STATE REGULATION OF CAPTIVE REINSURANCE TRANSACTIONS

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Learning Objectives

At the end of this presentation, you will be able to:

• Identify the concerns with XXX/AXXX captive transactions
• Understand the development of the XXX/AXXX Reinsurance Framework
• Describe the key issues discussed and revisions to Model #785
• Understand the development of the XXX/AXXX Model Regulation
• Understand the impact of Principles Based Reserving

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• Managing Counsel, NAIC Legal Division
  – Supports Reinsurance (E) Task Force
  – Legal Support Life Actuarial (A) Task Force
  – Legal Support Principle-Based Reserving Implementation (EX) Task Force
  – Legal Support Financial Regulation Standards and Accreditation (F) Committee
  – Joined NAIC March, 2006
Josh Arpin

• Sr. Acct. and Reinsurance Policy Advisor
  – Supports Reinsurance (E) Task Force
  – Supports Statutory Accounting Principles (E) Working Group
  – Supports Risk-Limiting Contracts Working Group
  – Provides technical and advisory services in SAP, GAAP and Reinsurance
  – Joined the NAIC in December 2014
  – CPA

Outline

• Concerns with Captive Regulation
• XXX/AXXX Captive Transactions
• XXX/AXXX Reinsurance Framework
• Revisions to Model Law #785
• Development of XXX/AXXX Model Regulation
• Accreditation
• Principles Based Reserving
DEVELOPMENT OF CAPTIVE STRUCTURE

- Pure captives developed as an official industry in the late 1970’s
- U.S. captive regulation/laws developed outside of the NAIC solvency framework
  - Risks covered by the pure captives were self insured by the parent and affiliates
  - Captives were not assuming policyholder risks written by licensed insurers
- Similarly, captives were excluded from the NAIC Accreditation Program, except for Risk-Retention Groups licensed as captive insurers

CONCERNS WITH CAPTIVE REGULATION

- Inconsistent regulation of the transactions is an important concern
  - From one captive state to another
  - Lack of a level playing field for all insurers (e.g. captive vs. non-captive XXX/AXXX transactions)
  - Regulatory arbitrage can occur
- Lack of transparency since captives do not file public financial statements
- Concerns Shared by Federal Gov’t - FSOC, FIO, OFR, Federal Reserve
CONCERNS WITH CAPTIVE REGULATION

• NAIC Statutory Accounting Baseline
  – Conservative accounting rules that provide consistency for all insurers, regardless of state of domicile
  – Permitted accounting practices were intended to be few in number, and include public disclosure of impact to net income and surplus to allow reconciliation to baseline statutory accounting
  – Captive transactions allow permitted accounting practices without public disclosure

XXX/AXXX BUSINESS

• Section 6, NAIC Model 830 (aka “XXX”)
  – In general, XXX was developed to address a reserving issue with level term (and similar) products
  – Reserves based on a specified interest rate and specified mortality table

• Section 7, NAIC Model 830 (aka “AXXX”)
  – Addressed reserving issues for Universal Life Insurance policies that Contain a Secondary Guarantee
XXX/AXXX INITIAL PROBLEMS

• Companies price their products using expected assumptions, not the assumptions required for calculating statutory reserves
  – Premiums collected are therefore not sufficient to fund the required statutory reserves
  – Companies are faced with a decision to fund this difference with surplus or look for other sources of capital

XXX/AXXX INITIAL PROBLEMS

• XXX/AXXX Reserves were established too high, sometimes 3-4 times the economic value of reserves.
• Insurers began reserve financing transactions by ceding reserve values to captives and SPVs.
• Result was an increase to statutory surplus for the ceding insurer. Insurers considered the result to be a more reasonable regulatory reserve (closer to economic reality).
CAPTIVE WHITE PAPER

- Captive and Special Purpose Vehicle (E) Subgroup studied the use of captives and SPVs by insurers
  - Primary Use – Financing of XXX/AXXX perceived reserve redundancies.
  - Need for regulators to be able to assess and monitor the risk captives and SPVs may pose to the holding company system
  - Need for the regulatory process to be enhanced to provide standardized tools and processes to be used by all regulators when reviewing these transactions.
  - PBR implementation would reduce the need to use captives/spv.

