August 12, 2014

Dear Commissioners:

The NAIC’s work on life insurer-owned captive insurance vehicles continues apace, but while there has been much sound and fury associated with initiatives aimed at reining in the use of captives, to date they have largely signified nothing. Indeed, by latching onto proposals from a now-toothless June 2014 report prepared by the NAIC’s consultant, Rector & Associates, Inc. (“Rector”) that will take years to implement, the NAIC is doing nothing more than legitimizing the untenable current state of affairs, and permitting captive transactions to continue unabated far into the foreseeable future. If the NAIC cannot get its own house in order to devise a better means of policing the use of captive insurance vehicles by life insurers, it will all but invite federal authorities to do so.

In June 2013, the New York Department of Financial Services (“DFS”) concluded a nearly year-long investigation into life insurer-owned captive insurance vehicles. Upon finding that New York-based insurers and their affiliates engaged in at least $48 billion in transactions that enabled them to reduce their reserves and artificially inflate their balance sheets by juicing their risk-based capital ratios by approximately 250%, DFS urged fellow state insurance commissioners to adopt a national moratorium with regard to future captives transactions until a fuller and more complete picture could emerge that would inform collective decision-making.

Recognizing full well that the life industry’s use of captives creates opportunities for regulatory arbitrage and encourages a lack of uniformity that raises serious questions about the efficacy of the state-based system of insurance to safeguard solvency and protect consumers, the NAIC opted not to heed the call for a moratorium but instead engaged Rector to propose a transparent framework that could provide, in very short order, regulatory oversight on a consistent and national basis.

In a February 2014 report (“February Report”), Rector put forth a detailed “interim” program intended to remain in place until and unless such time as the NAIC’s move towards principles-based reserving (“PBR”) – a deregulatory initiative that enables life insurers to set their own reserves based primarily on company-specific models that regulators are ill-equipped to understand or challenge – becomes operative.

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1 DFS has no quarrel with “pure” captives – i.e., the specialized form of insurance company typically created by a corporate parent that opts to self-insure risk instead of purchasing third-party insurance. The use of pure captives is a far cry from life insurer-owned captives, which exist to shed reserves, manipulate balance sheet strength, and free up capital to dividends to shareholders or increase compensation paid to company executives, all to the detriment of solvency and consumer protection.
Though far from perfect – indeed, DFS objected to its dependence on PBR – the February Report in many ways nonetheless had bite: it contemplated input and coordination from other interested and affected regulators; it established “penalties” that insurers would assiduously work to avoid; and it sought to institute changes on an accelerated time frame that would have begun as soon as July 31, 2014.

In early June 2014, Rector issued a modified report ("June Report") that bent over backwards to assuage the life industry’s worries and, in the process, essentially defanged the February Report. Over the objection of New York and California – jurisdictions in which more life insurance business is written collectively than in any other two states – the NAIC’s Principles-Based Reserving Implementation Task Force voted on June 30, 2014 to adopt the conceptual framework proposed in the June Report.

A closer look at three of the ways the February Report has been neutered demonstrates vividly how, if the NAIC continues on this path with regard to captives, it will lend an air of legitimacy to practices that it ostensibly has been working for years to eradicate.

First, the February Report expressly recommended a variety of ways that affected regulators would coordinate with one another, not the least of which was that all captive transactions would require the approval of both the domiciliary regulator of the ceding insurer and the domiciliary regulator of the assuming insurer, and that any other affected regulators would receive prior notice of the proposed transaction.

When the life industry dubiously asserted that such arrangements might run afoul of the federal Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the June Report dropped any pretense of coordination and consultation amongst regulators, and instead reverted to a proposal that keeps in place the existing fragmented system that encourages a race to the bottom amongst a small minority of states that “compete” with one another about who can be more lenient in exercising supposed regulatory oversight over these structures.²

Second, the February Report envisioned a new regulation to "codify" standards to govern transactions involving life insurer-owned captives. To deter non-compliance, the regulation included a provision that any nonconforming structures would enable state insurance regulators to presume that the ceding insurer was operating in a “hazardous financial condition.”

