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

Work on Life Insurer-Owned Captives Continues Following Adoption of White Paper

By Shanique (Nikki) Hall, CIPR Manager

In recent years, life insurers have increasingly turned to captives to "finance" purported "reserve redundancies" associated with requirements under Regulation XXX[1] and AXXX.[2] State insurance regulators and the NAIC continue to monitor and assess this emerging practice, which has drawn considerable attention in the industry and the mainstream press. The implementation of principle-based reserving (PBR) is expected to reduce the need for life insurers to create new captives and special purpose vehicles (SPVs) to address the perceived reserving redundancies. However, it could take a few years until the existing blocks of business are run off.

The NAIC has been studying the issues surrounding the use of captives and SPVs by life insurers and there are a number of working groups focused on examining the complex issues, including transparency and disclosure, accounting treatment and confidentiality. *The Captives and Special Purpose Vehicles: An NAIC White Paper* (White Paper) was recently adopted by the NAIC membership and outlines a number of recommendations of specific action items to various committees. This article marks the third installment in our series covering the NAIC's review of captives in an effort to keep you abreast of the latest developments and regulatory efforts on this important policy initiative. The previous articles appeared in the January 2012 and April 2013 editions of the *CIPR Newsletter*.[3]

◆ The White Paper and Its Recommendations

The use of captive reinsurance subsidiaries and insurance securitizations by life insurers to address perceived reserve redundancies associated with requirements under Regulation XXX and AXXX has accelerated in recent years. Traditionally, 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 and SPVs owned by life insurers are fundamentally different from captives used by non-insurance companies as a form of self-insurance.

Regulatory concerns over the use of captives by life insurers led to the establishment of the NAIC Captive and Special Purpose Vehicle (SPV) Use (E) Subgroup in early 2012. The Subgroup is charged to study insurers' use of captives and SPVs to transfer insurance risk, other than self-insured risk, in relation to existing state laws and regulations, and establish appropriate regulatory requirements to address concerns identified in this study. Based on its findings, the Subgroup would make recommendations on possible modifications to existing NAIC model laws or developing new ones as necessary.

To initiate this study, the Subgroup requested state insurance departments respond to a confidential regulator-only request for comment on the use of captives and SPVs by insurance companies. The request for comment was sent to all 50 states and the District of Columbia. Thirty-five responses were received. Results from the survey suggested, while insurers cede business to captives for a variety of reasons, the majority use of captive/SPVs by insurers was related to the financing of XXX and AXXX reserve redundancies. Thus, the Subgroup concluded it appears the use of captives may be more prevalent among life insurers than other lines of business.

The Subgroup developed the White Paper to address the broadened use of captives by life insurers. The White Paper was exposed for comment, and, after receiving industry feedback, it was subsequently adopted by the Subgroup on June 6, 2013. The Financial Condition (E) Committee and the Executive (EX) Committee and Plenary formally adopted the White Paper on July 17 and July 26, 2013, respectively. The White Paper outlines the findings of the Subgroup's request for comment and offers seven recommendations to the Financial Condition (E) Committee for consideration and/or possible further study. The recommendations address: 1) accounting considerations; 2) confidentiality; 3) access to alternative markets; 4) International Association of Insurance Supervisors (IAIS) principles, standards and guidance; 5) enhancements to the credit for reinsurance models; 6) disclosure and transparency; and 7) *Financial Analysis Handbook* guidance.

The Subgroup recommends (inter alia): captives not be used by insurers to avoid statutory accounting rules; enhanced transparency and disclosure on captives so regulators can assess and monitor the risks captives and SPVs might pose to the holding company system; the further study of issues relating to confidentiality; support be given to IAIS guidance paper on the regulation and supervision of captives; and consideration be given to modifying the Credit for Reinsurance Model Law (#785). The Subgroup also

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[1] Used to describe the actuarial reserves required to be held under the Valuation *of Life Insurance Policies Model Regulation* (#830), which is commonly referred to as Regulation XXX (or, more simply, XXX).
[2] Used to describe the actuarial reserves required to be held under the Actuarial *Guideline XXXVIII—The Application of the Valuation of Life Insurance Policies Model Regulation* (AG 38), which is commonly referred to as AXXX.
[3] For past editions of the *CIPR Newsletter*, please visit *www.naic.org/cipr_newsletter_archive.htm*.

recommended the current regulatory process be enhanced to provide standardized tools and processes to be used by all regulators when reviewing such transactions. Moreover, the Subgroup recommended the development of guidance in the *Financial Analysis Handbook* for the states' review and ongoing analysis in regard to insurers' use of captives and SPVs.

The Financial Condition (E) Committee assigned the task of determining how to implement many of the recommendations to the Principle-Based Reserving Implementation (EX) Task Force and the Reinsurance (E) Task Force. Although PBR is still being calibrated, the Principle-Based Reserving Implementation (EX) Task Force was recently charged to further assess the solvency implications of life insurer-owned captive insurers and alternative mechanism. The Principle-Based Reserving Implementation (EX) Task Force has formed the PBR Review (EX) Working Group to analyze the issue and propose possible solutions and further recommendations for any remaining XXX and AXXX issues not adequately addressed through PBR.

