Life Insurance Industry Use of Captive Insurance/Reinsurance

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In June 2013, the New York Department of Financial Services through its Superintendent, Benjamin M. Lawsky published the results of an examination they had conducted over the previous year, by the name ***"Shining a Light on Shadow Insurance: A Little-Known Loophole That Puts Insurance Policyholders and Taxpayers at Greater Risk"***. The Lawsky Report does bring to light some potentially alarming results.

The report stems from life insurance companies' use of "Captive Insurance/Reinsurance Companies". A *Captive* is an insurance or reinsurance company owned by one or more entities to insure or reinsure the risks of those owner-entities. Insurance is the transferring of risk from a non-insurance entity to an insurance company; reinsurance is the transfer of risk from an insurance company to another insurance company acting as a reinsurer. Captives are considered an alternative form of the risk financing called self-insurance (not to be confused with no insurance) whereby the captive is owned by the insured/reinsured. Captives are established to meet the risk-management needs of the entities that own them. Captives were originally formed and used within the Casualty Insurance industry to allow entities to deduct premiums paid to the captive insurance company in one year for losses that may be paid out over a number of years. The IRS will not allow a deduction for funds put into a reserve account for this same purpose. Captives are now used for a wide range of risks, including life insurance risks. Captive insurance companies being an insurance company or a reinsurance company, or both. A Captive can underwrite almost any risk a commercial insurer can provide, including some risks commercial insurer cannot or will not insure or reinsure.

Captives are formed by major multinational corporation, including almost all of the Fortune 500 companies, as well as, medium-sized closely-held family companies and nonprofit organizations, to name just a few categories of entities. These captive insurance companies are like any commercial insurance or reinsurance company, in that, they are regulated by state or national regulatory agencies depending on their domicile, just like any other insurance company, with annual reporting, capital and reserve requirements. The main difference in regular insurance companies and captive insurance companies (other than their ownership) is the capital requirements the states or country regulators require of them. Whereas a regular insurance company may be required to have $2,000,000 in minimum capital to begin operations, a captive insurance company could begin in the same domicile with as little as $250,000.

Regular insurance companies are limited to writing a multiple of their capital base (the exact multiples vary slightly from state to state and domicile to domicile), but for examples sake, let's say a state regulator would allow a regular insurance company to write premiums in excess of two times their capital base. A captive insurance company regulator in the same state might allow multiples of between five and 15 times the captives' capital base. The reason for this difference is that the regular insurance company is insuring the general public, while a captive is only insuring itself and their affiliated companies (for the most part); therefore, the regulations necessary to protect the public do not exist for captives. Taxpayers do however, have a vested interest in the financial viability of a captive insurance industry in their state, but not to the same degree as a regular state chartered insurance company.

The captive insurance industry began in the 1950's but did not grow significantly until the 1980's. Since then, the industry has grown dramatically. In 1980, it is estimated that there were 1,000 captives in the entire world; in 2012, there were over 5,000. Twenty-five states now have captive-insurance-company-enabling legislation and there are 45 foreign countries where captives can be created. The first captive was formed in Bermuda and the island is still the leader in terms of number of captives operating. The Cayman Islands has also been a favorite of off-shore domiciles for U.S. entities. Guernsey, Luxembourg and Ireland are the most favored domiciles for Europeans, and Vermont is the largest domicile in the U.S., and is considered a leader in captive legislation.

Captive insurance companies only insure their own risks. The largest segment of captives is "Parental" Captives but there are many other forms used by groups in various ways which continue the success of captives by an innovative and sophisticated financial services industry.

In the year 2000, the U.S. statutory reserve requirements for term life and universal life insurance increased dramatically, in some cases eight to ten times higher, estimated within the industry to be in the range of $100 to $150 billion. These new requirements from the National Association of Insurance Commissioners (NAIC) Model Legislation (adopted in most states) are NAIC Regulation XXX and AXXX specifically for term and universal life reserves respectively.

Insurance is regulated by each state and each state requires insurance companies domiciled in that state to file statutory financial statements to the insurance commissioner in order to protect the insurance-buying public from insurance companies that do not have enough capital to pay on the policies they are writing or proposing to write. This statutory financial statement can vary quite significantly from the Generally Accepted Accounting Standards (GAAP) established by

the Financial Accounting Standards Board (FASB) and recognized by the Security and Exchange Commission (SEC) and the American Institute of Certified Public Accounts (AICPA). This reserving discrepancy between these two financial statements led Term and Universal Life Insurers and others to believe that the statutory reserve requirements were redundant and onerously conservative.

The industry moved quickly to alleviate this burden and obstacle by producing competitive Term and Universal Life Insurance Products. Reinsurance has long been a useful tool for creating capital capacity for insurance companies but a competitive product for this type reinsurance did not exist, so a number of life insurance carriers created reinsurance facilities in the form of captive insurance companies. (Remember, captive insurance companies allow for greater leverage with less capital that a regular insurance company.) So, these life insurance companies created a special type of captive insurance company to reinsure the gap created between the Statutory Reserves and the GAAP Reserves. They financed these amounts with a combination of securitized debt created by the cash-flow of the policies and with a corporate guaranty by a corporation with sufficient assets to do so. This corporation would and must also be within the same holding company as the insurance company buying the reinsurance from the captive. The purchasing of reinsurance to fund the gap resolves the problem created by Regulation XXX and AXXX from a Statutory Accounting-Regulatory perspective. These types of captive reinsurance facilities are also called Special Purposes Vehicle (SPV) - (the accursed acronym so closely associated with the Enron debacle). In these cases however, there really are securitized asset or debt instrument for the financing of the reinsurance capital necessary to make an arrangement like this work from a regulatory perspective. If the arrangement is not securitized correctly and properly, it is the responsibility of the regulators to disallow the reinsurance deduction.

The Lawsky Report does bring to light some potentially alarming results, but only potentially. First, the Report runs somewhat rough-shod over a number of fellow insurance regulators around the country and the world. Second, it jumps the gun on a report, which the NAIC was planning to publish the following month, on the same subject. The flag the Lawsky Report wisely and legitimately raises is twofold: (1) This potential problem is a symptom of another problem - which is the incredible discrepancy between Statutory and GAAP Financial Reporting as it relates to Reserving for Term and Universal Life Policies and (2) Regulators of Standard Insurance Companies and Captive Insurance Companies need to communicate well to advance transparency, intent and understanding in these reinsurance activities.

There is already evidence that life insurance companies are moving away from this type of risk transfer and that the problem may be one of what to do with the arrangements already in place and how long the run-off of the claims within these arrangements will continue. While maintaining the need for transparency, we do not want or need to throw the proverbial "baby out with the bath water" by stymying the captive insurance industry from its continued inroads to bringing the capital market into the realm of capacity for a growing insurance industry.

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