with estimated duration of not less than 5 years.
	Loss-absorbency	(a) capable of absorbing a moderate level of losses on a going concern, include suspending coupon payments if ECR is breached; and	
	Subordination	(b) subordinated in a winding-up; and	
	Perpetuality	(c) estimated maturity of not less than 5 years (approval is needed for shorter maturity instruments held to match significantly lower maturity insurance obligations); and	
	Permanency	(d) non-redeemable if ECR is breached and may only be redeemed upon approval (such application would only be considered if the instrument is being restored with an equal or higher quality instrument); and (e) absent of terms incentivising investors or creditors to redeem; and	
	Absence of mandatory fixed charges	(f) the coupon payment is deferrable indefinitely when ECR is breached; and	
	Absence of encumbrances	(g) absent of encumbrances; and (h) absent of netting mechanisms designed to off set insurer claims and obligations to the investor or creditor.	
Tier 2 - ancillary capital		Capital instruments that satisfy the following:	Examples include: ➢ unpaid and callable common shares; ➢ qualifying unpaid and callable hybrid capital instruments meeting Tier 1 criteria (e.g. qualifying unpaid and
	Loss-absorbency	(a) Tier 1 capital instruments but are callable on demand and are unpaid; or (b) callable and convertible on	

Tiers	Criteria	Key Features	Examples Items
		demand to Tier 1 capital when losses begin to accumulate or when ECR is breached; and	callable non-cumulative, perpetual preference shares); ➢ approved irrevocable letters of credit; and ➢ approved parental guarantees.
	Subordination	(c) subordinated in a winding-up; and	
	Perpetuality	(d) estimated maturity of not less than 5 years (approval is needed for shorter duration instruments held to match significantly lower duration insurance obligations); and	
	Permanency	(e) non-redeemable if ECR is breached and may only be redeemed upon approval (such application would only be considered the instrument is being restored with an equal or higher quality instrument); and (f) absent of terms incentivising investors or creditors to redeem; and	
	Absence of mandatory fixed charges	(g) the coupon payment is deferrable indefinitely when ECR is breached; and	
	Absence of encumbrances	(h) absent of encumbrances; and (i) absent of netting mechanisms designed to off set insurer claims and obligations to the investor or creditor.	
Tier 3 - basic capital	Instruments not meeting Tier 1 or 2 basic capital criteria; however, display, to a limited degree, similar characteristics.	(1) statutory surplus adjustments on encumbered assets (see paragraph 39); and (2) capital instruments that satisfy the following: (a) subordinated in a winding-up or insolvency to all policyholder obligations; and (b) absent of encumbrances; and (c) estimated maturity of not less than 3 years; and (d) non-redeemable and non-	Examples include: ➢ qualifying short-term hybrid capital instruments (e.g. cumulative preference shares); ➢ short-term subordinated liabilities; and ➢ adjustments on encumbered assets (see paragraph 39).

Tiers	Criteria	Key Features	Examples Items
		payment of coupon if ECR is breached and may only be redeemed or paid upon approval; and (e) absent of terms designed to accelerate or induce an insurer's insolvency.	
Tier 3 - ancillary capital	Instruments not meeting Tier 2 or 3 basic capital criteria; however, display, to a limited degree, similar characteristics.	Capital instruments that satisfy the following: (a) Tier 2 – basic capital or Tier 3 - basic capital instruments but are callable on demand and are unpaid; and (b) subordinated in a winding-up or insolvency to all policyholder obligations; and (c) absent of encumbrances; and (d) estimated maturity of not less than 3 years.	Examples include: ➢ qualifying unpaid and callable hybrid capital instruments meeting Tier 2 or Tier 3 – basic capital criteria (e.g. cumulative preference shares); ➢ short-term approved irrevocable letters of credit; and ➢ short-term approved parental guarantees.

Appendix B

Illustrations to compute available capital eligible to cover the MSM and the ECR

In Year X, company XYZ has available capital of $4,000 classified comprised of Tier 1 capital of $2,000, Tier 2 capital of $1,500, and Tier 3 capital of $500. Determine the eligible capital available to cover:

a) MSM = $2,000
b) ECR = $3,000

Solution

Available capital eligible to cover MSM:

- Limited to Tier 1 capital and Tier 2 capital only;
- 80% of the MSM must be supported by Tier 1 capital and the remainder by Tier 2 capital

Tier	Available capital	MSM	Sufficient Capital (Y/N)
Tier 1	$2,000	$1,600	Y
Tier 2	$1,500	$400	Y
Tier 3	$500		
Total	**$4,000**	**$2,000**	

Available capital eligible to cover ECR:

- Minimal 60% of ECR must be supported by Tier 1 capital; and
- Maximum 10% of ECR is supported by Tier 3 capital;

Tier	Available capital	ECR	Sufficient Capital (Y/N)
Tier 1	$2,000	$1,800	Y
Tier 2	$1,500	$900	Y
Tier 3	$500	$300	Y
Total	**$4,000**	**$3,000**	

Summary

The insurer must hold at minimum $1,800 of Tier 1 capital, $900 of Tier 2 capital, and $300 of Tier 3 capital to meet its MSM and ECR regulatory capital requirements.

Tier	Available capital	MSM	ECR	Sufficient Capital (Y/N)
Tier 1	$2,000	$1,600	$1,800	Y
Tier 2	$1,500	$400	$900	Y
Tier 3	$500		$300	Y
Total	**$4,000**	**$2,000**	**$3,000**	