Duane Morris®

DUANE MORRIS LLP
1540 BROADWAY
NEW YORK, NY 10036-4086
PHONE: +1 212 692 1000
FAX: +1 212 692 1020

MEMORANDUM

DATE: November 26, 2012

TO: Commissioner William P. White
District of Columbia Department of Insurance, Securities and Banking

FROM: Hugh T. McCormick
Carla C. Small

SUBJECT: Comments on NAIC White Paper on Captives and Special Purpose Vehicles

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This paper offers comments on the White Paper on Captives and Special Purpose Vehicles (the "White Paper"), which was prepared by the Captive and Special Purpose Vehicle Use (E) Subgroup (the "Subgroup") of the Financial Condition (E) Committee of the NAIC.

Overview of the White Paper

The White Paper addresses issues that have been raised by the growth of captive insurers in recent years. The focus of the White Paper is less on the general use of captives, however, than on the use of different types of captive insurers by life insurance companies to obtain cost-effective financing for "non-economic" or "redundant" reserves that those insurers are required to establish, with respect to certain term life insurance or universal life insurance business.

The White Paper begins with a discussion of the "broadened use of captives," which raises a "potential concern that a shadow insurance industry is emerging, with less regulation and more potential exposures than policyholders may be aware of as compared to commercial insurers." The White Paper then states that the potential concern becomes amplified "when academics claim the shadow banking system was believed to have contributed to the recent financial crisis." This background then leads to a charge to the Subgroup to "Study insurers' use of captive and special purpose vehicles to transfer insurance risk, other than self-insured risk, in relation to other state laws and regulations and establish appropriate regulatory requirements to address concerns identified in this study."

As will be discussed in this paper, we question the characterization of the use of captive insurers by life insurance companies as a "shadow industry" that contains more risk than does the commercial insurance industry. As has been recognized by many domestic and international insurance regulators, the use of captive insurers by life insurers for various purposes—including funding of redundant reserves or monetizing embedded values—can make economic sense, as long as regulators and other key stakeholders are given the information they need to assess and regulate the risks the captives have undertaken.

In the context of transactions used to fund XXX or AXXX reserves, it is important to understand that these captives are subject to substantial regulatory review—by the insurance department with jurisdiction over the life insurance company that writes the business that generates the redundant reserves, and by the insurance regulator in the state or country in which the captive is established (for many reasons, including federal income tax concerns, most XXX and AXXX reserve transactions have been completed in the United States). Nor have only one or two states been involved in these transactions; reserve financing transactions have been accomplished in a number of states, and the regulators in each state have had the opportunity to review the transactions. In other words, the transactions that have given rise to the concerns expressed in the White Paper have not been structured in the shadows (unlike the types of transactions that almost brought down the economy in 2009); they have been required to be submitted for substantial regulatory scrutiny.

Of course, any good idea can be taken to extremes, and any good transaction can be badly done. There is a clear need for strong regulatory oversight. We agree with the goals of the White Paper to improve communication within the regulatory community with regard to the use of captives. In our view, however, treating a captive insurer that is used by life insurers as financing vehicles as a commercial insurer will impose unnecessary burdens on what are ultimately useful and (at least for the most part) well-designed transactions.

Set out below are comments on relevant sections of the White Paper. These comments are then followed by thoughts on issues and concerns raised by the White Paper.

Background and IAIS Considerations

The White Paper generally distinguishes captives from commercial insurers, by stating that "the traditional captive insurer is simply a form of self-insurance," in which "the business entity forms the captive insurer as its wholly-owned subsidiary to accept risk transfers from the business entity, its subsidiaries and/or affiliates for a fee. In contrast, "the commercial insurer is an entity whose business is accepting risk transfers from nonaffiliated businesses and people for a fee." These definitions are used throughout the White Paper for the premise that captives that accept only risks of parents and affiliates may reasonably be subject to lesser degrees of regulatory control; conversely, even when an entity is organized as a captive insurer, if it accepts substantial insurance risk from unrelated parties it should be regulated as a "commercial insurer."

The White Paper lists the traditional types of captives used by industrial enterprises: pure captives (which provide insurance to parents and affiliates), group captives (which provide insurance to members of the same industry) and other forms of captive insurers. For the most part, these captives are not used for life risks. It then discusses Special Purposes Reinsurance

Vehicles ("SPRVs"), Special Purpose Financial Captives ("SPFCs"), Limited Purpose Subsidiaries ("LPSs") and Special Purpose Captives ("SPCs") (for ease of discussion, these entities will be referred to collectively as "SPVs"). These types of entities frequently are permitted to write life risks, and have been used in connection with XXX and AXXX reserve financing transactions.

A fundamental proposition of the White Paper is that SPVs used in redundant reserve funding transactions are in essence formed to accept risk from unrelated parties (through reinsurance of the policies that generate the redundant reserves), rather than to provide self-insurance of risks that are already held by the ceding insurers as issuers of the underlying policies. Taking that as a starting point, the White Paper suggests that these SPVs should be treated as commercial reinsurers. The drafters of the White Paper derive support for this view from the definition of the term "captive" used by the International Association of Insurance Supervisors (the "IAIS") in its Guidance Paper on the Regulation and Supervision of Captive Insurers (the "Guidance Paper"). The Guidance Paper defines a captive as:

> [A]n insurance or reinsurance entity created and owned, directly, by one or more industrial, commercial or financial entities, other than an insurance or reinsurance group entity, the purpose of which is to provide insurance or reinsurance cover for risks of the entity or entities to which it belongs, or for entities connected to those entities and only a small part of its risk exposure is related to providing insurance or reinsurance to other parties. (Emphasis added.)

