NAIC ACTIVE ON CAPTIVES AND SPECIAL PURPOSE VEHICLES INITIATIVE

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The number of captive insurance companies and special purpose vehicles used as alternative risk transfer mechanisms has increased over time, as have the types of risks transferred to captives and the volume of such transfers. Many transactions with captives have been submitted to and approved by the governing state insurance department, and an increasing number of states have adopted statutory and regulatory schemes that have been specifically designed to regulate captive insurers and transactions with captives. Special purpose vehicles ("SPVs") have been used to facilitate the transfer of risks to the capital markets through insurance-linked securities, and the volume of risk transfers through such securities has increased greatly over the past several years as the market for such securities has developed. In 2001 the NAIC adopted a Model Act that addresses issues concerning special purpose vehicles. Despite these regulatory developments, some have raised concerns as to how some captives may be used.

In early 2012 the National Association of Insurance Commissioners ("NAIC") Financial Condition (E) Committee created a "Captives and Special Purpose Vehicles" Subgroup (the "Subgroup") charged with studying the use by insurers of captives and special purpose vehicles and applicable regulations. Based on its findings, the Subgroup would make recommendations on possible modifications to existing NAIC model laws or developing new ones as necessary.

In particular, the Subgroup examined each state's laws governing captives or SPVs, the types of products permitted to be transferred, transparency and confidentiality requirements, the types of business and risks ceded to captives and SPVs, capitalization standards, accounting and reporting requirements, credit for reinsurance, and holding company regulation. The examination included the assessment of some specific transactions with captives which had been approved by the governing insurance department. The Subgroup published a discussion draft of a white paper on the issues ("the White Paper"), which was revised in response to comments from some regulators. The Subgroup agreed at the most recent NAIC meeting on November 29, 2012 that further revisions to the White Paper were appropriate. The Subgroup has made a number of recommendations on the basis of its study. This paper summarizes the Subgroup's progress, findings, conclusions and recommendations based upon the work completed to date.

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Scope: Captives and Special Purpose Vehicles

Generally speaking, a traditional captive insurer is a regulated entity created to provide a form of self-insurance. Typically, a business forms a captive insurer as a subsidiary, and the captive performs traditional insurer functions, solely for the business (and perhaps its affiliates within an enterprise), for a fee. These are sometimes referred to as "pure captives" or "traditional captives." Similarly, a risk retention group is a type of captive, also operating under captive laws, but set up for a consortium of unaffiliated businesses in a particular industry, or with otherwise similar insurance needs, each of which pay fees to the captive.

The term "Special Purpose Vehicle" ("SPV") refers to a type of captive set up for specific risk transfers. SPVs may be used in the securitization of property-casualty risks in an insurance linked security, or catastrophe bond, to transfer insurance risks to investors for a particular type of risk, such as property risks due to hurricanes in Florida during a specified year or number of years. This use of an SPV facilitates the transfer of risks from a ceding insurer to investors in the capital markets, as a form of alternative risk transfer that may supplement the ceding insurer's risk transfers through "traditional" reinsurance agreements with non-affiliated reinsurance companies. Some reinsurers have used SPVs for the issuance of insurance-linked securities to transfer life insurance-related longevity and mortality risks to the capital markets. In response to the early onshore securitization of property and casualty insurance risks, the NAIC began looking into the use of SPVs in 1998 and adopted the *Special Purpose Reinsurance Vehicle (SPRV) Model Act* (#789) in 2001. The Subgroup noted that this Model Act may be outdated in part in that it fails to account for the development of the use of offshore SPVs and the use of SPVs in the securitization of life-related risks. While not criticizing the use of SPVs in securitizations, the Subgroup has recommended that this Model Act be reviewed to determine whether it should be updated in light of the actual use of SPVs in securitizations.

Life insurers are turning increasingly to captives to transfer life insurance risks, in part because traditional reinsurance has not been readily available at favorable pricing. This use of captives has been a source of concern for some regulators, and has been described as a way that some insurers have attempted to avoid the full financial impact of certain required accounting rules and procedures. One journalist has described the use of some captives as evidencing a "shadow insurance market," a characterization which has offended some in the insurance industry. These concerns have been voiced in some of the discussions of the Subgroup, and in the White Paper.

