The Use of Captives and the Regulatory Challenges Explored at CIPR Event

By Dimitris Karapiperis, CIPR Research Analyst

◆ INTRODUCTION

Captive insurance companies have been in existence for more than 100 years. However, over the past 30 years, there has been significant growth in the captive market. Today, there are almost 7,000 captives globally, compared to roughly 1,000 in 1980. Although, historically, captives were used by a variety of businesses to self-insure risks, their use has expanded significantly in recent years to include life insurer-owned captives used for reserve financing. While increased regulatory scrutiny of captive arrangements has added transparency and minimized risks, the use of captives, particularly by life insurers, is still a critical issue among state insurance regulators.

The NAIC Center for Insurance Policy and Research (CIPR) hosted an event on the regulation of captives in collaboration with The Griffith Insurance Education Foundation during the NAIC Fall National Meeting in November 2015. The event, which broke a CIPR attendance record with about 450 attendees, was designed to educate, as well as promote debate, among regulators and the industry on the use and regulation of captives.

A dynamic group of presenters and panelists was assembled to take a closer look from all sides at the benefits and challenges of using captives to determine how their use impacts the insurance industry, as well as consumers. The goal of this event, aside from its educational purpose, was to gauge the progress made in the regulation of captives and to help identify any remaining captive concerns that may still need to be addressed.

Director John M. Huff (MO) hosted the event and provided the opening remarks. “Insurers’ use of captive reinsurance transactions has grown considerably over the last several years… [and] states have enacted legislation to encourage captive formations and redomestications,” he told the audience, adding “in response to concerns related to the use of captive reinsurance, the NAIC began studying the use of captive reinsurance by life insurers in 2012” to find the most appropriate regulatory solutions.

◆ SESSION 1: THE EVOLUTION OF CAPTIVES

Director Huff introduced Robert E. Hoyt (University of Georgia), who presented on the evolution of captives to provide a better understanding of how they emerged 350 years ago and gradually morphed into the modern captives seen today. Mr. Hoyt traced the origin of captives to the 17th century, when shipping owners met in Lloyd’s coffee shop in London to figure out how best to pool their resources in order to insure their ships and manage their own risks.

Building on the early history, Mr. Hoyt explained how the term “captive insurance” was actually coined in 1955 by Frederic Reiss, a property-protection engineer in Youngstown, OH, when he helped Youngstown Sheet & Tube Company incorporate its insurance subsidiaries under the name Steel Insurance Company of America to insure its mines, whose output was put solely to the company’s use. Mr. Reiss can also be credited, according to Mr. Hoyt, with creating offshore captives for tax reasons when he moved his operations to tax-exempt Bermuda right after the passage of the federal Tax Reform Act in 1962, which eliminated the tax benefits of captive arrangements for U.S. companies.

Along with the historical exploration, Mr. Hoyt asked the audience to reflect on how the use of modern captives fits into the overall risk-management process. He shared his views on alternative risk transfer; i.e., alternatives to traditional insurance, with captives being a special case of that. Captive insurance is an important alternative risk tool and represents a sizeable share of the overall alternative risk transfer market. Mr. Hoyt also helped lay the foundation for the subsequent panel discussion by sharing some basic definitions of captives. He noted, ultimately, at the core of what essentially a captive represents is the establishment of “a subsidiary owned by one or more parent companies to primarily insure the exposures of its owner(s).” In the risk-management context, Mr. Hoyt added, captives combine risk retention and risk financing. The core benefits of establishing a captive were also introduced to provide the audience with an understanding of what motivates companies to form captives: 1) broader coverage; 2) pricing stability and availability; 3) direct access to reinsurance; 4) improved cash flow; 5) increased control over the program; and 6) structure and discipline.

Historically, there have been some key enabling legislative acts that proved seminal in the formation and growth of captives in the modern period; in particular, Bermuda's Insurance Act of 1978 and Vermont's captive law of 1981. Mr. Hoyt argued while these two laws were the most influential in the captives market, there are a number of early state captive laws—such as Colorado (1972), Tennessee (1978) and Virginia (1980)—that represent some of the earlier attempts to kick-start the market, despite the fact the numbers of domiciled captives in those jurisdictions stayed relatively small. He also pointed to IRS tax rulings regarding captives as a driving force behind the formation of captives and the choice of domicile, particularly explaining the attraction of offshore jurisdictions and the more recent movement back to the U.S. as onshore jurisdictions became more appealing.