The White Paper then uses this definition to make the following statement:

> [E]xclusion of entities owned by insurance or reinsurance groups from the definition [of captive] may imply an expectation that such entities be subject to supervision and regulatory requirements similar to traditional commercial insurers or reinsurers under the ICPs.

Finally, the White Paper states the following with respect to the IAIS Guidance Paper:

> [W]ith respect to entities meeting the IAIS definition of a captive insurer (i.e., not owned by [sic] insurance or reinsurance group), the paper provides that regulatory risk associated with captives varies by type, suggesting that pure captives [i.e., captives that insure only the risk of parents or affiliates] represent the lowest risk, while captives undertaking activities that more closely resemble those of commercial insurers present the highest risk. With respect to the latter, the paper provides that supervisors should consider applying regulatory and supervisory requirements similar to those applicable to commercial insurers.

Implicit in these statements is the argument that SPVs used in redundant reserve transactions must be subject to the full range of regulatory requirements applicable to commercial insurers and reinsurers, even though the SPV is generally exposed only to a carefully circumscribed risk of the ceding insurer. The IAIS' definition of "captive" is, however, less settled that the drafters of the White Paper suggest.

First, whether entities owned by insurance enterprises fall within the meaning of the term "captive" has had a mixed history. The Guidance Paper draws the definition of the term captive from the IAIS Standard on Disclosures Concerning Technical Performance and Risks for Non-Life Insurers and Reinsurers, dated October, 2004, footnote 1. In this regard it is significant that the definition of "captive" in the IAIS Issues Paper on the Regulation and Supervision of Captive Insurance Companies, October 2006, footnote 4, does not exclude captives of insurance or reinsurance companies, for the stated reason that "we know that there are some of these vehicles in existence." Although the definition used in the 2008 Guidance Paper does exclude captives owned by insurance or reinsurance groups, the Guidance Paper specifically refers to the 2006 Issues Paper. This history makes it difficult to formulate a persuasive argument that the IAIS has taken a firm position that captives of insurance or reinsurance groups are to be excluded from the definition of the term captive, and therefore such captives must be regulated as if they were commercial insurers.

Much more to the point is that the IAIS has issued parallel guidance with respect to captives used in connection with life insurance financing transactions. For example, in its Issues Paper on Life Insurance Securitization, dated October 2003, the IAIS discussed various types of life insurance securitization transactions, including embedded value transactions, reserve funding (with a specific reference to XXX reserve funding), mortality or longevity risk transfer, and funding agreement backed notes. The possible use of a special purpose reinsurer in connection with a securitization transaction was specifically noted. Nothing in the Issues Paper equated special purpose reinsurers used in these transactions with industrial captives or commercial insurers.

The distinction between captive insurers of the type addressed in the Guidance Paper and SPVs used in financing transactions is carried forward in later IAIS guidance. The IAIS publication Developments in (Re)insurance Securitisation, Global Reinsurance Market Report, Midyear Edition, 29 August 2009, at 18-19, contained the following statement:

> The quantitative growth in insurance securitisation and the qualitative expansion of securitised arrangements have been accompanied by a variety of developments in regulatory and supervisory frameworks.
>
> Regulatory developments addressing insurance securitisation have followed national policies on the matter, resulting in a variety of dissimilar frameworks and approaches. The European Union work [sic] the matter, in particular the Reinsurance and the Solvency II Directives, provide the only example of a regional approach to the issue. However, both directives still leave plenty of implementation latitude to European Union members.
>
> Notwithstanding national differences, there are some common threads that are emerging among most regimes. These include: the creation in law of the category of the special purpose insurer; the differentiated nature of the special purpose insurers, in particular in relation to licensing, on-going supervision and capital requirements; the subordination of investors claims on the assets of the special purpose insurers to those of the cedant; and the fully funded nature of the special purpose insurer. Importantly, a common element among most supervisory

> arrangements is the reliance on both quantitative and qualitative information in the assessment of the soundness of special purpose insurers.
>
> As mentioned in the Introduction to this report, the IAIS is currently engaged in the production of dedicated standards and guidance with respect to the supervision of insurance risk transfer to the capital markets.

Subsequent guidance by the IAIS is set out in its report entitled Reinsurance and Financial Stability, July 2012, at 6-7:

> In October 2011, the IAIS ratified revisions to the Insurance Core Principles (ICPs), which provide the global framework for the supervision of the insurance sector. The principles apply equally to the supervision of insurers and reinsurers and there is no specific separation of issues in relation to reinsurance. One exception, however, is ICP 13, which recognises specific issues and covers reinsurance as well as other forms of risk transfer. It calls for the supervisor to set standards to ensure that primary insurers and reinsurers, including captives, adequately control and transparently report their risk transfer programmes.