- July 2013 - The NAIC adopted the Captives/SPV Use White Paper, which initiated the development of the XXX/AXXX Reinsurance Framework

GOALS OF THE XXX/AXXX PROJECT

- Develop a uniform, national standard regarding these transactions (reserve financing for XXX/AXXX products).
  - More level playing field than exists today.
- Do not encourage movement of the transactions off-shore.
- Make changes prospectively.
- Continue to allow captives, but remove the reserve incentive to form these captives.
REINSURANCE FRAMEWORK

- June 2014 - Adopted by the PBR Implementation Task Force
  - Require the direct ceding company for reinsurance financing transactions, in most instances, to:
  - Book the full statutory reserve.
  - Collateralize based on a tiered reserve.
  - Disclose assets/securities supporting reserves.
  - Hold appropriate RBC capital charge.

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IMPLEMENTING FRAMEWORK

• Credit for Reinsurance Model Law
  – Will reference a new model regulation related to XXX/AXXX reinsurance transactions
  – This is the longer-term solution requiring state-by-state adoption.
  – The XXX/AXXX Reinsurance Model Regulation Drafting Subgroup is preparing a draft for the Reinsurance (E) Task Force to consider.

• New Actuarial Guideline 48
  – AG 48 was created for quick implementation.
  – AG 48 will sunset once Credit for Reinsurance Model Law & new Regulation are implemented.

ACTIONS TAKEN TO ADDRESS XXX/AXXX CAPTIVE TRANSACTIONS

• 2014 Blanks Change:
  – XXX/AXXX Reinsurance Supplement

• Improved Regulatory Review, Including 2014 Financial Analysis Handbook Changes

• RBC Changes:
  – RBC Charge for Qualified Actuarial Opinion
  – Primary Security Shortfall – This proposal increases ACL dollar for dollar for the total of all primary security shortfalls.
  – Consolidated RBC Shortfall – This proposal includes an exhibit that shows by captive the RBC risk components, ACL, TAC and calculated shortfall for each captive.
DEVELOPMENT OF MODELS

• June 2014: PBR Implementation (EX) Task Force adopted the XXX/AXXX Reinsurance Framework in concept, and adopted draft charges to the Reinsurance (E) Task Force with respect to implementation of the Framework

• August 2014: Executive (EX) Committee adopted charges to the Reinsurance (E) Task Force and requested for model law development with respect to these charges

• October 2014: XXX/AXXX Captive Reinsurance Regulation Drafting Group was created, which is an informal drafting group composed of members of the Task Force tasked with developing an initial draft of a model regulation and making revisions to the Credit for Reinsurance Model Law (#785)

DEVELOPMENT OF MODELS

• Charges
  – Request permission from the Executive (EX) Committee to create a new model regulation to establish requirements regarding the reinsurance of XXX/AXXX policies. The Principle-Based Reserving Implementation (EX) Task Force’s XXX/AXXX Reinsurance Framework Exhibit 4 should be considered for this model regulation, modified as deemed appropriate by the Task Force.—Essential

  – Request permission from the Executive (EX) Committee to amend the Credit for Reinsurance Model Law (#785) and draft the amendments to reference the new model regulation drafted in accordance with the previous charge.—Essential
MODEL LAW #785

• Intent of Revisions
  – Provide the commissioner authority to adopt regulations addressing reinsurance of XXX/AXXX policies

• Key Issues Considered
  – Scope of authority on policies other than XXX/AXXX
  – Exemption for “professional reinsurers”

• Adoption of Revisions to Model #785 (Sections 2, 3, and 5)
  – Financial Condition (E) Committee: 1/6/2016
  – Executive (EX) Committee and Plenary: 1/8/2016

ADOPTED REVISIONS TO MODEL #785

• Commissioner may adopt regulations with respect to:
  – Life insurance policies with guaranteed nonlevel gross premiums or guaranteed nonlevel benefits (XXX)
  – Universal life insurance policies with provisions resulting in the ability of a policyholder to keep a policy in force over a secondary guarantee period (AXXX)
  – Variable annuities with guaranteed death or living benefits
  – Long-term care insurance policies
  – Other life and health insurance and annuity products as to which the NAIC adopts model regulatory requirements with respect to credit for reinsurance
ADOPTED REVISIONS TO MODEL #785

• Professional Reinsurer Exemption
  – Maintains at least $250 million in capital and surplus when determined in accordance with the NAIC Accounting Practices and Procedures Manual, including all amendments thereto adopted by the NAIC, excluding the impact of any permitted or prescribed practices; and is
  • (i). licensed in at least 26 states; or
  • (ii). licensed in at least 10 states, and licensed or accredited in a total of at least 35 states.

