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Principle-Based Reserves and Captives: The Controversy Continues

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Tweeting about this conference?

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I. New York DFS's Investigation Into Life-Insurer-Owned Captive Insurance Vehicles

- In June of 2013, the New York Department of Financial Services ("DFS") concluded a year long investigation into life insurer-owned captive insurance vehicles used to finance certain life insurance reserves, i.e., redundant reserves. DFS concluded that they created a **"shadow insurance industry"** which threatened life insurer's solvency

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II. Redundant or “Non-Economic” Reserves

- Actuaries generally believe that the liabilities that statutory accounting principles require for certain term life (“XXX”) and Universal Life (“AXXX”) insurance business are significantly higher than the “economic reserve” – the amount necessary to satisfy liabilities under the relevant business

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- The difference between the statutory reserve and the economic reserve – the “redundant reserve”
  - Cannot be funded by premiums and investment income earned from premiums if the product is priced fairly and competitively
  - The company must tie up other funds that would otherwise be available as surplus

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- The Regulator’s Dilemma:
  - Regulators generally acknowledge that XXX/AXXX reserves are often redundant
  - The products are complex and have a long tail, which makes them attractive to companies that take excessive risks with their policyholders’ money, not to mention out-and-out Ponzi schemes

- Experience has shown that less conservative formulas that work effectively for well-run companies are easily circumvented by “bottom feeders”

- Most regulators believe the ultimate lesson is that one-size-fits-all formulas are simply unsuitable for these lines of business

- Major impetus for the NAIC's adoption of principle-based reserving **(PBR)**

Redundant Reserves – Threat or Opportunity?

- Not all bad
- The upside of having a balance sheet that looks worse than a company's true financial position, if the company can manage the reputational and capital-allocation problems, is that overstating the company's accrued losses lowers its taxes
- The taxes get paid in the long run, but for life insurers, the float lasts decades

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Legitimate Uses of the Captive Insurance Transactions:

- Captive reinsurance
  - similar to commercial reinsurance
  - both types of reinsurance transfer risk from the ceding company to another legal entity
  - financed by outside investors in ways that enable the ceding company to secure protection from the resources of the broad capital markets
  - Others are financed by the ceding company or its affiliates, but many commercial reinsurance transactions likewise take place between affiliates

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- Both types of reinsurance must satisfy similar regulatory requirements in order to afford the ceding company credit for insurance
- Affiliated captive reinsurance transactions require dual regulatory review by the insurer’s state of domicile and the captive’s state of domicile
- Often, independent actuaries are retained by the regulator to provide further validation of the transaction
- The captive, thus, must either be an authorized or accredited reinsurer in the insurer’s domicile or post collateral to satisfy credit requirements

- Well-designed captive transactions are beneficial because:
  - They allow for efficient use of capital
  - By segregating the risk in a captive, the sponsoring insurers are able to obtain third-party financing at a lower cost, which results in more affordable insurance coverage
  - Risk is spread as third-party finance partners are liable for the risks that are ceded to the captives (assuming the captive is not affiliated)
    - Such as redundant XXX/AXXX reserves

- Industry asserts that captive financing transactions provide full risk transfer supported by high-quality assets or financing arrangements (such as bank LOCs) which provide reimbursement, where necessary

- The NAIC had been studying the use of captive reinsurers for over a year and did not see a need to call for a national moratorium, as requested by the New York Division of Financial Services

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III. NAIC'S Enhanced Efforts to Investigate Captive Reserve Financing Transactions

A. The New York Moratorium

In June of 2013 when New York (closely followed by California) first announced its intent to pursue a national moratorium on captive reserve financing transactions, the NAIC charged several task forces with review and analysis of these practices and engaged **Rector & Associates** to conduct a detailed analysis and to report on its findings

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- Rector issued two reports, in February and June of 2014

- In an August 12, 2014 letter to the NAIC, New York DFS criticized both the Rector Reports and the NAIC's PBR initiatives

