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Captive and Special Purpose Vehicle (SPV) Use (E) Subgroup
Conference Call
July 26, 2012

The Captive and Special Purpose Vehicle (SPV) Use (E) Subgroup of the Financial Condition (E) Committee met via conference call July 26, 2012. The following Subgroup members participated: Doug Slape, Chair (TX); Judy Weaver (MI); Fred Heese (MO); William Carmello (NY); and Leslie Jones (SC). Also participating were: Dana Sheppard (DC); William P. White (DC); Cindy Donovan (IN); Bob Wake (ME); Joseph Torti III (RI); and Doug Stolte (VA).

1. Discuss Drafting Elements of White Paper

Mr. Slape stated that the purpose of the call was to discuss drafting the Captive and Special Purpose Vehicle white paper. He noted that he wanted to start the discussions with the Conclusions and Recommendations for the Financial Condition (E) Committee section, which had not yet been drafted. This section contains discussion on several issues, including redundant reserves; NAIC *Special Purpose Reinsurance Vehicle Model Act* (#789); International Association of Insurance Supervisors (IAIS) standards; *Credit for Reinsurance Model Act* (#785) enhancements, added reinsurance disclosures and transparency; and confidentiality. Mr. Slape asked the Subgroup to consider whether the issue of redundant reserves should be addressed differently than other types of transactions. Superintendent Torti said he did not think they should be treated differently, as doing so would indictment the statutory reserving requirements already in place. He said the issue of redundant reserves is already being addressed with the principle-based reserving effort. He said U.S. insurance regulators should consider whether redundant reserves should exist and how they should be handled before a precedent is set forth in the white paper. Mr. Carmello and Mr. Heese agreed.

Mr. Slape said he has difficulty reconciling the fact that separate treatment of redundant reserves would be an indictment of the system when the existence of captive special purpose vehicles (SPVs) is somewhat of an indictment of the system. He stated that, in essence, SPVs insure risk as a way to finance reserves created by the system, and SPVs do not otherwise fit into the regulatory framework. Superintendent Torti said it is a difficult question to consider, especially because he does not believe the Subgroup has concluded whether redundant reserves are even appropriate. Commissioner White noted that the Subgroup has agreed that some redundancy does exist with these reserves. In addition, redundant reserves are required to be reported and were created because a need for them existed. If a solution for the problem was created, there would no longer be a need for redundant reserves. Superintendent Torti noted that conservatism is built into statutory accounting, and eliminating redundant reserves is a way of getting around rules inherent in the system, which is particularly dangerous in light of the fact that not all of these reserves truly are redundant. Mr. Wake noted that because there is not currently a definitive way of determining what products are over-reserved and what products are reserved correctly, regulators should apply the principle of conservatism and presume that there is a risk that the product is not over-reserved.

Mr. Slape noted that another issue within the white paper involves the application of IAIS standards which state that insurer-owned captives should follow the regulatory framework in place in the applicable jurisdiction, rather than applying separate standards. Superintendent Torti said these entities should not be treated differently because he does not believe they actually fall under the definition of a captive. Mr. Wake agreed. Superintendent Torti noted that the danger in classifying these entities as captives is that they are less regulated than traditional insurance companies. Commissioner White disagreed and stated that he felt captive companies were adequately regulated.

Mr. Slape asked whether the statutory model should be amended at the ceding company level to alleviate the need for SPVs, such as expanding the assets that could support redundant reserving transactions. He said if these transactions are largely financed by letters of credit, then would it be acceptable to envision an environment that allows letters of credit to be an admitted asset on a commercial insurer's balance sheet. Commissioner White agreed on the merits of this idea. Superintendent Torti noted that making amendments at the ceding company level rather than setting up an expensive structure would address many of the concerns expressed regarding redundant reserves. Mr. Wake said some issues are on their way to being fixed at the ceding company level, but there are some things that will never be completely fixed, which is why alternative markets exist and are tolerated. Mr. Slape noted that this statement relates directly to the issue of the NAIC *Special Purpose Reinsurance Vehicle Model Act* (#789). He said that if IAIS standards were followed, but there was an allowance for a process whereby risk could be transferred to the capital markets, captive SPVs would be perceived as more transparent. Mr. Stolte agreed. Mr. Heese warned that amending Model #789 could take a long time, so the Subgroup may wish to focus its efforts on implementing short-term solutions. Ms. Donovan agreed. Mr. Slape said that the Subgroup could

embrace the concept on an immediate basis to outline a framework and recommend to the Financial Condition (E) Committee to advise states that permitted practices could be used to address the concerns that have been expressed.

Mr. Slape said the next issue to be discussed was credit for reinsurance. It has been discovered that some companies cannot get unconditional letters of credit; therefore, some states have allowed these companies credit for conditional letters of credit. Because this issue is outside of the scope of the Subgroup, Mr. Slape suggested recommending that the issue be addressed by the Financial Condition (E) Committee. Superintendent Torti agreed with this suggestion.

Mr. Slape said the final issue within the white paper was confidentiality. There has been some discussion in the regulatory community that there should be greater transparency with captive SPV reinsurance transactions, especially in light of states being unable to share information due to confidentiality rules. Mr. Sheppard noted that there had been some talk of assigning NAIC company codes to captive companies, which would require them to file with the NAIC. He said that requiring captives to file with the NAIC would enhance the quality and consistency of the information reported. Mr. Slape stated that there should be more transparency in filing, and Superintendent Torti agreed.

Mr. Slape asked whether it would be appropriate to suggest requiring an exhibit of the ceding company financial statement that shows financial information, net of captive SPV reinsurance transactions. Superintendent Torti said this would be a useful tool. Mr. Heese said this could be inappropriate for public filings because such a complex arrangement could be easily misunderstood. He suggested that there should instead be a disclosure of the existence of the transactions.

Mr. Slape suggested that another call be held before the Summer National Meeting.

Having no further business, the Captive and Special Purpose Vehicle (SPV) Use (E) Subgroup adjourned.

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Captive and Special Purpose Vehicle (SPV) Use (E) Subgroup
Conference Call
July 12, 2012

The Captive and Special Purpose Vehicle (SPV) Use (E) Subgroup of the Financial Condition (E) Committee met via conference call July 12, 2012. The following Subgroup members participated: Doug Slape, Chair (TX); Judy Weaver (MI); Fred Heese (MO); Richard Schlesinger (NJ); William Carmello (NY); Joseph Torti III (RI); and Leslie Jones (SC). Also participating were: George Sumner (HI); Cindy Donovan (IN); Ern Johnson (VA); and Sandy Bigglestone (VT).

1. Discuss Captives as Part of Holding Company Analysis

Mr. Slape discussed the draft version of the Captives and Special Purpose Vehicles white paper and highlighted the agenda topics. He asked Mr. Heese to begin the discussion related to holding company analysis and how the existence of captives and special purpose vehicles (SPVs) are factored into the analysis, especially where the holding company issues a parental guarantee, guarantees a letter of credit (LOC) or has some sort of terms regarding assets.

Mr. Heese discussed the benefits of completing a holding company analysis where "XXX reserve" transactions (i.e., reserves held in accordance with the *Valuation of Life Insurance Policies Model Regulation* (#830)) are involved. He said that a robust holding company analysis can help determine the amount of risk involved, as well as determine the ability of the parent to meet obligations pertaining to reimbursing LOCs, parental guarantees or other similar arrangements. In addition to the holding company analysis, Mr. Heese suggested the following: 1) work closely with the ceding state regulator; 2) expand the holding company analysis procedures within the *Financial Analysis Handbook* for captives and SPVs to help standardize the review with the intent to provide an assessment of the overall materiality of the reserves ceded to captives, exposure to holding company regarding parental guarantees or LOC reimbursement obligations, and other unique exposures; 3) have captive domestic states get together to formulate best practices; and 4) assist the ceding company states on how these transactions work and what types of questions to ask.