The State-by-State Survey

The Subgroup was tasked with and completed a regulator-only survey of the current state of regulation of captives in most U.S. jurisdictions. Approximately 35 state regulators responded, and the White Paper contains a summary of those responses. The White Paper notes that:

- Of the responding states, 26 define captives to include so-called "pure captives" and association or group captives (such as risk retention groups). Some states additionally define a number of specific types of captives as well, including Industrial, Sponsored, Special Purpose, Branch, Agency, Reinsurance, Risk Retention Groups, Protected Cell, Incorporated Cell, Segregated Account and Rental.

- More than 30 states, the District of Columbia and the U.S. Virgin Islands allow captives to domicile and form in the state. The number of captive domiciles has continued to grow over the past few years.

- State laws that allow for captive insurers generally regulate formation, capital and surplus requirements, and captive investments. Some state statutes also address taxation issues and require annual statements or other reporting.

- 10 states define SPVs. The specific types of SPVs defined include "Special Purpose Financial Captive;" "Special Purpose Reinsurance Vehicle;" "Limited Purpose Subsidiary;" and "Special Purpose Captive Insurer."

- A significant number of captives and SPVs are formed by commercial insurers in locations outside of the United States.

International Regulation

According to the Subgroup, the International Association of Insurance Supervisors ("IAIS"), a consortium of national insurance regulators, also has addressed issues relating to the use of captives. The IAIS defines captives as:

> *[A]n insurance or reinsurance entity created and owned, directly or indirectly, by one or more industrial, commercial or financial entities, other than an insurance or reinsurance group entity, the purpose of which is to provide insurance or reinsurance cover for risks of the entity or entities to which it belongs, or for entities connected to those entities and only a small part if any of its risk exposure is related to providing insurance or reinsurance to other parties.*

The IAIS's Insurance Core Principles ("ICPs") provide that the term "insurance" refers to the business of insurers and reinsurers, and specifically includes captives. Thus, the ICPs are generally thought to be applicable to captives. Starting in 2008, the IAIS has undertaken effort to specifically consider the application of the ICPs and standards to captive insurers, the review and resulting revisions of which are scheduled to be completed in 2013.

The issue of international regulation is important, as the Subgroup noted that a significant number of captives and SPVs are formed by commercial insurers in locations outside the U.S., and their use may have significant financial implications for U.S.-regulated insurers. While the Subgroup did not exempt these captives from its analysis, they were not included in the survey, as U.S. regulation does not apply in the foreign domiciles of such captives and SPVs. The Subgroup noted, however, that the solutions to any issues it uncovers must be able to affect the use by U.S.-regulated insurers of captives and SPVs in non-U.S. jurisdictions. It also noted that the most effective method to monitor all captive transactions is through insurance holding company system analysis. In this way, the risk to the insurance holding company system can be appropriately assessed, and "improper" transactions can be monitored, regardless of the captive's jurisdiction.

Transparency and Confidentiality

The use of captives raises a number of issues regarding transparency and confidentiality. The Subgroup's survey revealed widely differing legal requirements from state to state. It noted that all of the captive states have some form of confidentiality requirements. Some of the states publish information to varying degrees, but publicly available information is usually limited to the captive's name and owner.

Regulators were somewhat divided in their views on the level of confidentiality appropriate for captives. They all agreed that confidentiality is warranted for pure captive transactions, because such coverage is only for self-insured risks in which there is generally no public interest. Some expressed questions about the need for confidentiality and were supportive of public disclosure of at least some level of information, similar to what is disclosed in the life, accident and health annual statement.

Most of the states surveyed had examination laws granting broad access to company information to regulators, but protecting it from public disclosure (with exemptions for regulator-to-regulator information sharing, and law enforcement).

This is an area in which discussions continue in the Subgroup.