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B. Captive and Special Purpose Vehicle Subgroup of the NAIC's Financial Condition [E] Committee

- A year and a half before DFS called for a moratorium on "shadow insurance," in 2011, the NAIC had already formed a subgroup to study reinsurance captives and special-purpose vehicles ("SPVs")
- Subgroup issued an exposure draft in November 2012, and a White Paper was adopted in June 2013
  - Use of such vehicles to fund life insurance reserves was one of the major topics in the White Paper

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- June 2013 White Paper Acknowledges:
  - Some companies form SPVs to circumvent statutory accounting
  - Adoption of PBR will ultimately eliminate the use and need for SPVs in financing XXX/AXXX reserves
  - Advocates robust disclosure of SPV transactions to regulators and suggests that uniform credit standards, for letters of credit and parental guarantees be made “tighter” to strengthen the security underlying the SPV’s obligations

C. Principle-Based Reserved Implementation Task Force ("PBR Task Force")

1. What is PBR?

- A Replacement to the current, formula based static approach
- An approach tailored to the risk of modern, more complex insurance products
- An attempt to "Right Size" reserves
  - Some products will see reserves decrease (Level Premium Term, SGUL)
  - Others could see reserves increase

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- Companies required to hold the higher of:
  - The reserve using prescribed factors
  - The reserve which considers a wide range of future economic conditions and is computed using justified company experience factors
    - Mortality, policyholder behavior, and expenses
- Essentially, a “lighter” formula compared against the principles

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2. NAIC PBR Implementation Task Force

In March 2013, the NAIC established the PBR Implementation Task Force to:

- Serve as the coordinating body with all NAIC technical groups involved in projects related to PBR initiative for life and health policies
- Further assess the solvency implications of life-insurer-owned captives and other alternative mechanisms
- Review the final recommendations of Captive Sub Group in the context of the proposed PBR system
- Make further recommendations to the NAIC's Executive [EX] Committee

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D. The FIO Task Force

- In March 2013, Director McRaith of the Federal Insurance Office ("FIO") created a task force under the Federal Advisory Commission on Insurance (originally headed by then-DC Commissioner, William White), to:
  - Study the national implications for the solvency of the life insurance industry of the use of captives and SPVs to finance XXX and AXXX reserves
- The Task Force's recommendations were reflected in the FIO's November 2013 Report

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E. Adoption of the NAIC Principle-Based Reserve Model and New NAIC Valuation Manual and Their Impact on Captive Reserve Financing Transactions

Regulators and industry representatives conclude that:

- XXX and AXXX transactions generally require transparency and disclosure
- Some state insurance regulators go further, and believe that current reserve redundancies can be reduced or completely eliminated once PBR is implemented, which will make this type of captive transaction unnecessary in the future
- This is unrealistic. Life insurers will likely have a continuing need to finance redundant reserves through captives and SPVs, as some redundancy will likely still persist

IV. The Rector Reports to the PBR Task Force

A. February 17, 2014 Rector Report

- The Rector Report establishes a "framework" for addressing certain requirements for reserve financing transactions (in the event that the PBR Task Force decides to allow their continued use). The February report was replaced with the June version.

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B. June 2014 Rector Report

In response to extensive comments by a variety of interested parties on the February Rector Report, Rector issued a June Report which contains a number of additional and revised recommendations

- Proposes establishing an XXX/AXXX Reinsurance Framework (the "Framework") as follows:

- The Framework applies only to reinsurance involving certain types of XXX and AXXX policies
- The Framework does not materially change the ability of insurers to obtain credit for reinsurance ceded to the licensed or accredited reinsurers that follow statutory accounting and RBC rules, or ceded to “certified” foreign reinsurers that follow similar standards established by their countries of domicile