Mr. Slape asked what kind of additional information the states are receiving from the parent that assists in the holding company analysis.

Ms. Weaver suggested encouraging coordination of information between the captive state and the ceding state.

Ms. Bigglestone said that, to a certain extent, at the start of the transaction before the captive is licensed, there is quite a bit of coordination and communication between the ceding state and the captive state and she encouraged this on an ongoing basis.

Mr. Heese suggested that the states could do better in completing holding company analysis, which is why it is important to improve the *Financial Analysis Handbook* holding company analysis procedures for captives and SPV use.

Mr. Slape asked whether additional information is needed to assist the states in conducting the holding company analysis. Mr. Heese indicated that, to a certain extent, some additional information may be needed, but Missouri conducts an extensive analysis of the captive plans before they are approved, which includes having a third-party actuary review and assess the plan. Mr. Heese said he believes that transparency is also part of the issue and that there is better note disclosure at the ceding company level regarding these types of transactions, and that is an area that can be improved.

Mr. Slape asked the Subgroup members to provide their thoughts on ongoing analysis and stress testing of changing economic environments and assumptions that may affect the business.

Mr. Johnson suggested conducting an enterprise risk management analysis (ERM) of the holding company to see if they are assessing and measuring the risk on an enterprise-wide basis and to see if they are keeping up with their obligations in addition to requiring results of stress tests. Superintendent Torti agreed and said that, in many instances, the holding company's only source of funds is through the insurance entities. Superintendent Torti said that it is important to look at the structure as a whole and that there needs to be additional procedures to ensure that, under stress, these entities are able to make good on these guarantees. Mr. Heese agreed and said that ERM analysis will provide better insight into the structure of the company and how they are handling the risks.

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Ms. Bigglestone said that, to a certain extent at the captive level, under a situation where the state is requesting information on an annual basis, the actuary will comment on where they may differ significantly or adversely from where they originally projected. She said that this will help states determine whether additional capital or more financing is appropriate. She said that this information could be shared with the ceding state.

Ms. Donovan suggested putting together bullet points from the suggestions that have been made and sending them to chief regulators, which could assist the states in completing their holding company analysis.

2. Discuss IAIS Paper on Captives

Ryan Couch (NAIC) provided an overview of the International Association of Insurance Supervisors (IAIS) *Application Paper on the Regulation and Supervision of Captive Insurers*, which is a working draft and not yet publicly available.

3. Update on Drafting Elements of White Paper

Jane Koenigsman (NAIC) provided an update on drafting elements of the white paper and indicated that four states provided comments and/or additions.

4. Next Conference Call

The next conference call is scheduled for July 26.

Having no further business, the Captive and Special Purpose Vehicle (SPV) Use (E) Subgroup adjourned.

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Draft: 8/3/12

Captive and Special Purpose Vehicle (SPV) Use (E) Subgroup
Conference Call
June 21, 2012

The Captive and Special Purpose Vehicle (SPV) Use (E) Subgroup of the Financial Condition (E) Committee met via conference call June 21, 2012. The following Subgroup members participated: Doug Slape, Chair (TX); Judy Weaver (MI); Fred Heese (MO); Richard Schlesinger (NJ); William Carmello (NY); William Jones (SC); and David Provost (VT). Also participating was: Doug Stolte (VA).

1. Discuss Captive Arrangements vs. Traditional Reinsurance

Mr. Slape asked if there is a market for captive arrangements in the traditional reinsurance market. He said XXX term writers have not been able to find coverage in the traditional reinsurance market. The issue that drives these types of reinsurance deals are the redundant reserves for term life products under the *Valuation of Life Insurance Policies Model Regulation* (#830)—commonly referred to as "Regulation XXX"—and universal life with secondary guarantees (ULSG) products under *Actuarial Guideline XXXVIII—The Application of the Valuation of Life Insurance Policies Model Regulation* (AG38). Mr. Slape said the key is determining if the reserves are redundant. He said captives are ideal for single transactions, as it is difficult to establish a traditional reinsurer in the same time frame that a captive can be established; it is also less costly to establish a captive.

Mr. Carmello said New York has not seen any redundant reserves for AG38 ULSG products. He said the pricing of these products is out of control. Mr. Stolte said some of the states have found AG38 ULSG products to have redundant reserves.

Mr. Heese said that, without the U.S. captive laws and the ability to form U.S. captives, companies may have instead formed offshore captives. Traditional reinsurers have high capital requirements for reinsurance of XXX term and AG38 ULSG products. Captive laws allow for alternative capital sources, such as letters of credit (LOC) and surplus notes.

Mr. Provost said there is also the consideration of the impact of rating agencies views on use of captives. Mr. Provost asked if regulators need to define the ideal terms for an LOC. Mr. Stolte said the requirements for an LOC are in the *Credit for Reinsurance Model Law* (#785). Mr. Stolte said he has concerns that these captive transactions result in accounting arbitrage.

Mr. Slape said the key takeaway from this discussion include consideration of a bifurcated recommendation for redundant reserve transactions vs. those without redundant reserves. He said any recommendations should consider if transactions covering products with redundant reserves should be addressed differently than transactions covering products that do not have redundant reserves. He said regulators need to be able to logically conclude that transactions for products that transfer risk and that do not have redundant reserves have a legitimate reason to be utilizing captive transactions.

Mr. Heese said recommendations might include best practices for captive states, communication between the states and possibly recommended changes for the *Financial Analysis Handbook*. He said the recommendations need to assure consumers that the regulatory scheme is doing everything it needs to be doing to protect them.

2. Next Conference Call

Mr. Slape said regulator comments on the preliminary draft white paper should be sent to NAIC staff by July 6. The discussion draft of the white paper will be available on the next conference call, which will be held July 11.

Having no further business, the Captive and Special Purpose Vehicle (SPV) Use (E) Subgroup adjourned.

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Draft: 7/31/12

Captive and Special Purpose Vehicle (SPV) Use (E) Subgroup
Conference Call
June 14, 2012

The Captive and Special Purpose Vehicle (SPV) Use (E) Subgroup of the Financial Condition (E) Committee met via conference call June 14, 2012. The following Subgroup members participated: Doug Slape, Chair (TX); Judy Weaver (MI); Fred Heese (MO); Richard Schlesinger (NJ); William Carmello (NY); and Leslie Jones (SC). Also participating were: Jill Jacobi (CA); Dana Sheppard (DC); William P. White (DC); Cindy Donovan (IN); Bob Wake (ME); Jim Nixon (NE); John Talley (NJ); Ross Elliott (UT); Doug Stolte (VA); and David Provost (VT).

1. Discuss Captive Requirements for Accounting and Reporting

Mr. Slape asked the states to discuss the captive and captive parent accounting and reporting requirements in the domestic states.

Mr. Provost said that Vermont's typical pure captives and risk retention groups file statements using generally accepted accounting principles (GAAP), while special purpose vehicles (SPVs) file statements using statutory accounting principles (SAP). Even though SPVs only file on an annual basis, they must include all additional filings as traditional insurers, including an RBC report, the management's discussion and analysis (MD&A), the actuarial opinion, the investment risk interrogatories and the audit report (June 30 deadline). There is a permitted practice to allow a letter of credit (LOC) for SPVs. LOCs for other captives are statutorily approved, not a permitted practice, but an exception from GAAP. If there is a surplus note, it has to conform to *SSAP No. 41—Surplus Notes*. The funds withheld for an SPV are held by the parent as economic reserves.

Mr. Slape asked whether the SPVs use the NAIC annual statement blank. Mr. Provost said that they file the annual statement blank for life, accident and health insurers, but do not file the blank with the NAIC.