To provide a historical perspective in the global growth of captives, Mr. Hoyt showed how the total number of captives increased from a little more than 1,000 in 1982 to almost 7,000 in 2014. He specifically highlighted that during hard insurance markets (i.e., periods with generally high premiums), the usefulness of captives as alternatives to traditional insurance tends to become more important, which immediately leads to a noticeably faster rate of increase in captive formation. Also, he pointed to a deceleration in captive formation after the financial crisis in 2008.

To conclude his presentation, Mr. Hoyt briefly discussed some of the more common applications of captives, other than more prevalent general property and casualty coverage, such as directors and officers, professional (medical) liability, cyber, workers' compensation and terrorism insurance. The proliferation of microcaptives[1], mainly formed for tax reasons, was also noted as well as the recent development of long-term care captives. Because a good part of the event agenda was dedicated to issues related to the use of captives by life insurance companies for reserve financing purposes, Mr. Hoyt introduced captive reinsurance. He briefly talked about the main motivation and justification behind the formation of life insurance captives, namely the difference between the statutory reserves and the economic reserves as calculated by the life insurers for certain term and universal life policies.

◆ Session 2: Regulatory and Market Developments in Captives

This panel discussion explored the impact of insurer-owned captives on the insurance market and the regulatory response to the use of captives by insurance companies. The discussion was moderated by Commissioner Ted Nickel (WI) and included the following panelists: David Provost (VT); William Pargeans (A.M. Best); Alan Routhenstein (Milliman); and Neil Rector (Rector & Associates).

Mr. Provost opened the panel discussion, responding to Commissioner Nickel's first question regarding the origins of life insurer-owned captives. Mr. Provost recounted the history of life insurance captives, highlighting major milestones such as the passage of Regulation XXX[2] in 2001, which led to the issue of excessive or redundant reserves, as seen by a number of life insurers. In order to finance these extra reserves, insurers turned to captive reinsurance. It was the conservatism of the statutory reserves, which were often four or five times higher than companies' own economic reserves, that motivated many life companies to form captives. Mr. Provost explained how "companies seeking capital relief used securitization techniques and formed captives for reserve financing, initially going offshore and then working their way back onshore to such domiciles as South Carolina, Vermont, District of Columbia and a few others, to where we are now."

In addition to the fact there was, in some cases, an issue of redundancy with reserves, term life was an ideal

---

[1] Used to describe captives formed under Section831(b) of the Internal Revenue Code. Also referred to in 831(b) captives.

[2] 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).

product to securitize due to the cash flow predictability, Mr. Routhenstein explained. “It was easier compared to other life products to structure a transaction with predictable cash flows to investors,” he added. The chief financial officers (CFOs) of life insurance groups have historically used holding company issuance of debt and equity, as well as hybrid financing, as capital management tools to balance the competing interests of various stakeholders, namely policyholders, shareholders and debtholders. Faced with the Regulation XXX challenge and realizing their risk-based capital (RBC) ratios were going to decline with time, Mr. Routhenstein added, captives were considered as a new form of hybrid financing.

Concurring with the earlier comments made, Mr. Pargeans talked about how, throughout his career, he has witnessed firsthand the evolution of captives. Earlier on, the risks were passed on to the capital markets via securitization, he said. In 2000, life insurers had to convince investors to assume tail mortality risk. Although this is a remote risk with only little chance investors would not get paid on the securities backed by XXX reserves, it took time for the capital markets to embrace life insurance securitization. It was then, according to Mr. Pargeans, that captives started to gain more traction as a solution.