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- As a general rule, alternative risk transfer entities such as captives and SPVs are not subject to the same RBC requirements, and might also follow material different accounting standards or reporting requirements. If the assuming company doesn't maintain the same surplus cushion as a commercial reinsurer, or it's hard to tell because of apples-and-oranges accounting standards, it is not safe to allow credit unless the reinsurance is fully collateralized

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- Under those circumstances, the following additional requirements will apply to reinsurance of XXX/AXXX liabilities:
  - The ceding insurer must establish gross reserves under current XXX/AXXX reserving requirements
  - The assuming insurer must post "Primary Security" (cash and certain SVO listed securities) as collateral at least equal to an amount determined under the "Actuarial Method" (collectively the "Primary Security Requirement")
  - The Rector Report left open whether LOCs can be allowed as Primary Security if they otherwise meet credit for reinsurance requirements (i.e., they are "clean, irrevocable, unconditional and evergreen")

- The original proposal was that such LOCs could be used to a limited extent after the inception of the transaction, but that LOCs could not be more than 10% of what was then termed "Primary Assets," but is now defined as "Primary Security"
- Whether this provision eliminates the use of LOCs as credit for reinsurance when XXX or AXXX business is ceded to foreign reinsurers (as is currently permitted under the Model Credit Reinsurance Law) is unclear

- The Actuarial Method is defined as VM-20 (the PBR Valuation Manual for these lines of business), as modified to incorporate changes to modern mortality tables
- Another outstanding issue is whether VM-20 should eliminate the “net premium reserve” component that is used for PBRs generally

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- The portion of the gross reserves that exceeds the Primary Security Requirement (i.e. the redundant portion of the reserve determined under the new method) may be collateralized by “Other Security”
- “Other Security” is defined as any other security acceptable to the Commissioner for which the NAIC has developed an RBC asset charge

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- At least one party must hold appropriate risk-based capital to back the reserves (the so-called RBC "cushion")
- The transaction must be approved by the ceding company's regulator

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V. August 2014 NAIC Activity on Regulation of XXX/AXXX Financing Transactions.

The Executive Committee of the NAIC adopted a report of the Task Force that included the "XXX/AXXX Reinsurance Framework" and contemplated the following:

- Adopt the Framework approach as quickly as possible

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- Move forward towards implementation of the Framework by adopting changes to various NAIC model acts, regulations, and working group charges
- Use the Actuarial Opinion and Memorandum Regulation (NAIC Model #822) as the basis for adopting an Actuarial Guideline consistent with provisions adopted pursuant to the Framework. (AG 48 was adopted by the NAIC on 12/16/14)

- Amend the Credit for Reinsurance Model Law (NAIC Model #785) and adopt a new model regulation specifically for XXX/AXXX reserves (the proposed "XXX/AXXX Reinsurance Model Regulation") in order to require captive reinsurers that are licensed or accredited in the state of the ceding insurer (or meet other requirements), but do not follow full statutory accounting and RBC rules, to meet the Framework's collateral requirements
- The NAIC Reinsurance Task Force was given this charge

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- Some regulators, including one of our panelists, believe this principle is all the more important for “traditional” captive transactions such as cat bonds that finance NON-redundant reserves.

- In the new model regulation, limit the types of "other security" that can be used when XXX/AXXX reserves are ceded to a reinsurer that is subject to the Framework's collateralization requirements
  - When qualifying LOCs are posted for commercial reinsurance transactions, they must be evergreen and unconditional
  - Under current practices, some regulators permit the use of nonqualifying LOCs as "other acceptable security" for captive transactions, allowing for certain conditions (such as depletion of other assets) before the letter can be drawn

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- The LOC might also be secured by a pledge from the ceding company to the bank, which means that at the end of the day, it has no net value to the ceding company
- Require disclosure of key aspects of XXX/AXXX reserve transactions to the public. The Blanks (E) Working Group was given this charge