Mr. Slape asked whether there are any differences in Vermont's analysis or exam processes compared to traditional insurers. Mr. Provost said that it is the same sort of financial annual analysis and typically, because it only involves one transaction, the analysis is focused on comparing actuarial results to projections and talking with the parent company if there is a material variance. Mr. Provost said that the exam process is a standard exam and Vermont has adopted the risk-focused approach. Vermont is working on coordinating these exams with the lead state for the parent company to avoid duplicating effort. If there are material differences in the projections, then Vermont asks for updated projections annually.

Ms. Donovan asked Mr. Provost how many special purpose captives there are in Vermont. Mr. Provost said that Vermont has 36 special purpose captives.

Ms. Jacobi asked Mr. Provost why Vermont does not file the annual statements with the NAIC. Mr. Provost said that the regulation of SPVs falls under Vermont's captive statute, and the department has not asked the companies to file with the NAIC, although a couple of them have done so. He said that SPVs typically involve single transactions and, as such, public disclosure would make it easier to determine proprietary information, such as what rates the banks charge.

Mr. Stolte asked Mr. Provost to discuss the types of permitted practices that Vermont has granted. Mr. Provost said the only permitted practice granted is to allow a LOC in the favor of the ceding company as an asset of the captive. Mr. Provost said that, during prior Subgroup discussions, he mentioned that the LOCs sometimes include a condition that the LOC is the last available funds before a draw-down can occur. He also said that the LOCs are for longer term periods and are generally procured up to the projected maximum redundant reserve.

Commissioner White asked Mr. Provost to address whether Vermont has a separate section for special purpose financial captives (SPFCs) or if they fall under the SPV provision in the statutes. Mr. Provost said that there is a separate section in Vermont's captive statute for SPFCs. Mr. Provost said there is no specific SPV law and that he used "SPV" as a generic term.

Mr. Heese said that the accounting and reporting requirements in Missouri are similar to Vermont's requirements. He said some differences include Missouri's special purpose life reinsurance captives (SPLRC), which file using statutory accounting. Missouri allows LOCs for the excess reserves, which is considered a permitted practice. The LOCs must be clean and irrevocable. Quarterly filings are required for SPLRCs, but not for pure captives. He said that Missouri has a diligent

analysis process for these filings. The analyst that performs the review also performs the review for other Missouri domestic companies and is aware of the standard procedures that need to be performed. Some of the filing dates are different than those for traditional insurers. The audited financial statement is due June 1, and the statement of actuarial opinion is due March 1, and both are required annually. Missouri has an ownership situation whereby the owner company shows the subsidiary captive at statutory value, meaning any LOC is not included in the value of the company on the books of the parent. Updated projections are required if there are variances. In addition, if there are material variances, the department can ask the company to provide a new actuarial analysis of the plan and how it is operating. Lastly, Missouri requires an MD&A to be filed.

Mr. Slape asked Mr. Heese and Mr. Provost whether the CPA reports have to comply with the NAIC's *Annual Financial Reporting Model Regulation* (#205) and whether they receive a separate report on internal control and financial reporting as part of the filings. Mr. Heese said he believes that is the case in Missouri, but said he would have to double-check. Mr. Provost said he would have to check, but that Vermont does not specifically require them to comply with Model #205.

Mr. Talley said that New Jersey does not have a special purpose captive statute, but that it has pure captives and regular normal captive situations that are based on Vermont's statutes. Reporting requirements include the annual statement due March 1 and the audit and actuarial review due June 30. Pure captives can report under GAAP and can ask for statutory modifications.

Mr. Slape asked about the analysis and exams performed in New Jersey. Mr. Talley said that an analysis is performed by the department's analysis group that also performs analysis on traditional companies. He said that examinations can be completed on a three- or five-year basis.

Mr. Slape asked Missouri about their examination process. Mr. Heese said that it is typically three to five years, depending on the situation of the captive.

Mr. Slape asked New Jersey whether they have any specific requirements as to how a traditional domestic company that owns the captive values the captive. Mr. Talley said that they have to follow the investment rules that are set up for a traditional company.

Mr. Wake said that the only other difference in Maine from what was already heard is that the ability to capitalize a company with a LOC only applies if they come in under the captive law. He said that at this point Maine does not envision a traditional single transaction captive as an appropriate vehicle for an insurance company to set up a captive. Maine's captive law is based on Vermont's, but it does not have a special purpose financial captive subchapter. In the reinsurance chapter of the Maine's insurance code, there is a subchapter for special purpose reinsurance vehicles based on the NAIC's *Special Purpose Reinsurance Vehicle Model Act* (#789).

Mr. Elliott said that Utah's accounting and reporting requirements are the same as Vermont's. He said the only difference is that Utah performs an examination every three years on its single SPFC and its parent, which is also a Utah domestic.

Commissioner White said there appears to be some inconsistencies among the states in the terminology used to describe SPVs and suggested that the Subgroup work toward developing greater consistency.

Mr. Sheppard said the District of Columbia does not currently have any SPFCs. He said the District of Columbia does not have a separate reporting process different from regular captives and, if an SPFC was established, it would most likely be treated as a pure captive and the examination and analysis process would be similar.

In a memo distributed by Vermont pertaining to captives, Mr. Wake pointed out that the reserves for SPFCs should mirror the ceding company's reserves, which is not a traditional requirement for commercial insurers.

Mr. Slape asked the Subgroup to discuss some of these transactions where the captive is affiliated with the parent insurer and if the reserves are set at a SAP level or GAAP level. Mr. Provost said that the reserves are set by the parent and those reserves are ceded to the captive.

Mr. Nixon said that Nebraska does not distinguish between how they value the parent of the captive that holds an LOC. The LOC is admitted at the captive level but not at the parent level, because it is not allowed under SAP and if it is guaranteed by the parent. Mr. Stolte said that the statutory value is determined by the domicile of the captive, which is based on *SSAP No.*

97—Investments in Subsidiary, Controlled and Affiliated Entities, A Replace of SSAP No. 88. Mr. Stolte added that SSAP No. 97 indicates that the investments in U.S. subsidiary, controlled and affiliated entities shall be recorded based on the underlying audited statutory equity of the respective entity's financial statements. He said how that was interpreted is that if it is a prescribed or permitted accounting model and whenever the statutory accounting model for the captive domicile is the value that could be admitted.

Mr. Sheppard asked what the logic is of not allowing the LOC to be considered in the value of the subsidiary, if the parent can accept an LOC as an asset under the credit for reinsurance laws in order to secure reserves. Mr. Wake said that one difference is who the beneficiary of the LOC is and the conditions under which it can be called.

Commissioner White said that there is a key difference because, in these types of situations, it is about determining the solvency of the entity. He said that, in many instances, an LOC is perhaps preferable to cash because it has preconditions before it can be used or called. Mr. Sheppard described this preference, in that, in the event of liquidation, the LOC cannot be called unless approved by the domiciliary commissioner. Mr. Wake said that also depends in part on who the beneficiary is and what the conditions are, because there is the ability of the captive to cancel the LOC and collect the collateral when the company is the beneficiary. Mr. Provost said that Vermont has very specific wording for LOCs to avoid those kinds of situations, which prevents any changes to the LOC without the department becoming aware. He said that if the captive decides to not pay the renewal fees on the LOC, then a non-renewal will be sent and the commissioner can draw-down on the LOC.

Mr. Stolte said that there was a receivership case in Virginia that involved a clean and irrevocable LOC that the department wanted to draw-down on, but the bank wanted to enter litigation over whether it was paid or incurred claims.

Mr. Slape said that there have been prior discussions about some of the nuances of an LOC, such that it is the last available funds, means that a draw-down cannot occur until all other assets have been exhausted.