In short, when the White Paper states that the definition of captive in the IAIS documents leads to a particular conclusion as to the degree of regulation of all captives, it is not taking into account the full range of IAIS and EU guidance. At both the IAIS and EU levels, there is a differentiation between captives used to insure risks of non-insurance entities and SPVs that are used by insurers or reinsurers for financing or risk transfer purposes. There is nothing in the ICPs or EU guidance that stands for the proposition that a captive, whether referred to as a captive or as an SPV, used to finance redundant reserves or otherwise gain access to funding sources, is to be treated the same as a commercial insurer or reinsurer. As is discussed later in this paper, the IAIS and EU guidance does provide many useful points for domestic regulators.

State Authority

The White Paper notes that the number of captive domiciles has grown in recent years, with the “significant portion” ascribed to the use of captives for dealing with XXX and AXXX reserves. As noted above in footnote 6, the use of a captive insurer to finance redundant reserves began in 2003 with the use of a special purpose captive insurer formed under the laws of South Carolina. South Carolina initially established itself as the domicile of choice for various types of transactions using captive insurers, but a number of other states have seen economic benefits for the state in implementing legislation allowing SPVs. In addition, a handful of states have allowed the creation of LPSs, which are captive insurers owned directly by an insurer, and are used for financing purposes. Clearly, a non-trivial number of US jurisdictions have seen value in SPVs and LPSs, whether to bring insurance business to the state, or to allow domestic companies a cost-effective means of dealing with the capital strain imposed by redundant reserves. Notwithstanding growing acceptance by regulators, the White Paper explicitly links this growth in SPVs to a desire to avoid statutory accounting requirements. As will be discussed later in this paper, we believe XXX and AXXX transactions, as well as other transactions using SPVs, have been structured to be generally consistent with the overall intent of these rules, not to avoid them.

The White Paper also discusses the use of captives in jurisdictions outside the United States. There have been XXX transactions using reinsurance vehicles outside of the United States—for example, some have been structured with an Irish reinsurer. It is true that captive insurers domiciled in foreign jurisdictions are beyond the direct reach of the regime for the regulation of insurance companies in the United States, but as will be discussed below, they are not beyond the reach of indirect regulation.

Transparency and Confidentiality

The White Paper discusses the issue of maintaining confidentiality of information, while at the same time ensuring that the regulatory community has the information it needs about captive insurers in order to properly oversee insurers. As is discussed in the White Paper, the laws of the states that allow SPVs generally contemplate sharing of information with other regulators, but the White Paper suggests the need for more disclosure of information about the use of captives by ceding insurers. The issues of transparency and confidentiality go the heart of the White Paper—a "shadow insurance industry" could only exist in the absence of regulatory transparency.

The White Paper states the following:

> The Subgroup agreed that confidentiality is warranted for pure captive transactions since such coverage written is only for the parent company and its subsidiaries' and affiliates' self-insured risks and there is generally no public interest in their business plan. However, for captives and SPVs owned by commercial insurers that cede insurance risk, the Subgroup had different views on the level of confidentiality that was needed for such transactions.

The Subgroup broke out into two lines of thought. Some members are of the view that captives and SPVs are deserving of the protection of confidentiality provisions that are commonly contained in state laws. The rationale for this position is that most SPV transactions are "one-off" transactions, and not allowing confidential treatment would allow competitors to gain information about the business operations of the company that sponsored the transaction. The White Paper states that "These subgroup members believed that since captives and SPVs have no contractual connection to the individual consumer or event to the third party insurance companies [presumably with reference to reinsurance transactions], the only parties that would actually benefit from public disclosure are the competitors of the ceding insurance company and the financial institution that provided the financing."

The other line of thought is that "information similar to perhaps the blue blank" should be available, because "captives and SPVs owned by commercial insurers were very different than pure captives, and their financial statements should be available to the public." The members of the Subgroup who support this view noted that although there may be sensitive information released, the "vast majority of such information is similar to other information required by commercial insurers on other types of financial contracts," which apparently is a justification for making the information publicly available. These members of the Subgroup noted also that "most insurers desire to compete with other insurers on the basis of their overall financial strength, and that a consumer or distributor wanting to develop an assessment of such strength should have access to information about the insurer's reliance upon captives and SPVs make informed decisions about the insurer's financial strength."

It is indisputable that disclosure is generally desirable. As noted above, XXX and AXXX reserve transactions are completely open to regulators with direct control of the transactions. Subject to the need to keep business information confidential, increased communication within a wider regulatory community seems to be a worthwhile goal and entirely consistent with various aspects of the NAIC' s Solvency Modernization Initiative (the "SMI").

That being said, and as will be discussed later, SPVs used by life insurers in XXX and AXXX reserve transactions are financing vehicles. These SPVs are not functioning as commercial insurers themselves: they do not deal with the public; the commercial insurers that sponsor the SPVs deal with the public, and it their solvency that is of primary concern to the insurance consumer. Informing the public that an insurer is using a captive for financing purposes is undoubtedly warranted, but if the relevant regulators are satisfied with the solvency protection for the ceding insurer, there seems to be little to be gained by imposing further public disclosure requirements on the SPV.

Accounting and Reporting

The White Paper states the following:

> Captive SPVs are generally subject to the same accounting and reporting requirements as traditional insurers, with the exception of certain permitted practices for letters of credit. Permitted practices are expressly allowed under the NAIC Accounting Practices and Procedures Manual. Generally, on an annual basis, Captive SPVs report on the NAIC blue blank and are audited by independent auditors in accordance with NAIC standards. Those reports are filed with the Captive domicile regulator, the ceding life company state regulator, and with rating agencies, in the case of certain large, public life insurers.