Commissioner Nickel directed the discussion back to Mr. Provost as the regulator in charge of captive regulation in one of the major U.S. captive domiciles and asked how life insurance captives were first presented to him, how he determined if a captive structure made sense and what interactions he had with the ceding companies. “Most of the transactions, by the time I got involved as a regulator,” Mr. Provost said, “involved providing relief by the use of a letter of credit (LOC).” The ceding companies would either have funds withheld or other balances to support the economic reserves, plus a cushion and a LOC in a captive to cover the excess. This was pretty straightforward. Then he explained how the Vermont regulators insisted on simple illustrations of the transactions rather than overly complicated and hard-to-follow charts. “If I cannot explain it to my mother, it is not happening in Vermont,” Mr. Provost added, to the amusement of the audience. “That was the ‘Mom Rule’ we established in Vermont,” he continued, “if you cannot explain it, you do not understand it,” as Einstein had famously said.
A nice straight line from the ceding company to the captive to the risk-taker was required, Mr. Provost emphasized. A clear and straightforward illustration so it could be easily reviewed by attorney at the Vermont Insurance Division. It is important, he added, that everybody involved—ceding company regulators, captive regulators and rating agencies—have the same information and share the same understanding of how each transaction is supposed to work.

Discussions with the ceding company would be about the regulatory process and what is required by regulators in Vermont. The review process is explained, along with the surveillance and examinations, and how it is critical to ensure the LOC (or whatever the financing) is a good, solid asset. Also, where the line between economic reserves and excess reserves is drawn is important, Mr. Provost added, to understand where insurers hold cash and invested assets and where alternative assets are used to support the reserves. “Our own independent actuaries would review and make sure they are comfortable with the company’s assumptions and where that line is drawn,” Mr. Provost concluded.

As rating agencies were, from early on, one of the key players reviewing captive reinsurance transactions, Commissioner Nickel turned to Mr. Pargeans to address how A.M. Best viewed reserve financing through captive reinsurers. The rating agency point of view, Mr. Pargeans said, regards the captive financing solution as a reasonable mechanism for financing redundant reserves and managing the excess capital in an efficient manner. At the same time, the use of captives really exploded over the past decade to an estimated $100 billion to $150 billion of reserves funded, according to Mr. Pargeans. About 60% of that is universal life, while variable annuity (VA) business is relatively small in terms of reserves and as a percentage of total use of captives.

Responding to questions of transparency surrounding captives, Mr. Pargeans explained rating agencies enjoy an advantage because the captive statements are voluntarily filed with them. The information is proprietary and kept confidential. Mr. Rector noted while there was sufficient disclosure between the companies involved in the transactions and the rating agencies, the main challenge for regulators regarding transparency has been the lack of communication between regulators. “That secrecy fed the rumor mill like crazy,” he stated.

Some states were not allowing any captive finance transactions, other states were choosing to allow them in a conservative way, while a few states were far more permissive with allowing companies to use captives more aggressively, Mr. Rector explained. Because it was all surrounded by a veil of secrecy, no one outside the company and its rating agency knew about what was being done. As a result, many regulators were concerned there could be solvency issues with some of the companies engaged in these types of transactions. Other companies would claim their competitors were gaining a competitive advantage by using captives aggressively. They would argue with their regulators, Mr. Rector said, about the need to form a captive due to the competitive pressures, which may create financial difficulties regulators would have to deal with. Hence, companies would conclude, Mr. Rector added, the best course of action under the circumstances would be to follow the market pressure and do a captive finance transaction.

It became obvious, according to Mr. Rector, what was needed was to ensure transparency, not only between companies and rating agencies, but also between companies and regulators and, even more important, between regulators.

To Commissioner Nickel's question of how companies' financial risks are evaluated when they use captives and if, ultimately, all XXX/AXXX[3] solutions were viewed equally, Mr. Pargeans replied that ceding reserves to a captive is just reinsurance and not simply the company passing off the risk. It is essentially a financing mechanism, Mr. Pargeans added. He explained if mortality worsens significantly in excess of the reserves, the company still has to pay the policyholders. It may be a third party providing an LOC, but in none of these transactions is the risk passed off, he stated.

Rating agencies, Mr. Routhenstein added, evaluate the financial risk of companies ceding risk to captive reinsurers using their own proprietary rating methodology, balancing accuracy with simplicity. They often reach different conclusions about the relative advantages and disadvantages of different forms of transactions. Regulators, whether captive regulators or ceding company regulators, Mr. Routhenstein said, are not always in agreement, having expressed different views on what forms of financing they are comfortable approving and what forms they are not.

