National Association of Insurance Commissioners & The Center for Insurance Policy and Research
CIPR newsletter

Expected Changes to Insurance Regulation for Captives and Special Purpose Vehicles

By Kris DeFrain, Director, Research & Actuarial Department

◆ Introduction

State insurance regulators are given powers by state and federal law to regulate insurance companies and insurance captives[1] and special purpose vehicles[2] (hereafter referred to as "captives") domiciled in their state. While insurers and captives are subject to solvency regulation, the financial regulatory systems for insurers and captives can still be significantly different, largely because captives are unique. As regulators have said, "If you've seen one captive, you've seen one captive."

Regulators use a national state-based financial regulatory system for insurers (as developed by regulators through NAIC committees and the NAIC Financial Regulation Standards and Accreditation Program) and use their own state financial regulatory system for captives. Insurers are required to file a uniform financial statement that is shared with all regulators; captives must share specified information with their state regulator. For insurers, there is online shared information between regulators, including financial data and state action information; for captives, there is an option to share information upon regulatory request. For insurers, the domiciliary state takes responsibility with support of cross-checks and balances in the system; for captives, the individual state takes full responsibility.

In 2013, regulators conducted an NAIC study of these insurer-owned captives, analyzing potential ways to enhance the regulatory framework and provide insurance departments standardized tools and processes for reviewing certain types of captive transactions. Two of the important bodies of work that resulted from the study were 1) regulators sought to clarify when they should use the national state-based financial regulatory system for the regulation of captives; and 2) regulators sought to identify adjustments to the regulatory system (e.g., elimination of the perceived redundancy in specific required reserves) to no longer incent insurers to use captives for XXX/AXXX[3] reserves.

◆ National System for Multi-State Reinsurers

States and U.S. territories have collectively established certain standards for regulating the solvency of U.S. insurers. Adherence to those standards by the states is monitored through the NAIC accreditation process. If a state demonstrates its system achieves the objectives of these standards and the state regulators continue to operate their system reliably, the state becomes accredited. Accreditation can be a signal to other states (and even to international regulators) that the state's system has been evaluated, meets the agreed-upon standards and has been implemented to ensure adequate solvency regulation.

The standards apply to a state's multi-state domestic insurers and reinsurers, generally defined as insurers and reinsurers: 1) domiciled in the state; and 2) either licensed, accredited, or operating in at least one other state or operating or accepting business as an excess and surplus lines insurer or non-captive risk retention group (RRG) from another state. Confusion arises from an exclusion that the definition "does not include those insurers that are licensed, accredited or operating in only their state of domicile but assuming business from insurers writing that business that is directly written in a different state." Some find it unclear whether reinsurers—including those organized under captive laws and reinsuring business written in other states—are considered multi-state insurers subject to the accreditation standards.

At the 2014 Spring National Meeting, the Financial Regulation Standards and Accreditation (F) Committee exposed a definition of "multi-state reinsurers" along with an accompanying clarification of when such a reinsurer would need to be regulated under the agreed-upon accreditation standards. The intent of the new definition was to: 1) recognize that a multi-state reinsurer that assumes business written in any state other than its state of domicile would constitute multi-state business, and would therefore be regulated under the accreditation standards; and 2) generally exempt captive insurers owned by non-insurance entities for the management of their own risks.

Of the more than 30 comment letters submitted, most expressed some opposition to the revised definition and opined the scope was too broad. A few letters were sent in support of the change, expressing the issue needing to be addressed is broader than just the XXX/AXXX captives and

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[1] "A captive is an insurance company created and wholly owned by one or more non-insurance companies to insure the risks of its owner (or owners). Captives are essentially a form of self-insurance whereby the insurer is owned wholly by the insured." NAIC website: CIPR: CIPR Key Issues: Captive Insurance Companies.

[2] According to the *Special Purpose Reinsurance Vehicle Model Act* (# 789), special purpose reinsurance vehicles (SPRVs) are designed to facilitate the securitization of one or more ceding insurers' risk as a means of accessing alternative sources of capital and achieving the benefits of securitization. Investors in fully funded insurance securitization transactions provide funds that are available to the SPRV to secure the aggregate limit under an SPRV contract that provides coverage against the occurrence of a triggering event.

[3] The *Valuation of Life Insurance Policies Model Regulation* (#830) is commonly referred to as "XXX" and *Actuarial Guideline XXXVIII—The Application of the Valuation of Life Insurance Policies Model Regulation* (AG 38) is commonly referred to as "AXXX".

that the state-based system of regulation would be strengthened as a result of the change. The Committee is expected to discuss the comments received at the Summer National Meeting.

◆ PROPOSED XXX/AXXX DISCLOSURE, REGULATORY FINANCIAL ANALYSIS, AND REINSURANCE FRAMEWORK

The U.S. financial regulatory framework includes regulatory controls or needed approvals on typical affiliated transactions and reinsurance, largely because of the potential to use these tools to misrepresent economic reality, such as attempting to reduce or bypass high capital requirements.