The White Paper goes on to note that state laws permit accounting and reporting by captive insurers that vary from those requirements for "commercial insurers" because the risks assumed by captives (generally, risks of parents or affiliated companies) differ from the risks assumed by commercial insurers, which provide insurance to the public. The White Paper then questions whether the accounting and reporting for captives should differ if the business that is being transacted by the captive is the assumption of commercial risk from an affiliated commercial insurer, and states that the use of captives to finance XXX or AXXX reserves raises "the concern … that such transactions may be consummated in part to provide relief from statutory accounting."

The White Paper briefly summarizes some of the steps in the regulatory review of a typical XXX or AXXX reserve transaction, and acknowledges that "for these type of transactions, the belief is that the regulatory review of the transaction ultimately matches the risk posed by the transaction." The White Paper then states that "however, the question that has been raised …is whether a more appropriate treatment of such transactions would be to deal with the accounting for this transaction within the ceding company, thereby eliminating the need for the separate transaction outside the commercial insurer [i.e., the insurer that cede XXX or AXXX reserves to the captive]."

Further, the White Paper states that:

> Notwithstanding the need to address the accounting for dealing with perceived XXX and AXXX reserve redundancies, the Subgroup held a consensus view that it was inappropriate for Captive and SPV [sic] to be used as a means to avoid statutory accounting. Use of other means of accounting may be appropriate when risks under the entity/transaction are perceived to differ from commercial insurance risk. However, the practice of using a different entity or different structures outside of the commercial insurer to engage in a particular risk because of a perceived inadequacy of the regulatory framework to accurately capture such a risk should be discouraged.

The White Paper argues that the use of captive to cure regulatory inadequacies could lead to, for example, allowing the discounting of non-life reserves, which is not currently allowed. The White Paper states that "again, the Subgroup held a consensus view that a more appropriate accounting treatment of XXX and AXXX reserves should be pursued as opposed to the use of captive insurers and SPVs, thereby eliminating the need for the separate transaction outside of the commercial insurer simply to address these reserve redundancies." As will be discussed later in this paper, eliminating reserve redundancies is a desirable goal, although it seems unlikely that such goal will be entirely achieved under any system of accounting currently under consideration.

Credit for Reinsurance

The White Paper acknowledges that most states ensure that XXX and AXXX reserve transactions meet credit for reinsurance requirements in their states, so that the ceding insurer can properly take reserve credit for XXX and AXXX reserves that have been ceded to the SPV. It then notes, however, that "some XXX and AXXX transactions may not have met the requirements under the credit for reinsurance models," because regulators have allowed some variances from strict application of the credit for reinsurance rules. For example, some regulators have permitted the use of a letter of credit (a "LOC") with conditions to the right to draw on the conditional LOC, such as ordering rules, which require that other available collateral be exhausted before the LOC can be drawn upon. The White Paper notes that such conditions or limitations are not "otherwise permitted," although it goes on to note that "credit for reinsurance models include a provision under which collateral may take the form of 'any other form of security that is acceptable to the commissioner.'" Other laws (or regulators) allow parental guarantees to meet a portion of the capital and surplus requirements of an SPV used in connection with XXX and AXXX transactions.

The drafters of the White Paper indicate that such deviations from regular rules for LOCs are not appropriate, and state the view that XXX and AXXX reserve issues should be dealt with by addressing the accounting for ceding insurers. The White Paper states that:

> The transactions involving conditional LOCs or parental guarantees effectively permit assets to support reinsurance recoverables, either as collateral or capital, in forms that are otherwise inconsistent with requirements under the credit for reinsurance models or other financial solvency requirements applicable to U.S.-domiciled commercial assuming insurers. The subgroup held a consensus view that these types of transactions were not consistent with the NAIC credit for reinsurance requirements and a more appropriate way to address such concerns regarding redundancy in reserves would be through accounting for the underlying business at the primary insurer level, thereby eliminating the need for the separate reinsurance transaction. The subgroup expressed its support for the use of solutions designed to shift risk to the capital markets or provide alternative forms of business financing and believes the NAIC should consider developing a uniform framework for the implementation of such alternative market solutions.

As noted elsewhere in the White Paper (and as is discussed below), under the Insurance Holding Company laws transactions between a ceding company and an affiliated SPV are subject to review by the ceding company's regulator in connection with a Form D filing. The ceding company's regulator is in a position to determine whether the XXX or AXXX reserve financing transaction meets the relevant criteria before allowing the ceding company to complete the transaction. The White Paper points out that:

> Typically a domestic regulator would review an affiliated reinsurance agreement before approving the use of such agreement by the ceding company. This prior approval is typically required by statute/regulation consistent with the U.S. windows and walls approach to group regulation. Typically, the domestic regulator would not review a reinsurance agreement with an unaffiliated reinsurer unless it met certain materiality standards. It should be noted that some of these arrangements noted within the study by the Subgroup were larger and more complex than a typical reinsurance agreement with an unaffiliated company and would typically result in a more detailed review of various aspects of the proposed transaction before being approved. In addition to the reinsurance agreement, all ancillary agreements to the transaction are reviewed, including management, investment and tax sharing agreements with affiliates and non-affiliates, and all agreements with counterparties, such as the letter of credit facility agreement and reimbursement agreements. Regardless, regulators need to be able to logically conclude that transactions for products that transfer [risk] to the alternative risk transfer market are sound as well as permissible under current statutory accounting guidelines….