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- Amend the RBC instructions to require at least one party to the transaction to hold an RBC "cushion," and develop RBC asset charges for assets allowed in the Framework as "Other Security." The goal is to make these changes effective by the end of 2015. This charge was given to the Capital Adequacy Task Force, which delegated the task to the Life RBC Working Group

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- Evaluate existing reinsurance risk transfer rules to address the use of parental/affiliate guarantees of the obligations of the captive or third-party reinsurer in order to keep the risk inside the holding company. This charge was given to the Financial Condition [E] Committee
- Update the NAIC Financial Analysis Handbook to address XXX/AXXX Reserve Financing Transactions. The Financial Analysis Handbook Working Group was assigned to address this charge

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- Require audited financial statements to indicate whether reserve financing transactions meet the requirements of the Framework. This charge was given to the Statutory Accounting Principles [E] Working Group
- The June Rector Report recommends that many of its suggestions be reflected in the NAIC Accreditation Program, and the Executive [EX] Committee is giving this consideration

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VI. The Aftermath of the Rector Report.

- The framework adopted as part of the June Rector Report is not expected to change the statutory reserving requirements for captive financing transactions and is viewed as an interim solution until full PBR is adopted
- It is anticipated to change the types of assets and securities that are needed to be held by the direct/ceding company to support the statutory liabilities

- The Rector Framework would also require the direct/ceding company to disclose the assets and securities used to support the statutory reserves and to hold a risk-based capital (“RBC”) cushion if the assuming captive does not file RBC

State’s Reponses to Rector’s Finds

- Not all state regulators agree with the Rector Report Framework. North Carolina Insurance Commissioner Wayne Goodwin found it to be too harsh, ultimately voting against adoption of its recommendations

- The issues identified by North Carolina were the lack of a materiality threshold and the possibility of a double RBC hit
- Commissioner Goodwin advocated for a delay in adoption, saying a proper discussion will require the airing in open session of presently confidential NAIC work product
- New York voted against adoption for the opposite reason, finding the Framework to be too mild

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- Rhode Island Commissioner Joseph Torti disagreed with Commissioner Goodwin's analysis, responding that the proposal "sets a standard, does not inhibit transactions . . . a double RBC hit does not exist"
- Torti noted that no moratorium would be imposed as a result of the Rector Report as had been called for by New York's regulators
- In general, however, the Framework recommendations were favorably received by NAIC representatives and will form the basis of the NAIC's actions on the subject going forward

From the Rector Report to Regulations

- The PBR implementation (EX) Task Force, along with other NAIC groups and committees, will be charged with developing an action plan to create the Framework and draft the implementing regulations
- It is anticipated that the recommendations in the Rector Report will be applied prospectively

- On December 16, 2014, the NAIC adopted the Revised Insurance Holding Company System Regulatory Act and Actuarial Guideline 48 which, among other things:
  - Establishes national standards regarding XXX/AXXX captive reinsurance transactions
  - Includes regulation of the types of assets held in backing an insurer's statutory reserve
  - AG48 takes effect in 2015

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VII. Future of PBR and Captive Financing Transactions

A. Practical Effects of the Regulatory Scrutiny

- A shift away from abusive transactions that reduce reserves without injecting new capital into the system
- Expectation of greater transparency of captive financing transactions

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- Peer pressure on the captive jurisdictions to demonstrate that they are scrutinizing these transactions and adequately regulating the solvency of the captive
- Pressure on the NAIC to achieve greater uniformity – backed by the specter of intervention by FIO or FSOC

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B. Will Captive/SPV Used To Finance Life Reserves Be Abolished?

- Probably not anytime soon – may increase in use as there is further validation with the increased transparency and framework
- The need to bring outside capital into the life insurance industry is undeniable
- PBR is not a panacea – reserve redundancies are inevitable under any reserving system
- Middle-of-the-roaders have the upper hand over the abolitionists
- More scrutiny, more transparency, more uniformity – but not abolition
- Consequences of abolition would be too severe

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