Mr. Pargeans argued rating agencies do not view all captive transactions equally. Furthermore, because rating agencies have full access to data, he added, they look at all the risks and the capitalization and can fully evaluate the company as if the captive never existed.

Mr. Provost noted regulators often ask similar questions, evaluating how the ceding company would look when the captive is taken out of the picture. The usual answer by the company, he added, is this is not a good comparison because the company, if it were not using a captive, would be using some other type of special purpose vehicle. Mr. Provost explained, when regulators look at the financial risk of a captive, it is to make sure that if the ceding company is on the hook, the captive is sound and there is no way to escape responsibility, no matter who is providing the financing.

Commissioner Nickel turned to Mr. Rector, asking him to discuss Rector & Associates' report[4] on captive reinsurance and how they arrived at their recommendations. Stated simply, Mr. Rector said, the key recommendation is everybody should approach this problem in the same way. In the past, he explained, everyone was using a different method, so, in some transactions in certain jurisdictions, for example, 30% might be backed by traditional assets, in others the split may be 50-50, while still in others the percentages may be reversed. What Rector & Associates has tried to do, he said, is to come up with a measuring stick to make the calculation so everyone would use the same general approach to decide how much would need to be backed by traditional assets and how much could be financed. The decision was to use the principle-based reserving (PBR)

[3] Used to describe the actuarial reserves required to be held under Actuarial Guideline XXXVIII—The Application of

[4] The Rector and Associates, Inc. Report, *XXX/AXXX Reinsurance Framework*, June 4, 2014, can be found at: www.naic.org/committees_ex_pbr_implementation_tf.htm.

methodology to draw the dividing line, Mr. Rector stated. The second part of the national uniform approach is getting everyone to agree to what kinds of assets must be allowed, or could be allowed, to be used to back each portion. As Mr. Rector described, the uniform rule everyone has to now follow is that traditional assets backing one portion must be in the form of primary securities and the other portion is eligible to be financed.

He went on to explain the main focus in developing the national uniform approach was on ensuring the ceding company would have enough money to pay its policyholders, instead of focusing on the secondary issue of how to regulate the captive. The requirements say the ceding company has to hold primary assets up to that PBR level, so even if the captive regulation is not done in the best way in the world or even if the captive fails, at least the ceding company will have the money to pay its policyholders. The second reason the Rector & Associates report focused on the ceding company is because there is no way U.S. insurance regulators could come up with a regulatory scheme perfectly applicable to all captive jurisdictions. Even if the perfect captive regulation was devised, it could not be imposed on jurisdictions outside the U.S., which means insurers could move their captives from onshore to offshore domicile to circumvent the rules.

Mr. Rector, responding to the question of how the industry has responded to the regulatory changes, noted it varies by company and domicile. If a company is domiciled in a state already requiring “primary security” type of assets then, as in Vermont, the only difference in approach would be the exact amount of primary security assets they are holding. In other states that may have allowed a more aggressive financing of captive transactions, Mr. Rector added, the assets required have probably changed to assets that must qualify as primary security. “Keep in mind, the rules just became effective in the beginning of this year,” he stressed, adding “companies and regulators are still trying to figure exactly what the change means.” What is of paramount importance, according to Mr. Rector, is for regulators not to allow companies to “game” the system by leaving loopholes open to exploit.

In the discussion of whether *Actuarial Guideline XLVIII—Actuarial Opinion and Memorandum Requirements for the Reinsurance of Policies Required to be Valued under Sections 6 and 7 of the NAIC Valuation of Life Insurance Policies Model Regulation* (AG 48) and, more important, PBR would reduce the use of captives, the responses by the panelists pointed to the fact it is too early to tell. Mr. Routhenstein said his expectation is by itself, AG 48 would not substantially change the formation and use of XXX/AXXX captives. On the other hand, he noted PBR would help significantly reduce the use of such captives.

Mr. Provost added to that point by saying the clear goal of PBR adoption is to reduce the demand for these captives. But, given enough conservativism is built in, some companies might still attempt to find ways to use captives. Mr. Pargeans agreed and added rating agencies hear exactly the same thing from companies when they are asked if PBR would eliminate their need for captives. There is no definitive yes-or-no answer to this question, but depending on the level of conservatism still present in PBR reserving practices, there may be still some advantages in using a captive. “A.M. Best believes indications are captives are not going to be used as prolifically as they have in the past,” he said.