Mr. Provost said that there are two different kinds of LOCs: first, there is the traditional captive LOC that is used to capitalize a single parent or other kind of captive where the LOC is completely unconditional, evergreen, and in favor of the commissioner; and second, there is a transactional LOC that is used by SPVs reinsuring the parent insurer, and the LOC will have some conditions and is in the favor of the parent.

Commissioner White said he believes there needs to be some distinctions drawn, because not all LOCs are the same and some say they are not acceptable because they are not allowed under statutory accounting. He said that it depends on the type of LOC.

Mr. Heese said that the key point to keep in mind is that the ceding companies are secure and most of the transactions discussed meet the credit for reinsurance requirements. He said that these type of situations of backing the reserves with an LOC, funds held or other sort of trust funds makes the transaction secure for the ceding company.

Mr. Slape said one of the takeaways from the discussion is that there are a lot of consistencies amongst the states with regard to accounting and reporting requirements; the Subgroup needs to include in its recommendations how often they should report. The Subgroup also needs to spend additional time determining how to go about providing recommendations regarding LOCs and how they are to be accounted and the scenarios in which they are being used, such as capitalization or collateralizing reinsurance credit balances, and how the parent accounts for the LOC. Mr. Heese said that captive states seem to be using statutory accounting. Mr. Stolte said there are permitted practices, as well.

2. Staff Update on Drafting Elements of White Paper

Jane Koenigsman (NAIC) summarized the progress on the white paper, outlining the sections and providing an overview of the sections that have already been address by the Subgroup.

3. Next Conference Call

The next conference call is scheduled for June 21.
Having no further business, the Captive and Special Purpose Vehicle (SPV) Use (E) Subgroup adjourned.

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Captive and Special Purpose Vehicle (SPV) Use (E) Subgroup
Conference Call
May 24, 2012

The Captive and Special Purpose Vehicle (SPV) Use (E) Subgroup of the Financial Condition (E) Committee met via conference call May 24, 2012. The following Subgroup members participated: Doug Slape, Chair (TX); Judy Weaver (MI); Fred Heese (MO); John Talley (NJ); William Carmello (NY); Leslie Jones (SC); and Sandy Bigglestone and Dave Provost (VT).Also participating were: Steve Kinion (DE); Bruce Sartain (IL); and Bob Wake (ME).

1. Discuss Credit for Reinsurance

Jane Koenigsman (NAIC) provided an overview of the responses to certain questions in the Request for Comment pertaining to captive states' credit for reinsurance standards and treatment of captive and special purpose vehicle (SPV) transactions. The majority of states that responded to the survey indicated that the state allows traditional insurers domiciled in the state to cede third-party risks to captives and SPVs in the state. Also, most states indicated that they require credit for reinsurance requirements to be met when insurers domiciled in the state cede third-party risks to captives and that the credit for reinsurance requirements are the same whether the captive or SPV is a domestic or of another state or jurisdiction.

a. Captive States Credit for Reinsurance Standards & Treatment of Captive & SPV Transactions

Mr. Wake said Maine has a law that specifically has different credit for reinsurance requirements for SPVs, since SPVs are designed to be fully collateralized and collateral would be required, unlike traditional licensed companies. The requirements would be the same as any non-admitted company.

Ryan Couch (NAIC) summarized the *Credit for Reinsurance Model Law* (#785). Under the Model, U.S. domestic ceding insurers are allowed credit for reinsurance ceded to an assuming insurer that meets any one of the following criteria:

- The assuming insurer is licensed to transact insurance or reinsurance in the state of domicile of the ceding insurer.
- The assuming insurer is accredited in the domestic state of the ceding insurer as a reinsurer. There are some specific requirements that go along with being accredited: The assuming insurer would have to file with the commissioner evidence of submission to the state's jurisdiction; submit to the state's authority to examine books and records; would have to be licensed to transact insurance or reinsurance in at least one state; would have to file annual financial statements with the commissioner; and would have to maintain $20 million in policyholders' surplus.
- The assuming insurer is domiciled in a state that has substantially similar credit for reinsurance laws as the domestic state of the ceding insurer. Not every state has this provision in its laws, but that is one method under the Model. Such an assuming insurer is also required to maintain $20 million in policyholders' surplus and submit to the authority of the domestic state to examine its books and records.
- The assuming insurer would maintain assets in the U.S. in the form of a multiple beneficiary trust, and that trust would be funded to a level equal to 100% of that assuming insurer's obligations to U.S. ceding insurers and maintain $20 million in policyholders' surplus.
- Premiums are ceded to a certified reinsurer that qualifies for the collateral reductions.
- Credit is allowed where it is required by law.

If an assuming insurer does not meet any of the above requirements, which are generally considered to be authorized, credit is allowed if the assuming insurer posts collateral in an amount not to exceed the reinsurance obligations. Model #785 sets out the type of collateral that is allowed as an offset for the credit, which can be in the form of cash; securities listed by the NAIC Securities Valuation Office; or a clean, irrevocable, unconditional Letter of Credit (LOC) issued or confirmed by a qualified U.S. financial institution. The Model includes a discretionary provision that allows the commissioner to approve other forms of security, although not all state laws include this provision.

Mr. Provost said Vermont has a pure captive that retrocedes and although Vermont captives do not have to follow Model #785, the department does apply Model #785 and requires trusts or some other form of collateral.

Mr. Heese said Missouri has a special purpose life reinsurance captive that retrocedes business to an offshore captive. The offshore captive posts collateral as required under the credit for reinsurance requirements. Mr. Slape asked about the type of collateral posted. Mr. Heese said it was structured in a trust with normal assets and investments.
Mr. Talley said New Jersey captives are subject to the credit for reinsurance statutes similar to the NAIC Model. He said a New Jersey pure captive retrocedes and is collateralized by an LOC.

Mr. Kinion said the *Credit for Reinsurance Model Law* (#785) is applied to captives in Delaware, and that the transactions are typically collateralized by trusts.

b. <u>Domestic Ceding States Credit for Reinsurance Standards and Treatment of Captive and SPV Transactions</u>

Mr. Slape asked about the extent to which the domestic states are applying the *Credit for Reinsurance Model Law* (#785). He said that in previous Subgroup discussions relating to transactions that involved LOCs, some states considered the LOC conditional because it includes side agreements or parental guarantees, which may influence how the LOC can be drawn upon. He asked domestic ceding states to discuss how they are allowing credit for reinsurance, along with a general discussion about LOCs with these types of side agreements.

Mr. Provost said that when these transactions occur, the ceding state has to grant credit for reinsurance to the ceding company; otherwise, the transaction cannot occur. He said that either a trust is funded to allow the ceding company to get credit for reinsurance or, in some cases, the captive reinsurer becomes accredited in the ceding company's state of domicile. In those cases, just like any other accredited reinsurer, the captive reinsurer has $20 million or more in policyholders' surplus; it is licensed in the state; and it agrees to file to the commissioner of the ceding state. Mr. Provost said Vermont allows the condition that the LOC is the last money drawn if the captive has used up its trust assets to the point that the captive's policyholders' surplus is close to falling below minimum capital levels, and the ceding company has used all of the funds withheld. In this sense, the draw-down on the LOC can only be used to meet the reinsurance obligations to pay claims.

Mr. Slape asked how these conditions work in a situation where the assuming company has illiquid assets.

Ms. Bigglestone said that the captive is usually funded with capital to support the operations of the captive from the parent company; therefore, there are still some assets that could be used in addition to the trust assets that are set aside specifically for the statutory obligations. She said economic reserves are funded with premiums that go into the trust and the excess reserves are usually supported by the LOC, whether conditional or unconditional. She said that before a draw-down on the LOC, all assets need to be fully exhausted.