When the life industry again raised the specter of the Dodd-Frank Act, the June Report – rather than sticking to its guns – instead pivoted to a construct whereby company actuaries will have to provide a certification about a proposed transaction, and to the extent that the transaction

² A portion of the Dodd-Frank Act is known as the Nonadmitted and Reinsurance Reform Act ("NRRA"). Section 531 of the NRRA relates to "credit" for reinsurance – i.e., the accounting for when an insurer cedes risk to a reinsurer. Section 532 relates to the regulation of reinsurer solvency. In both instances, the NRRA establishes a regime where regulators of other states cannot challenge determinations made by the domiciliary regulator (i.e., the cedent’s regulator in the case of Section 531, and the reinsurer’s regulator with regard to Section 532). However, nothing in the February Report contravened these provisions; at all times the domiciliary regulator would have retained the ultimate power to render the kinds of determinations that the NRRA contemplates. The unsubstantiated assertions offered by the life industry to the contrary constitute nothing more than a smokescreen to water down a report that sought, with dispatch, to address a situation that the NAIC has identified as one of its supposedly top priorities.
deviates from the basic guidelines of Rector’s framework, any single regulator may provide a “permitted” accounting practice to allow it.

To authorize company actuaries to certify what constitutes an appropriate reserve, and to vest any given regulator with the power to sign off on transactions that imperil solvency and harm policyholders, already are hallmarks of the status quo. These proposals permit the NAIC to accomplish nothing with regard to captives, other than to mark the current system with its formal stamp of approval.

Third, the February Report contemplated that the NAIC would move quickly to put a lid on life insurer-owned captive transactions, with certain parameters going into place by the middle of 2014, and the balance being installed for the start of 2015.

The June Report scraps that implementation schedule in favor of a variety of further work by numerous NAIC work groups, task forces, and committees, with no concrete end dates in sight. This functionally guarantees that insurers will continue to look to certain states as havens for misbegotten captive insurance transactions for years to come, especially since there is no reason to believe that industry partisans will not continue to oppose, stall, and water down at every opportunity aspects of the Rector framework that they continue to find inconvenient.

Fortunately, it is not too late for the NAIC to shift gears and rethink its intended approach for “fixing” captives. If the push for continued use of captives (and PBR, for that matter) derives from life industry’s belief that the current reserve formulas are too high, then state insurance regulators should modernize those formulas to keep pace with innovation and changes in product design, as opposed to jettisoning the formulaic system in its entirety.

Indeed, since March 2014, New York has been engaged in the process of promulgating new regulations for the reserves (known as “XXX” reserves) that back level term insurance products, which is expected to result in a reduction of reserves of 30-35%. Further, this summer New York will begin the process of amending regulations for the reserves (known as “AXXX”) that back universal life insurance policies with secondary guarantees.

If other states join with New York in eliminating the so-called redundancies in the existing formulas for XXX and AXXX reserves, it will dramatically reduce, if not eliminate entirely, the putative “need” of life insurance companies to engage in captive insurance transactions. Most of all, collective action to that end will demonstrate the state insurance regulators can band together to address a systemic problem, instead of simply replacing one mistake (the move towards PBR) with another (the legitimization of the status quo with regard to captives).
When the NAIC enlisted Rector to address the troubling boom of reserve financing through captives, it appeared to be doing so with a seriousness and urgency that recognized that these structures pose a clear and present danger to our system. Sadly, the revised and now-defanged report simply permits more of the same. The NAIC's initial seriousness and urgency on this issue appears to have been overcome by industry lobbying. As we recognized last year, if the NAIC fails to take meaningful action with respect to captives, we will have left unresolved a gaping regulatory problem that is central to the safety and soundness of our system and the protection of policyholders. And that is where we find ourselves today.

Sincerely,

[Signature]

Benjamin M. Lawsky
Superintendent
New York State Department of Financial Services

cc: The Honorable Jacob Lew
Secretary
United States Department of the Treasury

Mary Miller
Under Secretary for Domestic Finance
United States Department of the Treasury

Michael McRaith
Director, Federal Insurance Office
United States Department of the Treasury