This discussion, and the following discussion of regulation under Insurance Holding Company laws further undercut the idea that SPVs used in XXX and AXXX reserve transactions exist in a shadow system. In addition, although the use of conditional LOCs may not be explicitly permitted by the credit for reinsurance rules, to the extent that the conditions have been determined by the relevant regulator[s] to be economically reasonable, the permitted variances would not appear to materially increase risks to the sponsoring insurer or its policyholders. The use of parental guarantees as capital for SPVs that are licensed in the state of domicile of the sponsoring insurer, so that collateral is not required to secure credit for reinsurance, does point out the need for careful supervision under the relevant state's insurance holding company system laws.

Moreover, there are other uses of SPV-based securitization transactions, such as embedded value monetization, which can be a cost-efficient means of raising capital from the capital markets, which the White Paper appears to accept. There seems to be little regulatory value in making it difficult or impossible for life insurers to engage in properly disclosed, properly regulated, but cost-efficient securitization transactions, but that would be the result if SPVs were to be subjected to the full range of requirements applicable to commercial insurers.

Holding Company Considerations

This section of the White Paper notes that "a significant portion of captive transactions occur outside the United States," and that the more onerous and costly that requirements for captive are made, the more likely that companies will establish captives in "jurisdictions that are not as transparent and that are outside of U.S. regulation." (As previously noted, however, most XXX and AXXX transactions are completed within the United States.) The White Paper then states that "through the proper use of the insurance holding company system law and regulations, these transactions can effectively be monitored such that they do not pose a threat to the policyholders while still allowing for the approval of transactions with valid business purposes." The White Paper specifically applies this statement to XXX and AXXX reserve transactions, stating that:

> [A] majority of the most recent increase in captive insurers and SPV activities can be attributed to an intent to finance perceived redundant reserves without actually transferring the risk outside of the insurance holding company system. Notwithstanding the working group's recommendation to develop more appropriate accounting for such transaction within the ceding company, thereby potentially eliminating the need for the separate transaction outside of the commercial insurer, the most effective method to monitor all captive transactions is through insurance holding company system analysis. In this way, the risk to the insurance holding company system can be appropriately assessed, and improper transactions should be prohibited, regardless of the Captive/SPV jurisdiction.

The White Paper also noted that:

> [A] robust holding company analysis can determine the amount of risk involved as well as to determine the ability of the parent to meet obligations pertaining to reimbursing LOCs, parental guarantees or other similar arrangements. Specific issues expected to be encountered on these particular transactions include the need to 1) encourage communication and coordination between the captive regulators and ceding company regulators; 2) request on an annual basis for the company actuary comments on where there may be significant or adverse differences from original projections; 3) ensure that under stress, the entities are able to meet the guarantees.

Takeaways From Case Studies

This section noted the following:

- The majority of transactions identified by the Subgroup were with respect to life insurance, and mostly related to XXX and AXXX reserves.

- Most transactions used affiliated captive reinsurers and SPVs.

- Domestic regulators have approval authority over these transactions.

- Domestic regulators coordinate with ceding company regulators, and in most cases retain outside advisors to examine the merits of each transaction.

- Credit for reinsurance requirements for some transactions were met, with some commissioner discretion for some ceding company states.

- Most non-XXX and AXXX transactions reviewed were conducted for various "legitimate business purposes," to access capital markets and provide alternative financing to certain business risks for better cost and use of capital than retaining the risk or reinsuring the risk.

Conclusions and Recommendations to Financial Condition (E) Committee

The White Paper noted that the primary focus of the Subgroup was upon the use by domestic commercial insurers of affiliated captives or SPVs, and reiterated the concern that "onerous requirements placed on U.S. captive domiciles may lead to increased use of non-U.S. captives, where transparency may be even more limited," but then note that if regulators in the United States exercise their authority to analyze and comprehend the risks of cessions to captives located outside of the country this concern should be mitigated.

The White Paper noted the three structures primarily used in XXX and AXXX reserve transactions:

- Captives as a conduit to securitizations that provide capital markets financing of reserves.

- Captives capitalized by letters of credit accounted for as assets in support of the redundant portion of XXX and AXXX reserves.

- Captives/SPVs capitalized by parental guarantees accounted for as assets in support of the redundant portion of reserves.

The drafters of the White Paper identified other affiliated captive/SPV transactions, more limited in number, that were not related to XXX and AXXX reserves, in which:

> [O]ne indirect effect, whether intended or not, was to provide relief from what may be perceived as overly conservative requirements of statutory accounting, and in some instances by allowing a captive/SPV to account for letters of credit or

> parental guarantees as assets, something not permitted in the current statutory accounting framework.

The White Paper "acknowledges that there are business reasons other than statutory accounting relief for the use of a captive or SPV, such as financing; however, the Subgroup would prefer that there be alternatives that are more transparent than the solutions to the issues captives/SPVs were designed to address." It goes on to state that:

> [T]he implementation of Principles Based Reserving (PBR) may ultimately reduce the desire of commercial insurers to create new captives and SPVs to address perceived reserve redundancies, but existing captives and SPVs are likely to remain in existence for several years or decades until the existing blocks of business are run-off. Therefore, there is a need to improve the regulation and transparency of these existing transactions. Regulators need to be aware of and monitor the risks that captives/SPVs may pose to the holding company system as well as to the legal entity insurer. With the proper tools and communication regulators can adequately analyze past transactions to ensure the proper protections for policyholders are included.