Mr. Provost said there may be some degree of investment risks. The captive's assets are typically cash or invested in the same manner as the parent company's assets. Thus, there is the potential risk that these assets may have to be sold at a loss; but this risk may exist in any company.

Mr. Heese said the Subgroup has not discussed much about offshore captives. He said that he would have a higher comfort level if the ceding company ceded business to a captive in another state because of the state's oversight and the communication among the states. He said he would have an even greater comfort level if a Missouri domestic ceded to a Missouri captive because he gets to see the entire picture and can assess the transaction through holding company analysis.

Mr. Slape asked if any state that has allowed conditional LOCs has in its statutes any other security provision, or if these conditional LOCs are accepted on the faith of the LOC. Mr. Heese said that although Missouri does not allow conditional LOCs, he can certainly understand the argument of having these conditions, in such that it may prevent rogue draw-down. Mr. Provost said that in Vermont, they originally required conditional LOCs, but they have gotten comfortable with some minimal conditions on the LOC. He said this is worked into the licensing order for each captive, so it is technically under the commissioner's approval.

Mr. Kinion said that in Delaware these reinsurance transactions are handled with a fully collateralized trust. In the case of an LOC, the preference is that it is unconditional. He said there is a provision in state captive statutes that gives the department some flexibility in certain circumstances that could approve a conditional LOC.

Mr. Heese said that ultimately it is the ceding company's decision, and with the guidance of the regulator, it can be the one to agree or not agree to the arrangement.

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Mr. Talley said New Jersey is similar to Delaware in that unconditional LOCs are preferred; however, they have the flexibility to consider conditional LOCs.

Mr. Kinion pointed out that Delaware heavily scrutinizes banks issuing LOCs due to the high number of banks that have failed recently. He said Delaware has become much more cognizant of the FDIC rules with respect to how LOCs are treated when a bank fails. Mr. Slape asked if the state is allowing banks other than what the NAIC Securities Valuation Office (SVO) consider acceptable. Mr. Kinion said that typically is not the case. At times the state has deviated from the SVO list, but only for transactions that were relatively small and after other due diligence was performed by the state.

Mr. Slape asked about the collateral requirements that some of the banks are poising on the LOCs.

Mr. Sartain said Illinois has the discretion to adjust the security requirements—other than cash, securities and LOC—within its regulation.

2. Next Conference Call

The next public call is scheduled for June 14.

Having no further business, the Captive and Special Purpose Vehicle (SPV) Use (E) Subgroup adjourned.

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Draft: 7/31/12

Captive and Special Purpose Vehicle (SPV) Use (E) Subgroup
Conference Call
May 3, 2012

The Captive and Special Purpose Vehicle (SPV) Use (E) Subgroup of the Financial Condition (E) Committee met via conference call May 3, 2012. The following Subgroup members participated: Doug Slape, Chair (TX); Judy Weaver (MI); Fred Heese (MO); Richard Schlesinger and John Talley (NJ); William Carmello (NY); and Leslie Jones (SC). Also participating were: Sean O'Donnell (DC); Karen Weldin-Stuart and Linda Sizemore (DE); Robert Ballard (FL); George Sumner (HI); Russell Coy (KY); Bob Wake (ME); Joseph Torti III (RI); Ross Elliott (UT); and David Provost (VT).

1. Discuss Capitalization Standards, RBC, and Other Related Topics

Mr. Heese provided a summary of Missouri's capitalization requirements. He said that the minimum capital requirement for captives is $250,000, compared to Missouri statute for a standard commercial life company of $1.2 million and casualty companies of $2.4 million. There are no RBC requirements for captives in statute, but the department does analyze the RBC of captives and utilizes it to determine any necessary infusion of capital from the parent. Even though there are no RBC requirements, for the most part, Missouri captives have high RBCs. Whenever the captive requests dividends, the department takes RBC into consideration and typically does not approve dividends if it would decrease RBC below 350%, which is typically addressed in the licensing order. With regards to assets, they can be in any form that is acceptable for a traditional company, but may also include letters of credit (LOCs), AAA-rated surety bonds and financial guaranty policies for the benefit of the ceding company. LOCs are only approved from a qualified U.S. financial institution and must be clean, irrevocable, contain an evergreen clause and must meet the LOC requirements for credit life reinsurance. If there is a draw-down on the LOC, there is an agreement in place that requires the parent to pay back the bank immediately. The captives file using statutory accounting, which allows the department to use the RBC as a guide to the adequacy of their capital levels. Whenever the captive files their original business plan, the department and a third-party actuary assess the plan and thoroughly review the application, including the business plan agreements and actuarial information, to ensure that the captive has adequate capital to meet liquidity needs for unexpected adverse scenarios, as well as having access to additional capital if needed. Any type of issues the department may have is included in the licensing order. When the department performs examinations, they also have the actuaries review the reserves.

Mr. Slape asked whether the LOC has any sort of parental guarantee to the bank. Mr. Heese said that if there is a draw-down on the LOC, there is an agreement that the parent will immediately pay back the bank. Mr. Wake said that a prudent bank will require collateral for the LOC, but it is the unconditional commitment of the bank. Superintendent Torti said that what is important is that the LOC is unconditional and contains an evergreen clause, but it could also increase the cost of the transaction significantly.

Mr. Wake provided a summary of Maine's capitalization requirements. He said that Maine has both SPV and captive laws. Maine has not seen the captive law used for sidecar arrangements, although the captive law could certainly be used for fronting arrangements. Under Maine's SPV law, the exposure is limited by the securitization and the capital only has to be sufficient to the defined limits of the contract, which follows the NAIC's *Special Purpose Reinsurance Vehicle Model Act* (#789). Under Maine's captive law, the captive has the ability to use an irrevocable LOC for capitalization on the assumption that the captive is a self-insurance vehicle for the policyholder. There are some special requirements for association health insurance captives, which are required to operate under several joint liabilities; they do not assume reinsurance. Association or industrial insured captives are required to report using statutory accounting principles (SAP), although the association filings are confidential. Other captives report using generally accepted accounting principles (GAAP). Filings are annual but, at the discretion of the superintendent, quarterly reports are sometimes required.

Mr. Provost said that Vermont has seen examples where certain restrictions were placed on the LOC, such as making the LOC the last available funds before a draw-down can be initiated. In Vermont, there is a LOC reimbursement requirement as part of the application process.

Superintendent Torti asked whether, in situations where the bank is relying on the parent to guarantee reimbursement of the LOC draw-down, the banks are relying on the creditworthiness of the parent or whether there are some other financial vehicles that are being utilized. According to Ms. Jones, banks generally rely on the credit of the holding company when issuing an LOC. She said that there are also specific collateralization requirements, such that if the company's credit rating

decreases then it might have to post specific collateral at the bank. Mr. Provost said that the bank is really relying on the credit of the group, which will affect the level of collateral that is required.

Mr. Slape provided a summary of Texas' capitalization requirements. He said that the Texas Legislature recently passed a limited purpose licensed subsidiary that is limited to just life insurance products. Under this license, excess reserves can be ceded to the limited purpose licensed subsidiary. As of today, there has been no formation of any such vehicles. However, in comparison, the minimum capital requirement for traditional life company is $1.4 million, they must maintain RBC and they are held to traditional investment requirements. As for the limited purpose licensed subsidiary, the minimum capital requirement is $10 million, they must maintain an RBC of 300% or higher and they are generally held to the same assets/investment standards of a traditional company, although the subsidiary can break out the excess reserves between what is SAP and GAAP and can back the excess SAAP reserves by other than traditional assets, including LOCs, reinsurance and parental guarantees (limited to companies with $100 million capital and the capital must meet or exceed the amount of the guarantee).