◆ RECTOR & ASSOCIATES, INC. – INITIAL REPORT

In an effort to further assess the solvency implications of life insurer-owned captive insurers' and other alternative mechanisms in the context of PBR, the Principle-Based Reserving Implementation (EX) Task Force was given the following charge by the Executive (EX) Committee: "Upon completion of the Captive and Special Purpose Vehicle (SPV) Use (E) Subgroup's report and subsequent referral by the Financial Condition (E) Committee, consider the report's recommendations in the context of the proposed PBR system and make further recommendations, if any, to the Executive (EX) Committee."

To assist with this charge, the NAIC engaged the consultant Rector & Associates, Inc., to make recommendations for improving uniformity and transparency and to provide recommendations regarding the potential regulatory treatment of these transactions in light of PBR. To initiate the study, Rector & Associates interviewed insurers, as well as regulators representing approximately 15 jurisdictions, many of which have approved these types of transactions in some form or another.

An initial report from Rector & Associates was released Sept. 13, 2013. The report found some insurers have entered into various reinsurance transactions to finance different portions of the statutory reserve differently (i.e., to fund different portions of the reserve using different kinds of assets) based on what insurers believe is a better correlation between the kind of asset used and the probability it will be needed.

The report notes those interviewed believe these transactions to be safe, legal and conservative, and they more closely match assets held to the likely need for those assets. In addition, some of those interviewed believe insurers should be allowed to use lower quality nonadmitted assets, at least to some extent, if the insurer can conservatively demonstrate there is a low probability such assets will be needed to pay claims. However, the report further notes, even though most of those interviewed appear to accept this general logic, there appears to be significant unease regarding how the logic is currently being implemented, and especially the lack of consistency from insurer to insurer and regulator to regulator regarding key aspects of transactions.

The report concludes the Principle-Based Reserving Implementation (EX) Task Force will need to decide: 1) whether to accept insurers' general logic allowing lower quality nonadmitted assets to back portions of the reserve that have a low probability of being needed to pay claims; or 2) whether, instead, to seek to prohibit transactions that result in an economic effect different than the current statutory accounting requirement that admitted assets be used to back 100% of statutory reserves.

The report sets out a regulatory framework for consideration relative to these types of transactions if the Principle-Based Reserving Implementation (EX) Task Force decides in favor of continuing to permit these types of financing arrangements in some form, but also concludes changes to the existing regulatory framework are needed to promote consistency and to ensure the existing transactions are appropriately conservative. The report also includes a corresponding list of "Issues to be Addressed." The full report can be found on the NAIC website.[4]

◆ FINANCIAL ANALYSIS (E) WORKING GROUP CHARGE

In addition to the White Paper, the Financial Condition (E) Committee charged the Financial Analysis (E) Working Group with conducting a peer review analysis on the practices of captive and SPV transactions within the life insurance industry to understand their nature and how extensively they are used. The Working Group is charged with analyzing troubled nationally significant insurers and to sup-

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[4] *www.naic.org/documents/committees_ex_pbr_implementation_tf_related_rectors_associates_draft.pdf.*

port multi-state efforts in addressing solvency problems, including identifying adverse industry trends.

The peer review by the Working Group would be voluntary on the part of the domestic state insurance regulators of the life insurers engaging in such transactions. For transactions completed prior to a certain date and still in place, the Working Group would collect specified data in order to provide information into the prevalence and significance of these transactions throughout the industry. The Working Group also would inform the domiciliary state regulator and the Principle-Based Reserving Implementation (EX) Task Force of any issues and concerns arising from its review. The Working Group would not have the power to approve or reject captive transactions, as this decision remains with the domiciliary state of the insurer establishing the captive.

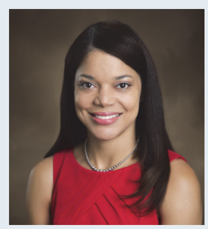
The Working Group's specific charges relating to the use of captives and SPVs are:

1. Perform analytical reviews of transactions (occurring on or after a date as determined by the NAIC membership) by nationally significant U.S. life insurers to reinsure XXX and/or AXXX reserves with affiliated captives, SPVs or any other U.S. entities subject to different solvency regulatory requirements than the ceding life insurers, to preserve the effectiveness and uniformity of the solvency regulatory system.
2. For such transactions entered into and approved prior to this date, and still in place, collect specified data in order to provide regulatory insight into the prevalence and significance of those transactions throughout the industry.
3. Provide recommendations to the domiciliary state regulator to address company specific concerns and to the Principle-Based Reserving Implementation (EX) Task Force to address issues and concerns regarding the solvency regulatory system.

◆ CONCLUSION

State insurance regulators and the NAIC will continue to assess and monitor the use of captives by life insurers in an effort to understand and improve practices employed by many life insurers to address perceived reserve redundancies. The issue is a top priority for state insurance regulators and the NAIC. The CIPR will continue to report on these developments and provide updates as appropriate.

ABOUT THE AUTHOR



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