XXX/AXXX Model Regulation

• Aug. 2016 – Task Force exposed first draft of the proposed Model Regulation
• Oct. 2016 – Task Force voted to use consequence option, which provides zero credit for reinsurance for a shortfall in Primary or Other Security
• Feb. 2016 – Task Force exposed second draft of the proposed Model Regulation
• April 2016 – Directed NAIC staff and consultants to work with the Drafting Group on drafting a revised Model Regulation, which considers the comments received and discussions held, to be presented to the Task Force for future consideration and exposure
XXX/AXXX Model Regulation

• Key Issues Considered
  – Consequence Option of Shortfalls
    • The amount of reduction in credit for reinsurance if there is a shortfall in primary or other security
  – Consequence Options Discussed
    • All or Nothing (Task Force voted to use this option)
    • Dollar for Dollar
    • Proportional Percentage
    • Primary Security Limitation

XXX/AXXX Model Regulation

• Key Issues Considered (Continued)
  – Actuarial Method
    • Changes from current language of AG 48 specific to reinsurance
  – Professional Reinsurer Exemption
    • In addition to the exemption adopted in Model #785, the ACLI proposed an additional exemption targeted toward smaller “professional reinsurers”
ACCREDITATION

• In Summer 2015, the NAIC revised Part A Accreditation Preamble to scope in captive reinsurance transactions involving XXX/AXXX, variable annuity (VA), and long-term care (LTC) business into the accreditation requirements effective January 1, 2016, although VA and LTC provisions not yet effective.

IS THE XXX/AXXX PROBLEM SOLVED?

• Principles Based Reserving
  – Once implemented, expect these captive reserve financing transactions to stop.
  – PBR will largely address the perceived reserving redundancies that have precipitated captive financing transactions.
  – Insurers will be required to hold admitted assets for the PBR reserves (which will be the new statutory reserves).
VALUATION MANUAL OPERATIVE DATE

Section 11B of the Standard Valuation Law was drafted with 3 supermajority requirements in order for Principle-Based Reserving (PBR) and the Valuation Manual to become Operative:

1. Valuation Manual must be adopted by NAIC by a vote of 42 states;
2. The SVL as amended by NAIC in 2009 must be enacted by 42 states, or they must have legislation with substantially similar terms and provisions; and
3. Jurisdictions representing 75% of applicable 2008 premiums from NAIC annual statement must enact SVL.

The VM was adopted by the NAIC in 2012, and 42 states with 75.003% of applicable 2008 premiums have adopted the SVL. PBR should become effective January 1, 2017.

WRAP UP

• Addressing regulatory concerns with XXX and AXXX captive/SPV transactions paired with implementation of PBR is a priority issue for the NAIC Officers
• Now that we have made significant progress addressing XXX/AXXX captive reinsurance transactions, we must address these regulatory concerns for variable annuity, long-term care and possibly other products as well, including addressing Accreditation
Implementation of 2011 Revisions to Credit for Reinsurance Models
Model Law #785
Model Regulation #786
[status as of April 4, 2016]

Adopted both 785 & 786
(22: AL, CA, CO, CT, DE, FL, GA, IA, IN, LA, MD, ME, MO, NE, NH, NJ, NY, OH, PA, RI, VA, VT)

Adopted 785
(10: AR, AZ, DC, HI, MA, MT, ND, NM, NV, WA)

No Action to Date

Disclaimer: This map represents state action or pending state action regarding NAIC amendments to the model(s). This map does not reflect a determination as to whether the pending or enacted legislation contains all elements of NAIC amendments to the model(s) or whether a state meets any applicable accreditation standards.

QUESTIONS OR COMMENTS