Mr. Provost provided a summary of Vermont's capitalization requirements. He said that Vermont's standards are similar to those in Missouri and Texas. Any investments in the captive are typically held or managed by the parent. The only unusual asset allowed is an LOC, which is included in the licensing order as a perscribed practice. The minimum capital requirement for captives is $250,000, although most Vermont captives have significantly higher capital. Vermont requires the special purpose financial captives to file on a SAP basis using the annual statement blank for life, accident and health insurers, and also requires a full RBC calculation. Mr. Provost said they would not allow a line of credit as an asset or capital. He said the LOC is a prescribed practice because it is in the Vermont statutes. He said most captives report on CAAP basis but the special purpose financial captives (SPFC) owned by insurance companies report on SAP basis so that they can consolidate easily and so that they can report RBC. He said all but two Vermont captives owned by insurers are SPFCs. Those two captives are pure captives because they do not have securitizations or LOCs. Mr. Ballard asked if Vermont captives report quarterly in additional to annually. Mr. Provost responded that they only report on an annual basis.

Mr. Coy asked about the type of review Vermont completes on the banks that hold the LOCs and whether Vermont has ever had to deal with a troubled bank. Mr. Provost said that, with SPVs, the LOCs tend to be with bigger banks, but for all other captives with much smaller LOCs, the department monitors the stability of the bank. Mr. Wake said Maine monitors the bank by communicating with the Bureau of Financial Institutions to track the bank's ratings. Mr. Provost said Vermont conducts the same type of review and does an annual analysis of public banks using publicly available information. Mr. Slape asked if there is any relationship with the federal banking regulators. Mr. Provost and Mr. Wake said they do not have that communication with the federal regulators. Mr. Coy said that they had a captive that was technically insolvent and no notice of the bank failure was given to the department until after the fact. However, he said that the federal regulators and FDIC gave the state unofficial priority in trying to resolve the status of the LOC. NAIC staff indicated that the NAIC is working with the FDIC to identify if, at any time since the financial crisis, an LOC was not paid or honored.

Mr. Schlesinger provided a summary of New Jersey's capitalization requirements. He said that New Jersey's requirements are similar to the other states that have spoken. New Jersey's minimum capital requirement is $250,000 for captives, compared to $9.7 million for traditional licensed companies. At present, there is no RBC requirement. Captives are required to report on a GAAP basis. The requirements for investments are the same as that for a traditional company, except they also allow LOCs. He said New Jersey currently has four captives. Mr. Talley said they have had similar situation where the LOC had guarantees of the parent.

Mr. Elliott provided a summary of Utah's capitalization requirements. He said that Utah's requirements are similar to those in Missouri and Vermont. Utah only has one special purpose financial captive, which has an LOC with a similar structure requirement as Missouri. The captive has more freedom in investment options, but the department does have the ability to get back the investment restrictions if necessary. SPVs report on a SAP basis, but they can file on a GAAP basis.

Mr. O'Donnell provided a summary of the District of Columbia's capitalization requirements. He said that the requirements are similar to the other states that have spoken. Traditional insurers and stock property/casualty companies have a minimum capital requirement of $600,000. For mutual or reciprocal traditional companies, the minimum capital requirement is $300,000. Pure captives and special purpose financial captives have a minimum capital requirement of $250,000, while it is $400,000 for most other captives (agency, association, etc.). For mutual or reciprocal captive companies, the minimum capital requirement is $500,000. The law requires cash or LOC for the minimum capital. The NAIC's *Investments of Insurers Model Act* (#280) does not apply to captives, but there are specific guidelines for special purpose financial captives in the state's SPFC laws.

Mr. Sumner provided a summary of Hawaii's capitalization requirements. He said that Hawaii allows pure captives to get a strategic investment policy put in place; assets are dictated by the collateral to the LOC or to the trusts that are involved, which are sometimes more restrictive than the state's laws. There are no minimum capital requirements instead the required capital requirement is applied to the transaction. The transactions are generally very large.

Mr. Mathews said Montana does not have any SPVs. Montana is not different from other states that have spoken.

Ms. Sizemore provided a summary of Delaware's capitalization requirements. She said the minimum capital requirement for a captive is $250,000 for most captives, which can include a LOC. For an industrial captive it is higher and varies. The investments for special purpose captives, association captives and risk retention groups (RRGs) must comply with the investment codes for traditional companies, but there are also parts of the code that allow for the approval of the commissioner upon application. The pure captives, industrial captives and agency captives are not held to the investment codes and may have different investments. GAAP is required for captives, but they can elect to file on a SAP basis. There are no RBC requirements, but the state may require RBC upon application. Delaware can require on application a quarterly or statutory filing.

Mr. Slape said that some of the key takeaways from the call include that there are clearly some inconsistencies amongst the states that the Subgroup might want to study more in future calls.

Mr. Heese said that if the regulatory community can get comfortable with the use of LOCs, then it seems that the capitalization is pretty safe. Mr. Provost agreed and said that has been the approach of companies Vermont has dealt with and that it has been pretty conservative in nature, as the companies are concerned with their reputations in the marketplace.

Superintendent Torti pointed out that there is a difference from traditional insurers in that LOCs are not allowed and he does not feel that regulators should get too comfortable in allowing LOCs as a form of capital. Mr. Heese said LOCs are allowed for unauthorized reinsurer.

Mr. Provost said that there are different scenarios in determining the beneficiary of the LOC. In the typical pure captive scenario, the LOC is to the beneficiary of the commissioner, which is allowed as an asset and capital; in the typical special purpose transaction, the LOC is to the beneficiary of the ceding company and has a permitted practice to be included as an asset on the reinsurer's books. Mr. Heese said this was the same in Missouri. Mr. O'Donnell said in District of Columbia it is the same. Commissioner Weldin-Stuart said it is the same in Delaware.

Ms. Jones said South Carolina would normally require the LOC be for the benefit of the director. In one transaction, the captive set up a trust that owns the LOC and the beneficiary of the trust is the ceding company.

Mr. Wake said that captives that do not hold a license are really more like an unauthorized insurer. He said Maine captive law expressly allows an LOC but the SPV law does not. It may be acceptable as a permitted practice.

Mr. Slape asked if captive companies have tried to use assets other than LOCs. Mr. Coy said in Kentucky mutual companies can use surplus notes. Mr. Provost, Ms. Sizemore and Mr. Heese said surplus notes are allowed in Vermont, Delaware and Missouri.

Superintendent Torti said that in the outline of the White Paper, the Subgroup should include a definition of captive, considering that different states define these entities differently.

2. Next Conference Call

The next public call is scheduled for May 24.

Having no further business, the Captive and Special Purpose Vehicle (SPV) Use (E) Subgroup adjourned.

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Draft: 7/31/12

Captive and Special Purpose Vehicle (SPV) Use (E) Subgroup
Conference Call
April 19, 2012

The Captive and Special Purpose Vehicle (SPV) Use (E) Subgroup of the Financial Condition (E) Committee met via conference call April 19, 2012. The following Subgroup members participated: Doug Slape, Chair (TX); Judy Weaver (MI); Fred Heese (MO); Richard Schlesinger (NJ); Leslie Jones (SC) and David Provost (VT). Also participating were: Kurt Regner (AZ); Steve Kinion (DE); Robert Ballard (FL); Bob Wake (ME); Frank Stone (OK); Dale Bruggeman (OH); Russell Latham (OR); and Joseph Torti III (RI).

1. Review Additional Responses to Regulator Survey

Jane Koenigsman (NAIC) provided a summary of the four additional responses to the regulator request for comment. Ms. Koenigsman indicated that one of the responses was essentially not applicable across-the-board, while the other three responses were in line with the majority of responses previously discussed.