Mr. Rector added even if the regulatory structure were to go straight to PBR, the new statutory reserve may still be higher than what a company believes economic reserves are, so there is still an incentive to do a captive, even if it is much smaller than before. If PBR and AG 48 are combined, in theory at least, the incentive should be completely eliminated, he suggested, because there would no longer be a gap to be financed.

Regarding the use of variable annuities (VA) captives, Mr. Routhenstein noted the efforts and initiatives of the Variable Annuities Issues (E) Working Group are expected to help reduce the future use of VA captives, although it is still too soon to tell with any certainty whether they would be completely eliminated. Mr. Pargeans said the VA reserving practices are complex and convoluted. He believes in the long-term, the use of VA captives will be reduced or eliminated, but it is too early to know for sure.

Commissioner Nickel asked Mr. Provost to tell the audience about the trends he is seeing on how captives are structured. Mr. Provost noted that, mostly, Vermont is still seeing pure captives formed and a fair number of risk retention groups, adding that, probably, the only structural change is the fact the number of cells of cell captive companies are increasing. Most states have some sort of cell company legislation. More stop-loss health care programs are being put into groups, Mr. Provost added, where some self-funded employers get together and share a layer of risk in the stop-loss range and then cede the rest to the traditional reinsurance market. The driving force behind these changes, according to Mr. Provost, is the rise in cost, especially in health care. Also, opportunity can drive the formation of captives as, for example, in the case of 831(b) captives, which can provide tax advantages.

Mr. Pargeans, responding to what he is seeing as far as the impact of captive reinsurance on life company ratings, acknowledged that, in the public announcements of A.M. Best's ratings, the use of captives has not been connected with the rationale behind a specific rating. Mr. Routhenstein concurred, noting he is not aware of any life captive transactions that have resulted in ratings actions by a rating agency. That said, he added, each of the four rating agencies that assign financial strength ratings to life companies have issued some captive-related criteria over the past few years.

On the question of what is driving the increase in captive domiciles, Mr. Provost demonstrated with the use of a visual aide, a dollar sign drawn on piece of paper, to emphasize what has historically been the main motivation for the states in passing captive laws. "Vermont, years ago, did a study on the economic impact of captive insurers in the state," Mr. Provost explained, "and, given the small population of Vermont, it did not take much to make an impact which would convince our legislature."

Commissioner Nickel commented that another driver may be the preference of the insurance department, in the case of a life captive, to keep the captive in the same state, allowing for better communication with both the ceding company and the captive, as well as more enhanced supervision at the group level.

Responding to the last question regarding whether the current framework is adequate, Mr. Provost explained in the case of traditional captives, it most certainly is. "On the other hand, once we get into captive reinsurance, there are still things we as regulators need to work on," he added.

◆ Session 3: Remaining Challenges and Concerns

This panel discussion was moderated by Superintendent Joseph Torti III (RI) and included the following panelists: Commissioner Nick Gerhart (IA); John Finston (CA); and Paul Graham (American Council of Life Insurers—ACLI).

Superintendent Torti kicked off the session with a presentation on challenges presented by life insurer-owned captives and what regulators have done to address them. He explained how, historically, captive regulation in the U.S. developed outside the traditional NAIC solvency framework because captives were viewed as self-insurance. Likewise, captives were also excluded from the NAIC Financial Regulation Standards and Accreditation Program.

But, as captives continued to evolve beyond just self-insurance, their regulatory treatment had to keep pace, Superintendent Torti said. Regulators, he stressed, need to make sure there is the same transparency with captive reinsurance as with traditional insurance companies.

The fact state regulatory approaches to XXX/AXXX captive reinsurance could differ, Superintendent Torti explained, without any corresponding differences in product designs and transaction structures, created the potential for regulatory arbitrage. An uneven playing field can occur, he noted, in such conditions and, if combined with a lack of transparency, regulators can have a tough time comparing transactions, as well as assessing market and industry dynamics. "The point that captive transactions work outside our well-established rules is exactly what caused the concerns we had when we first started to look at these captive reinsurance transactions," Superintendent Torti said. Regulators, he added, have to ensure rules governing these transactions are consistent across all jurisdictions.