The White Paper further states that:

> In transactions reviewed by the Subgroup, regulators of the ceding company and captive worked together to ensure alternative assets, such as letters of credit or parental guarantees, were used to support only those reserves considered redundant. Regulators require the companies engaged in these transactions to support economic reserves, plus some margin, with investment grade, liquid assets. The net result of the transactions is that collectively the ceding insurer and the captive have liquid assets supporting GAAP equivalent reserves, plus a margin for reasonably adverse developments.

The White Paper makes the following recommendations:

1. The Subgroup advocates dealing with XXX and AXXX reserves at the ceding company level, such as by allowing disclosed permitted accounting practices that would, presumably, reduce or eliminate reserve redundancies. The Subgroup stated that the consensus view is that the NAIC's Financial Condition (E) Committee should form a separate subgroup to develop possible solutions to address remaining XXX and AXXX perceived redundancies, including changes to actuarial guidelines or disclosed prescribed or permitted accounting practices. The Subgroup also advocated consideration of allowing alternative assets (such as "Tier 2 type assets") to be held by commercial insurers to support "specific situations," thereby eliminating the need for the separate transactions outside the commercial insurer.

2. The Subgroup held a consensus view that captives and special purpose vehicles should not be used by commercial insurers to avoid statutory accounting prescribed by the states, with a stated concern that captives and SPVs could be used in the future for

“unseen purposes.” The Subgroup advocated the development of additional guidance by the NAIC to assist states in uniform reviews of transactions, which should eliminate inconsistency among the regulators of ceding companies and captives.

3. The Subgroup states that it supports shifting of risk to the capital markets, and suggests the NAIC should re-evaluate and update the NAIC Special Purpose Reinsurance Vehicle Model Act to reflect alternative markets solutions acceptable to state regulators to ensure there is a common framework the implementation of alternative market solutions, and that that the NAIC should encourage states to adopt the model. Finally, the Subgroup suggests making adoption of the model an accreditation standard in those states that have an active captive and SPV market.

4. The Subgroup supports the IAIS Guidance Paper on the Regulation and Supervision of Captive Insurers which, in the view of the Subgroup, advocates subjecting captives/spvs that are not self-insurance vehicles to a similar regulatory framework that now applies to commercial insurers.

5. The Subgroup advocates that consideration be given to ways to limit the variability in qualified LOCs or other security that may not provide the protections that are intended by the Credit for Reinsurance Model Law.

6. The Subgroup also recommends enhanced disclosure in ceding company statements regarding the impact of transactions with captives and SPVs on its financial position.

7. The Subgroup further recommends that the Financial Condition (E) Committee study the issue of confidentiality related to commercially owned captives and SPVs more closely, in order to bring “greater clarity regarding the specific reasons for and against the use of confidentiality for such entities” in order to provide greater uniformity with regard to the types of information that should or should not be held confidential.

8. Finally, the Subgroup suggests further work should be done to enforce the ability of a state or other functional regulator of a group to obtain additional information from the captive regulator on a confidential basis in order to understand the details of a captive or SPV transaction. One recommendation noted by the Subgroup is that the domestic regulator of each member of a holding company system be notified of a transaction

within the holding company system utilizing a captive or SPV even when a member insurer is not a party to the transaction. Additionally, the recommendation is made that "the ability to ensure future communication of information through Supervisory Colleges should be addressed."

General Comments on the White Paper

The White Paper's reference to a "shadow insurance industry" is ultimately not supported by the paper itself. The use of captives, SPVs, SPFCs or similar vehicles by whatever name they are called, dates back almost a decade. Each XXX or AXXX transaction has been presented to at least one domestic regulator, and as most transactions have been structured using a domestic captive, to a second domestic regulator as well. In the case of the ceding company, its regulator will be provided whatever information the regulator deems relevant in the Form D filing. As is noted in Section VIII of the White Paper, the insurance holding company laws provide the "most effective way to monitor all captive transactions," and that a "robust holding company analysis can 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 similar arrangements." Certainly, the analysis required by the NAIC Insurance Holding Company Regulatory Act (Model 440) and accompanying regulations (Model 450) will enhance the robustness of this analysis. The volume of information that must be provided to the captive's regulator and the ceding company's regulator, as well as the LOC provider, would seem to be in marked contrast to the situation in the banking industry that led up to the events of 2008 and 2009. Indeed, it is important to keep in mind that only a relatively small number of XXX and AXXX reserve transactions have been completed, and certainly it cannot be said that the volume of transactions could overwhelm the regulatory community's ability to assess these transactions. This is not to say that disclosure of information by ceding insurers involved in transactions with captives could not be strengthened, but the idea that captives, particularly those used in XXX and AXXX reserve transactions exist in a shadowy world is not borne out by reality.