Types of Businesses and Risks Covered by Captives

The survey sought information about the types of insurance risks allowed to be placed with captives in the states with captive laws. Some of those states have limitations on the types of risks that can be transferred. Some similarities across the states surveyed were noted and summarized:

Risks Not Allowed in Certain States:

Personal Auto
Workers' Compensation
Long-Term Care
Critical Care
Employers Liability
Homeowners
Directors and Officers (D&O)

Risks Allowed in Certain States:

Life
Casualty
Marine and Transportation
Marine Protection and Indemnity
Property
Liability
Surety Title
Credit Life
Credit Disability
Other (as Approved)

The discussion draft of the Subgroup's White Paper indicates that the majority of the transactions studied by the Subgroup involved life reserves that are transferred to affiliated captives. However, extrapolation of the finding on this point should be cautious, because the meeting summary report from November 29, 2012 indicates that modifications will be made to the White Paper to avoid misinterpretation of the findings, particularly pertaining to the reasons cited for an increase in the use of captives.

Capitalization, Accounting, Credit for Reinsurance and Capital Requirements

The Subgroup found that state statutes were relatively similar in terms of capitalization standards for captives, versus commercial companies. However, accounting and reporting requirements for captives and SPVs differ from commercial insurers and vary from state to state, due to the differing risks and differing regulatory positions. The Subgroup raised the question of whether the accounting and reporting *should* differ from commercial insurers if the business that is being transacted within the captive or SPV is the assumption of commercial risk from an affiliated commercial insurer.

The Subgroup also looked at NAIC's recently amended *Credit for Reinsurance Model Law* (#785) and *Credit for Reinsurance Model Regulation* (#786). These models provide that

collateral may take the form of "any other form of security that is acceptable to the commissioner." The credit for reinsurance laws are applicable to transactions with both affiliated and non-affiliated assuming insurers. However, neither model provides a specific definition of the term "assuming insurer." Therefore, the Subgroup found it unclear as to whether the term was intended to include captives, and concluded that transactions involving captives may not be consistent with the NAIC models.

The Subgroup also looked at the Non-admitted and Reinsurance Reform Act (NRRA), passed as part of the Dodd-Frank reforms in 2010. It found that the following terms need to be interpreted in order to develop an appropriate definition of the term reinsurer: (1) "principally engaged in the business of reinsurance"; (2) "significant amounts of direct insurance as a percentage of net premiums"; and (3) "engaged in an ongoing basis in the business of soliciting direct insurance." It noted that the NAIC might develop a standard definition of "reinsurer" for the purposes of the NRRA, in an effort to promote uniformity for the application of the NRRA throughout all member jurisdictions, which would account for captives.

<u>Conclusions and Recommendations</u>

The scope, conclusions and recommendations of the work of the Subgroup to date include the following:

- The majority of the transactions identified by the Subgroup were related to life insurance products, in connection with statutory reserve requirements.
- The review was primarily limited to transactions with affiliated captive reinsurers and SPVs.
- Domestic regulators have authority over these transactions.
- Generally, domestic captive regulators coordinate with the ceding company regulators and examine each captive transaction.
- Regulators have statutory discretion in certain states under the revised credit for reinsurance models to approve credit for reinsurance in particular transactions which might not be traditional reinsurance transactions.
- So-called "pure captives" or other similar structures providing self-insurance to non-insurance affiliates were not included in the scope of the Subgroup's activities.
- The survey revealed nothing which suggests that captives are directly competing with professional reinsurers in the U.S.

- The use of offshore domiciled captives is significant, and while domestic captive regulation will not apply directly to offshore domiciled captives, regulators may address the financial and other impact of transactions with offshore captives on U.S.-domiciled insurers through the exercise of their authority over domestic insurers and holding company structures, which may mitigate some of the concerns voiced by Subgroup members.

- The implementation of principle-based reserving could ultimately reduce the desire of commercial insurers to create new captives and SPVs to address perceived reserve redundancies.

The Subgroup will meet again to discuss and finalize the White Paper, after NAIC staff make the recommended modifications agreed to at the Fall 2012 NAIC meeting. Its efforts are taking shape and give some indication as to how its work may ultimately be implemented in amendments to existing model laws or the creation of new ones.

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