Until PBR is implemented, Superintendent Torti explained, the solution regulators have agreed upon is spelled out in the XXX/AXXX Reinsurance Framework, which requires the ceding company to book the full statutory reserve.

The goal of the Reinsurance (E) Task Force is to finalize and adopt a model law. We understand though, he clarified, this is a longer-term solution and it takes some time because it requires state-by-state enactment. In the interim, AG 48 was developed as a solution that could be implemented quickly through the *Actuarial Opinion and*

Memorandum Regulation (#822). The idea behind AG 48 was to establish a uniform national standard governing XXX/AXXX reserve financing. It defines, at least it attempts to define, he said, what a primary security is.

However, the permanent solution is still PBR, Superintendent Torti underscored. Although because PBR does not apply retroactively, XXX/AXXX captives will continue to exist for a while as the business runs off. "We are well on our way toward PBR, as 39 states having already adopted it, with 42 needed in order to fully implement it. In terms of
premium, we are at 70% of the premium needing to get to 75% threshold," he said.

Also, in order to address the issue regarding a lack of transparency, "in 2014, we pushed through a blanks change that added a very good disclosure schedule on these transactions" Superintendent Torti said. Regulators modified it in 2015 to include the new transactions done subsequent to the adoption of AG 48.

"When we did our original survey on how companies were using captives, we found the No. 1 use was XXX/AXXX," he said. The second use was variable annuities, so, at the beginning of 2014, he added, "we decided our next priority should be VA captives and trying to figure out what the solution should be."

The NAIC established the Variable Annuities Issues (E) Working Group to study and address, as appropriate, regulatory issues resulting in VA captive reinsurance transactions. Superintendent Torti went on to explain a solution has been suggested, which could actually work to even retroactively eliminate the use of VA captives. He noted while the work is a great challenge, the Working Group, under Commissioner Gerhart's leadership, is up to it, adding, "we are all encouraged by all the work that has been done so far."

A Quantitative Impact Study has been approved, funded with costs shared with the industry. The study should be completed by year-end 2016, Superintendent Torti said, adding he is "confident it will go a long way to proving we can address the issue and develop an appropriate solution." The regulators' other priority, he said, is addressing long-term care captives, although there are currently only two groups using captives.

Furthermore, Superintendent Torti explained how regulators have had to thoughtfully reexamine the accreditation preamble, which defines "multi-state insurers," and try to determine whether XXX/AXXX, VA and long-term care captives should be included in Accreditation.

Concluding his presentation, Superintendent Torti assured the audience, "the NAIC membership and officers have considered captives a priority since 2011, and we will continue to view captives issues a regulatory priority."

Following his presentation, Superintendent Torti turned to the panelists and asked if all captives, including pure captives, should be considered for the same regulatory treatment.

Commissioner Gerhart responded there is no apparent reason to treat all captives the same. Mr. Graham added that not only should there be a difference between pure captives and life insurer-owned captives, but also among different types of insurer-owned captives. As there are two different approaches for XXX/AXXX and VA captives, he added, it is important to understand the underlying business issues that led to using captives in the first place and to develop regulatory solutions that protect solvency without making it too difficult for companies to get in particular lines of business that meet social needs.

Agreeing with the panelists, Superintendent Torti commented captives have worked well in the past but have, unfortunately, been tainted by "throwing them in the same bucket" with life company captive reinsurance.

The next question about how regulators assess risk at the entity and group level was addressed to Commissioner Gerhart, who pointed to how Iowa deals with this issue. He explained Iowa has a unique law about what is referred to as "limited purpose subsidiaries," requiring the carrier to be domiciled in the state, and all of its financials publicly available through the insurance department's website. Additionally, every two years, an actuarial test and assessment of those transactions is performed. "From my perspective," Commissioner Gerhart noted, this process "has worked very well," adding the same analyst looks at both the subsidiary and the company. This has proven valuable to Iowa regulators, because they can see through the entire transaction, he concluded.