Another conclusion set out in the White Paper is that captives engaged in XXX or AXXX reserve financing transactions are the functional equivalent of commercial insurers. In reality, the life insurance companies that have XXX or AXXX reserves on their books have undertaken the risk of the business from policyholders—the risk that is being ceded in a XXX or AXXX reserve transaction is the ceding company's risk on the underlying policies—the policyholder still looks to the ceding insurer for performance. It is the ceding company's reserve funding and capital structure that is important; the captive's assets stand behind the ceding insurer. These captives function in the same manner as captives discussed in the IAIS Issues Paper on Life Insurance Securitization. They may be invisible to the public, but they are not invisible to the regulatory community. As long as the regulator who oversees the ceding company is performing his or her responsibilities, the public is not put at additional risk. This is not to say that the financial strength of the captive in a XXX or AXXX reserve transaction is not important to regulators, and to the insurance-buying public, but the appropriate means of regulation is through the insurance holding company and credit for reinsurance laws and regulations.

Nor does the allegation that these transactions are being done to avoid statutory accounting rules hold up under scrutiny. XXX and AXXX reserve transactions to date are nothing more than financing transactions. Those reserves, which must be held notwithstanding their redundant nature, cannot be funded from premiums and investment income without making the products uncompetitive. The original XXX reserve transactions were intended to raise funds in the capital markets to support the redundant reserves in a manner that was cost effective, and provided for long-term funding (something that was not available in the LOC market at the time). In those transactions the risk that losses in excess of economic reserves would emerge was shifted to the SPV, and ultimately to the capital markets. Some later transactions shifted risk to LOC providers. In both cases, funding providers became comfortable that the XXX or AXXX reserves were in fact redundant, and thus they would not be called on to absorb losses. More recent LOC transactions have reportedly been structured on a full recourse basis, so that the risk that losses would exceed economic reserves is transferred to a parent or affiliate of the SPV. Regardless of the form chosen for XXX and AXXX reserve transactions, they are structured specifically to observe the statutory accounting rules, subject to exceptions that are discussed below.

To the extent a captive either funds a trust or posts a traditional LOC to secure XXX or AXXX reserves, the ceding company that sponsors the transaction would generally be in full compliance with statutory accounting requirements. In early capital markets transactions, the SPVs were funded with a combination of invested capital, reinsurance premiums equal to economic reserves, and the proceeds of surplus notes to fund the redundant reserves (with some or all of the assets held in a qualifying trust). In these types of structures it is clear that the SPVs were functioning purely as a means of gaining access to the capital markets, and not as commercial reinsurers, and there would be little to be gained by treating them as such. The same would be true if SPVs were to be used in other types of capital-raising transactions.

There have been some recent transactions in which a captive is funded with a LOC as an admitted asset. In those cases there may not be strict compliance with statutory accounting rules, but in point of fact the reinsurer still holds an asset, the bank-issued LOC, that guarantees that the obligations of the captive to the ceding insurer will be performed. Additionally, the White Paper notes that some recent transactions reportedly involved LOCs that may not have met all of the requirements for traditional LOCs; in particular, some LOCs permitted by regulators in XXX or AXXX reserve transactions have had some conditions on draws, such as ordering rules that require the SPV to draw on other sources of funds before drawing on the LOC. Regulators have traditionally been concerned about anything that can impede an insurer's access to funds to pay claims of policyholders. Accordingly, LOCs in reinsurance transactions were expected to be available for draws without any limitations on the right of the ceding insurer to convert the LOC to cash. Concededly, when a LOC used to secure an SPV's obligations to a ceding insurer is subject to conditions as to when it may be drawn there may not be strict compliance with credit for reinsurance requirements, but in these cases the regulator of the ceding company has become comfortable with the quality of the LOC put up by the SPV (whether domestic, foreign or alien) to back the redundant reserves, and has allowed what may be viewed as "non-conforming" LOCs under "any other security approved by the insurance commissioner" language under the credit for reinsurance laws and regulations. Ultimately, when the ceding insurer has sufficient protection with respect to assets backing the economic reserves in a XXX or AXXX reserve transaction through the use of other recognized security devices, such as trusts or modified coinsurance or funds withheld coinsurance to secure economic reserves, and the redundant reserves are backed by LOCs, even when the LOCs are subject to conditions, the risk to the insurance system is minimal.

Parental guarantees backing LOCs raise other concerns. As noted above, many recent XXX or AXXX reserve transactions have be structured with "full recourse" LOCs; i.e., the LOC is guaranteed by a parent or other member of the holding company system of the ceding company and/or the SPV. In the case of recourse LOCs, the interests of the ceding insurer and the captive would generally be protected by the right to draw on the LOC—which would result in injection of additional funds into the SPV and/or the ceding insurer. The parent that provided the guaranty would, of course, now have a liability to the LOC bank, but as the guarantor is most likely not a regulated insurer, the solvency of the regulated entities would not be implicated. In essence, the guaranty could be viewed as something akin to a contingent capital call on the guarantor. These arrangements would have been described to the regulator of the ceding company in connection with Form D filings, and perhaps in annual holding company act filings as well. As is the case with any other case in which there is a parental guarantee, as when an insurer is backed by a net worth maintenance agreement or similar agreement, regulators should monitor the financial strength of the guarantor and other members of the insurance holding company system in order to ensure that the overall financial strength of the system is not threatened.