2. Discuss Types of Business and Risks

Mr. Slape said that as it that pertains to the types of business and risks, in the regulator survey some of the states identified specific types of business that the respective state's captive laws do not allow captives/special purpose vehicles (SPVs) to assume as third-party risks, and other states indicated that their respective captive laws limit the transfer of third-party risk to specific types of business. Mr. Slape asked the states participating on the call to discuss the types of business outside of products with "XXX reserves" (i.e., reserves based on the NAIC's *Valuation of Life Insurance Policies Model Regulation* (#830), which is commonly referred to as "Regulation XXX") that their state does or does not allow for the transfer of third-party risks to captives and SPVs.

Mr. Bruggeman described an example in Ohio where car dealers set up captive insurers that, in addition to providing auto warranty and mechanical breakdown coverage, also provide credit life and credit accident and health products. Mr. Bruggeman said Ohio does not have a captive law; instead, this is an example of an Ohio domestic utilizing another state's captive or offshore captive. Superintendent Torti asked if in this transaction it is an insurer that is underwriting the credit life business that is ceded to the captive. Mr. Bruggeman said the dealership owns the captive but that these captive may or may not be 100% owned by the car dealership. Mr. Wake asked if this type of transaction would be considered reverse fronting. He said that a lot of what captives are used for is to reinsure fronted coverage back to the policyholder that has a stake in the captive. Mr. Bruggeman stated that the use of a captive in this sense is an ease in accounting method, so that the fully licensed company could cede to a captive and that the captive that is owned by the insurance group could split the business out amongst the dealer-owned captives. Mr. Wake said that these dealer-owned programs are a method of sending the risk back to the dealer, but that another common use of captives in this context is to allow a sophisticated insured to go out and buy on the unregulated reinsurance market, while the paper actually goes to the licensed carrier.

Mr. Kinion said that during his tenure in Oklahoma, it was typical for auto dealers to form offshore captives to reinsurer their own book of credit business. This appears to be an agency captive arrangement.

Mr. Provost indicated that this example might be outside the scope of the study, given that the captives are not owned by the insurance companies. Mr. Heese and Mr. Schlesinger both agreed these auto dealer transactions are outside the scope of the Subgroup.

David Vacca (NAIC) said the scope of the Subgroup is insurer's use of captives, and does not limit it to insurer owned captives. Mr. Slape agreed that the Subgroup's charge does not specifically limit its discussion to affiliated captives. Ms. Koenigsman read the Subgroup's charge:

> *Study insurers' use of captives and special purpose vehicles 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. The appropriate regulatory requirements may involve modifications to existing NAIC model laws and/or generation of a new NAIC model law.*

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Mr. Provost said that, based on the Subgroup's charge, an insurer acting as a front is not using a captive; it is reinsurance, and the captive is providing reinsurance to the front company. He said that the key focus was to look at insurers owning their own captives to transfer books of business out of the insurance company to their own captive subsidiaries. Mr. Wake said that it has to go beyond literal ownership because, for example, if an SPV is organized under the NAIC's *Special Purpose Reinsurance Model Act* (#789), there are tax reasons why the owner is a separate party to the transaction, but the insurer is certainly sponsoring the captive but doesn't have legal ownership of the captive.

Mr. Slape suggested making note of these types of uses of captives and to highlight in the final work product that there are other types of captives. Superintendent Torti said that he is not opposed to this plan, but he believes the reason for the Subgroup's study is because of the non-traditional use of a captive to provide reinsurance. For example, a workers compensation carrier who fronts business so an employer could self-insure its workers compensation risk. Traditionally the company would front the business and it would be 100% ceded to a captive owned 100% by that employer. This was the traditional use of the reinsurance in the captive statutes. He said he would suggest we be aware of any twists on these transactions. Mr. Slape agreed and said that, as the Subgroup's study moves forward, if Subgroup members think these might be outside of the scope to bring it to the attention of all members.

Mr. Provost said that the only life, non-XXX reserves transaction in Vermont involved variable annuities, the associated with guaranteed minimum death benefits and minimum withdrawal benefit riders.

Mr. Stone said that Oklahoma had a medical malpractice company create a captive, made a change in all of their policies from an incurred to claims-made basis and ceded all of their incurred reserves, which helped their RBC. It was a special purpose vehicle.

Mr. Regner provided an example in Arizona, where a life company with a guaranteed living benefits rider on a variable annuity product ceded from the domestic insurer to their affiliated captive.

Ms. Jones said South Carolina has a captive that has a variety of life business, including whole life. This is a securitization transaction.

Mr. Heese said that with any of these products mentioned, and whether they are allowed to be transferred to captives or not, it depends on several factors, including whether they meet the credit for reinsurance requirements, funds held or secured by letters of credit, etc. Without getting too deep into the transactions, it is difficult to determine if there are potential issues.

Mr. Provost said that Vermont only had one casualty business that ceded mortgage guaranty to an affiliated captive.

Mr. Latham said Oregon just recently passed their captive law, but currently do not have any licensed captives.

Mr. Ballard said Florida has a captive law but it does not have any licensed captive. He said there is proposed legislation that will widen the current law.

3. Next Conference Call

The next public call is scheduled for May 3.

Having no further business, the Captive and Special Purpose Vehicle (SPV) Use (E) Subgroup adjourned.

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Draft: 7/31/12

Captive and Special Purpose Vehicle (SPV) Use (E) Subgroup
Conference Call
April 5, 2012

The Captive and Special Purpose Vehicle (SPV) Use (E) Subgroup of the Financial Condition (E) Committee met via conference call April 5, 2012. The following Subgroup members participated: Doug Slape, Chair (TX); Judy Weaver (MI); Fred Heese (MO); Richard Schlesinger (NJ); William Carmello (NY); Leslie Jones (SC); and David Provost (VT). Also participating were: Dana Sheppard (DC); Jim Armstrong (IA); Mike Lynch (NV); Joseph Torti III (RI); and Ross Elliott (UT).

1. Discuss the States' Transparency and Confidentiality Requirements

Mr. Sheppard summarized the District of Columbia's transparency and confidentiality requirements, whereby it openly shares all information regarding captives with any other state regulator under the confidentiality agreement. In terms of sharing with the public, Mr. Sheppard said that the District of Columbia does not share any information.

Mr. Slape asked whether the District of Columbia has had any conversations regarding any changes to its captive laws, especially regarding any captives or special purpose vehicles (SPVs) that may be taking on first- or third-party risks outside the traditional pure captive role. Mr. Sheppard said that there are no pending changes to the laws.

Mr. Slape asked if any captives or SPVs in the District of Columbia have NAIC company codes. Mr. Sheppard indicated that the department does not believe that it has legal authority to require captives or SPVs to report any information to the NAIC. However, the District of Columbia did provide a list of all of its domiciliary captives and SPVs, along with contact information, to the NAIC. Mr. Slape asked, to the extent that the transaction involves transferring "XXX reserves" (i.e., reserves based on the NAIC's *Valuation of Life Insurance Policies Model Regulation* (#830), which is commonly referred to as "Regulation XXX"), what is the logic in keeping that type of transaction confidential. Mr. Sheppard said that, in that context, the information would not be confidential from the perspective of sharing with other states. He further stated that the department would direct public inquiries regarding these types of transactions to the ceded company's domiciliary regulator.

Superintendent Torti asked Mr. Sheppard to distinguish between a traditional reinsurer assuming third-party risk with publicly available information and a captive that assumes third-party risks that does not file public information, such as the annual statement blank for life, accident and health insurers. He asked what makes this business captive business versus traditional reinsurance. Mr. Sheppard said that, in terms of risk transfer, there are no significant differences; however, if the company is licensed as a captive, then the transparency policy is different. Superintendent Torti said that these differences seem to blur the line between a captive and a traditional reinsurer. It creates a problem when other regulators have difficulty getting information on these captive companies that may be viewed as a traditional reinsurer. Mr. Sheppard said that, when it comes to sharing information, there is a whole new set of issues, such as the reporting conventions. In the District of Columbia, captives that are not risk retention groups (RRGs) do not file an annual statement blank. Mr. Sheppard also said if the discussion moves to filing with the NAIC, then the discussion leads to annual statement blanks, which in term will lead to a discussion of generally accepted accounting principles (GAAP) vs. statutory accounting principles (SAP) reporting, RBC, etc.