In a Feb. 11, 2014 letter, the Financial Analysis (E) Working Group explained the regulatory concern with captive reinsurance agreements. The Working Group explained that the "risk for XXX and AXXX captive reinsurance agreements is generally considered to be different, in part because they are structured different than a pure cession. This is because many state insurance regulators consider XXX and AXXX to create overly conservative statutory reserves. As such, the transactions are generally structured in a manner to shift the "redundant" portion of the reserve to the captive insurer in order to more accurately reflect the expected cash outflows that could occur on the underlying policies... FAWG believes the primary risk associated with these XXX and AXXX captive reinsurance agreements is if the experience on the underlying business develops unfavorably to where the statutory reserves on such business may be insufficient to absorb such development."[4]

In June 2014, Rector & Associates, Inc. issued a report with a proposal for an XXX/AXXX Reinsurance Framework, a new reporting requirement in the 2014 financial statement blank for insurers ceding XXX/AXXX reserves, and the idea of a new section in the *Financial Analysis Handbook* regarding XXX/AXXX transactions. On June 30, the Principle-Based Reserving Implementation (EX) Task Force put in motion the development of 1) a new financial statement supplement to be required with 2014 annual reporting; 2) the need for regulatory financial analysis procedures for the states' review of XXX/AXXX reinsurance transactions with captives/SPVs; and 3) details to support the XXX/AXXX Reinsurance Framework that was adopted in concept.

A new financial statement supplement to be required with 2014 annual reporting will be considered by the Blanks (E) Working Group. The Working Group is using Rector's proposed draft supplement as a starting point. Rector's proposal includes three tables detailing information about reserves, securities and collateral regarding each assuming insurer. Among other required reporting, the first table would include the name of the assuming insurer, the reserve amounts ceded and the type of reinsurer; the second table would include the name of the assuming insurer, the reserve credit taken by the ceding insurer, and the securities held in the current and prior year; and for each transaction included in the second table, a separate table would include the name of the assuming insurer, categories of assets and the amounts of assets and affiliate or parental guarantees.

The Financial Analysis Handbook (E) Working Group will be developing a new section in the *Financial Analysis Handbook* to specify procedures or best practices for reviewing XXX/AXXX reinsurance transactions with captives/SPVs. This Working Group is instructed to consider the changes recommended in the Feb. 11, 2014, letter from the Financial Analysis (E) Working Group. These changes include having a life actuary determine the reasonableness of the "economic reserve calculations" such that sufficient margins are included, the company can handle stresses (e.g. significant changes to mortality) and the assets supporting the economic reserves are of sufficiently high quality.

The third part of the project is to develop the details around the proposed XXX/AXXX Reinsurance Framework. Similar to how the Principle-Based Reserving Implementation (EX) Task Force adopted the framework in concept, the Executive (EX) Committee will consider adopting the proposed XXX/AXXX Reinsurance Framework in concept at the Summer National Meeting. If adopted, numerous groups will develop the details to create the framework for subsequent consideration by the entire NAIC membership.

The proposed framework, as currently adopted by the Task Force, would apply only to the XXX term life insurance business and AXXX universal life with secondary guarantees (ULSG) business. The Framework seeks to address regulatory concerns regarding reserve financing transactions and to do so without encouraging them to move off-shore. The primary goal of the Framework is to ensure enough assets are available to the ceding company to pay policyholder claims. In general, reinsurance transactions with large professional reinsurers, and other transactions that are not of

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[4] Feb. 11, 2014 letter, "Recommendations Regarding the Solvency Regulatory System Related to XXX and AXXX Captive Transactions" from Steve Johnson, chair, Financial Analysis (E) Working Group to Superintendent Joseph Torti III, chair, Financial Condition (E) Committee and co-chair, Principle-Based Implementation (EX) Task Force and Commissioner Julie Mix McPeak, co-chair, Principle-Based Implementation (EX) Task Force.

the types that regulators have been concerned about, are not affected by the proposed Framework.

It is important to note the proposed framework does not change the statutory reserve requirements applicable to a ceding insurer. Rather, the framework addresses the types of security that can back those reserves in connection with reserve financing transactions. By way of either new requirements or what are effectively safe harbors (depending on the specifics of the transaction), the direct ceding company for reinsurance financing transactions, in most instances, would:

1. Collateralize a portion of the total statutory reserve approximately equal to the principle-based reserving (PBR)-level with hard assets such as cash and securities listed by the Securities Valuation Office (SVO).
2. Collateralize the remainder of the statutory reserve with other assets and forms of security identified as acceptable by regulators.
3. Disclose the assets and securities used to support the reserves.
4. Hold a risk-based capital (RBC) cushion as required for other business.

The proposed framework would be codified through the *Credit for Reinsurance Model Law* (#785) with the creation of a new model regulation to establish requirements regarding the reinsurance of XXX/AXXX policies. A modification to the Actuarial Opinion and Memorandum Regulation (#822) or other regulation will require the opining actuary for the ceding insurer to issue a qualified opinion if the framework is not followed. Prior to the regulation being modified and adopted by the states, an actuarial guideline would be adopted. As another enforcement tool, a note to the annual audited financial statement would require the ceding insurer, and its independent auditor, to indicate whether the framework is being followed.

It is expected once PBR is implemented, the perceived reserving redundancies precipitating the use of captives for reserving purposes will be addressed and, therefore, the incentive to create these types of captives will be almost, if not fully, eliminated. Industry representatives have agreed if regulators can remove the excessively conservative reserves to get to the “right” reserve level, then financing transactions would no longer exist.

◆ CONCLUSION

Regulators are now in the final stages of implementing some regulatory changes for 2014, including revised financial analysis procedures for evaluating XXX/AXXX transactions for approval and new disclosures through a supplement to the financial annual statement. Based on what gets approved at the Summer National Meeting, changes to RBC could be implemented in 2015 with other changes to follow.

ABOUT THE AUTHOR

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