Mr. Finston commented Iowa is an example of how a single state can address this issue effectively. But, as Superintendent Torti mentioned earlier, Mr. Finston explained, one of the issues regulators have had to deal with is the fact the affiliated reinsurer was not always regulated by the same state as the ceding company to allow for the same degree of coordination and transparency as in Iowa.

To the question of whether all captives should be considered for accreditation, Mr. Graham said addressing the issue of captives through the Accreditation Program may not be the best course of action, because captives can be moved offshore. As mentioned earlier by Mr. Rector, trying to regulate the captives themselves instead of the ceding company would not be a complete solution.

Commissioner Gerhart noted, although he has some reservations about throwing all captives in the accreditation process, he believes there is value in looking at some of the captive transactions, because the captive may be domiciled in a different state than the ceding company. Mr. Finston concurred, saying the focus so far has been trying to limit that rule to multi-state risks. If what the ceding life company is passing onto its captive reinsurer is multi-state risk, then it is appropriate to include these captives in the accreditation process, he added.

Mr. Graham, responding to the question of what impact the implementation of PBR may have on new captive formations, noted if the impetus is only reserve financing, then there would not be any reason to form captives, but, as mentioned earlier, there could be other reasons for using a captive. It could be for risk aggregation, tax reasons or any other reasons where captives could be a good risk mechanism, he explained. Mr. Finston commented captives will probably continue to exist if there is a mechanism that can be developed to allow for the financing of a risk at a lower cost than the company by itself could provide. Commissioner Gerhart added the intent of the XXX/AXXX Reinsurance Framework is to mitigate the use of captives and PBR is the answer; however, for VAs, the solution has not yet been developed.

Superintendent Torti cautioned regulators against building so much conservatism into PBR such as to create another issue with the industry trying to design a workaround to finance the reserves. Regulators recognize this and are well on the way to implementing PBR, he noted, which would be the right solution without creating any new issues.

As far as what are the implications should an insurer not comply with the regulatory framework, Mr. Finston mentioned a number of options considered by regulators. The first option the Reinsurance (E) Task Force is considering, he said, is if the ceding company enters into an agreement with a captive reinsurer and there are insufficient primary assets to support the reserve, then it will not receive any credit for the transaction. The other option is a proportionality-type concept where, if there is a shortfall in the primary assets, then there would be a similar reduction in the reinsurance credit. This option suggests if there is a shortfall in the primary assets, the company gets no credit for the other assets but would still get some credit for the primary assets.

The Financial Condition (E) Committee, Superintendent Torti noted, has adopted a new process for issues of national significance to be brought forth, in order to prevent single-state solutions. If the process had previously been in place, he asked whether it would have prevented the need for XXX/AXXX captives. Mr. Graham said it probably would have brought the issue to the forefront sooner. If the Financial Condition (E) Committee process is to work, he added, the industry and regulators alike should move rapidly toward national solutions.

Commissioner Gerhart, as the chair of the Variable Annuities Issues (E) Working Group, explained the first thing the Working Group tackled was the transparency issue. The Working Group went to the industry first, he noted, and proposed to agree on some disclosure framework. The disclosure covers: the type of benefits reinsured; the amount of the reserves ceded; the reserve method used; the amount of collateral supporting the agreement; the risks associated with the cession; the risks retained by the reporting entity and its parents and affiliates; and, most important, the purpose of the transaction. What the Working Group is trying to accomplish, Commissioner Gerhart explained, is to look at the framework in total and eliminate the need for these transactions.

◆ CONCLUSION

As this event successfully illustrated, state insurance regulators, working together through the NAIC, have responded to these challenges by working extensively to identify and address potential risks the use of affiliated captive reinsurers may have on ceding insurers. This has led to the recent adoption of several new regulatory requirements focused on transparency, disclosure, consistent accounting requirements and standardized tools. State insurance regulators have successfully tackled the challenge presented by XXX/AXXX captives. Following the event, the Reinsurance Task Force, in January 2016, adopted a series of revisions to the *Credit for Reinsurance Model Law* (#785) providing commissioners authority to adopt regulations with respect to life policies with guarantees, universal life policies, variable annuities with guarantees, and long-term care insurance policies. Given the nature and complexity of various types of captives, the heightened form of regulatory work and surveillance will persist in the interest of protecting policyholders and safeguarding insurers' solvency.