Mr. Armstrong summarized Iowa's transparency and confidentiality requirements, indicating that captives are treated the same as traditional companies, in that the information is public and they file the traditional annual statement blank for life, accident and health insurers. Mr. Slape asked whether captives file with the NAIC. Mr. Armstrong said that they do not make any single state company filing with the NAIC. Superintendent Torti inquired about what types of companies are defined as captives in Iowa. Mr. Armstrong indicated that they are called "limited purpose life subsidiaries."

Mr. Lynch summarized Nevada's transparency and confidentiality requirements, and said that Nevada's program mirrors the District of Columbia's program. Hypothetically, Mr. Lynch said, Nevada would share all information with other state regulators, but would hold that the information is confidentiality and not shared with the public. SPVs in Nevada would not be required to file with the NAIC. He said Nevada does not have any licensed single parent pure captives assuming third party risk such as life business. He said there is no provision for that kind of coverage in Nevada statutes. Hypothetically, Nevada would not be able to license them for that type of business without an amendment to statutes.

Ms. Jones said that South Carolina's requirements are similar to the District of Columbia's requirements. The only caveat is that South Carolina has one life reinsurance special purpose captive, while the rest are licensed as special purpose financial captives (SPFCs). Ms. Jones said that South Carolina's legislation for SPFCs specifically includes a requirement that the state can disclose information to the securities commissioner. The SPFC legislation was developed by combining the NAIC's *Special Purpose Reinsurance Vehicle Model Act* (#789) and South Carolina's captive statutes. South Carolina has not licensed any special purpose reinsurance vehicles, but there are no specific confidentiality provisions for those types of vehicles; the confidentiality standards would be the same as for a traditional insurer. South Carolina can share information with other state regulators and can share with any other party, including the NAIC, with written consent from the captive; otherwise, the information is considered confidential. Superintendent Torti asked why South Carolina uses the SPFC. Ms. Jones said the special purpose reinsurance vehicle was specifically targeted at catastrophe type business and it didn't fit the model for a life reinsurer. She said South Carolina had a special purpose captive (SPC) under the captive statutes. She said subsequent to their first SPC transaction, the state then combined Model #789 with the provisions of the captive statutes. Superintendent Torti said special purpose vehicles generally require securitizations. He asked if South Carolina's statutes require securitizations. Ms. Jones said it requires the captives to be established for the limited purpose of accessing alternative sources of capital. It was originally contemplated this would be a securitization transaction.

Mr. Elliott said that Utah has two chapters in its code dealing with traditional pure captives and SPFCs. Utah has two licensed SPFCs. Mr. Elliott said that Utah's SPFC code is based on its Captive Insurance Companies Act, which refers to Utah's Government Records Access and Management Act in regard to confidentiality. Specifically for captives, all of the application documents, examinations documents, etc., are considered protected. In terms of sharing, other states are granted access if there is a legitimate reason for the request and if the requesting state allows for the documents to be maintained confidentially. Mr. Elliott said that other entities can request access to the records, which could require the state getting permission from the insurer before granting access. Utah has provided the NAIC with the names of the captive companies and their respective contact information so that an NAIC company code could be issued.

Mr. Provost summarized Vermont's transparency and confidentiality requirements, which allows for the state to share information with other state regulators provided that the requesting states keep the information confidential. Vermont generally does not provide any information to the public, other than to acknowledge the existence of the captive, the parent company and the manager. A list of all captives is provided to the NAIC, whereby the NAIC assigns the captives with company codes. Vermont communicates with the ceding state regulator when licensing a special purpose captive. Mr. Provost indicated that part of the justification in keeping the information confidential is that, in many cases, the SPV is a single transaction; thus, if the financial statements of the captive are made public, then management fees, and letter of credit fees can very accurately be determined. This information is proprietary.

Mr. Provost said that Vermont is looking at changing the confidentiality provisions for these types of captives in order to make it easier to share with other regulators. Mr. Heese asked whether Vermont's proposed change to confidentiality provisions is to make it easier for other regulators or to make certain information public. Mr. Provost said that the change would be to the benefit of other regulators when the parent company is a regulated entity, but the state will also look at what, if anything, should be made public.

Superintendent Torti asked Vermont to discuss the differences between a traditional company and a captive, and how the state goes about distinguishing those differences. Mr. Provost said that there is a separate statute for SPFCs that specifically states that the agreement between the ceding insurance company and the captive is for a specific purpose, which is a single financing transaction. Mr. Provost also said that for other captives reinsuring third-party risks, Vermont requires that the parent companies have management control over the business assumed by the captives. Vermont said an example is that a grocery store change hired an independently owned trucking company. Ninety percent of the trucking company's business was to deliver goods to the grocery store's goods, they followed the store's risk management and if the grocery store were to fail, the trucking company would be severely impacted. He said Vermont calls this type of relationship controlled unaffiliated third-party business. The control and risk management exists.

Mr. Slape summarized the key takeaways from the call and posed the question to Subgroup members as to whether there needs to be greater consistency amongst the states on transparency and confidentiality requirements. He said that, based on the states that shared their respective transparency and confidentiality requirements on this call, it appears that, for the most part, the states are able to openly share information with other state regulators. He said there may be examples where there are limits.

Mr. Sheppard said that he has not heard any state give examples of any compelling reason why the general public would want to have information on captives. He further asked that, if all of the states could get to a point to openly share information with other states, and perhaps the NAIC, then is there a reason to go beyond that with regard to the general public. Mr. Slape said that this may be something the Subgroup should consider discussing.

Superintendent Torti suggested taking a different perspective, in that as a government agency, the way we approach public access is that everything that is filed as public, unless there is specific statutory authority to maintain confidentiality. Superintendent Torti said that the specific statutory authority is there for a specific reason and suggested approaching the questions from the perspective of why should the information not be public. Mr. Provost said that looking at ceding companies' publicly available annual financial statement clearly indicates that these companies cede business to companies in other states/jurisdictions, although the report does not include the level of detail that would give away proprietary information. Mr. Heese asked what information should be disclosed that is not being disclosed.

Ms. Weaver said that a takeaway from the call is that it appears most captive states that discussed their respective confidentiality and transparency laws can share information with other state regulators, which appears to be the best approach.

David Vacca (NAIC) asked if states can share with regulators who are not the ceding company domestic regulator, such as the other states where the ceding company is licensed or the Financial Analysis (E) Working Group. Ms. Weaver said licensed states have the capability to get the information from the ceding domestic regulator but the captive states may not be able to share openly with the NAIC.

Mr. Heese suggested the Subgroup needs to develop a baseline regarding what is the adequate amount of information the captive states can share and to what extent this could be made uniform.

Mr. Vacca said with regard to captives having NAIC cocodes the purpose would be to allow regulators to have a list of the companies that exist so that states can be responsive to the Federal Insurance Office and other international regulators. Mr. Slape asked if there is a need to centralize basic information at the NAIC. Superintendent Torti said it depends on what the Subgroup concludes on the need for any public information. Mr. Provost said there may be need for basic information about the transaction in the Notes to the Financials, without disclosing any proprietary details. Mr. Slape agreed that high level information may be enough.

2. Next Conference Call

The next conference call is scheduled for April 19, 2012.

Having no further business, the Captives and Special Purpose Vehicle (SPV) Use (E) Subgroup adjourned.

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