Second, some states allow parental guarantees to be reflected as assets of a LPS. The parental guarantee does not involve the infusion of additional funds into the system; thus, if the guarantor becomes impaired, the value of its guarantee will likewise be impaired. In the (highly unlikely) event that the ceding company has losses that exceed the economic reserves that are secured by a modified coinsurance reserve or funds withheld asset, the liability to pay the excess claims that would have been backed by reinsurance with the LPS may, in fact, revert to the ceding insurer. Ultimately, the viability of the parental guaranty in this instance is predicated on two things: the financial strength of the parent/guarantor, and the redundant nature of the XXX or AXXX reserves. It should be kept in mind that solvency concerns would arise only if both the parent/guarantor were to become unable to perform on its guarantee, and losses on the reinsured XXX or AXXX business exceeded the economic reserves of the captive, plus capital and surplus funds held by the LPS. These types of arrangements illustrate the importance of the group supervision and enterprise risk management aspects of SMI.

Other structures for funding XXX and AXXX reserves have been used (or proposed). For example, notes issued by a domestic funding vehicle that are guaranteed by an offshore reinsurer have been permitted for use as assets of a trust used for credit for reinsurance purposes. Whether an arrangement of this nature is consistent with credit for reinsurance or other rules is an issue for the regulator of the ceding company. For example, will the note qualify as an admitted asset when held by the captive?

The White Paper takes the view that the use of captives to finance reserves should be discouraged, and that the best way to proceed is to adopt PBR, which, presumably, would eliminate the redundancy in XXX and AXXX reserves. Perhaps adoption of PBR would eliminate reserve redundancies, but that is not clearly the case; it appears equally likely that PBR would reduce redundancy in some cases and increase it in others, but in most cases it appears that reserve redundancies would not be eliminated. Moreover, adoption of PBR is uncertain as to timing. To the extent that reserve redundancies exist, and cannot be funded from premiums or other sources on an economically efficient basis, captives can perform a fully supportable function. The NAIC can perform a useful role in suggesting a uniform set of rules for XXX and

AXXX reserve financing transactions, but there is no need to treat these transactions as anything other than what they are: innovative but sound structures to deal with economic realities. Although PBR may reduce the need to form SPVs to fund redundant reserves, implementation of PBR is under continued reconsideration and should not be relied on as a solution in the near term.

In this regard the White Paper makes two suggestions: The first is to allow the use of "disclosed prescribed or permitted accounting practices; the second is to allow the use of alternative assets, such as "Tier 2 assets," to support "specific situations." Consistent with these suggestions, we believe the NAIC should give careful, open-minded consideration to the types of assets currently permitted by a significant number of states in connection with XXX and AXXX reserve transactions. We are not sure how the White Paper suggests allowing "disclosed permitted accounting practices" as an alternative accounting treatment, "thereby eliminating the need for the separate transaction outside of the commercial insurer," is preferable to the use of SPVs to obtain outside financing.

The White Paper states that the Subgroup supports shifting risk to the capital markets. As noted previously, early XXX reserve transactions did precisely that. Although later transactions using LOCs may keep the primary risk within the SPV's affiliated group, the LOC issuer does provide new funds, and does have residual risk.

Finally, the Subgroup supports the IAIS Guidance Paper. We suggest that the Subgroup expand its view to consider the full range of relevant IAIS and EU guidance. In the context of the use of captives in reserve funding transactions the most relevant guidance is now set out in ICP 13.6, which applies to transactions in which risk is transferred to the capital markets.

ICP 13.6.2 provides that:

> Risk transfer to the capital markets can occur by making use of a wide variety of arrangements. These usually entail the creation of a dedicated entity, specifically constituted to carry out the transfer of risk. These are variously referred to as Special Purpose Vehicles, Special Purpose Reinsurance Vehicles, Special Purpose Insurers, Special Purpose Entities, etc. In the ICP material the term SPE is used to cover all such vehicles. However, risk transfer to the capital markets is not limited to the use of SPEs. Supervisors should monitor developments in this area.

ICP 13.6.3 states that:

> It should be noted that, in many respects, these transactions are the same as traditional reinsurance arrangements, and therefore the guidance throughout this paper will be applicable. These transactions do, however, have special features that supervisors will need to bear in mind in order to assess the appropriateness and effectiveness of their use by cedants.

ICP 13.6.4 states that:

> A key element of any SPE structure is the transfer of insurance risk to a "fully funded", bankruptcy-remote vehicle whereby the claims of any investors are subordinated to the

> cedant and whereby the investors have no recourse to the cedant in the event of an economic loss to the vehicle. Supervisors should be in a position to understand and gain comfort with the extent to which SPEs fulfill the "fully funded" and "bankruptcy remote" conditions.

ICP 13.6.5 through 13.6.14 then address in detail regulatory concerns for SPEs. The two most critical points are the requirements that an SPE be "fully funded," and that risk be fully disclosed. With respect to the first requirement, ICP 13.6.5 provides as follows:

> In order to ensure that an SPE structure meets the "fully funded" criterion, supervisors should take the following into account when supervising SPEs:
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> - ownership structure of the SPE;
> - investment and liquidity strategy of the SPE;
> - the SPE's strategy in relation to credit, market, underwriting and operational risks;
> - the ranking and priority of payments (e.g. waterfall);
> - the extent to which the cash flows in the SPE structure have been stress tested;
> - the arrangements for holding the SPE's assets (e.g. trust accounts) and the legal ownership of the assets;
> - the extent to which the SPE's assets are diversified; and
> - use of derivatives, especially for purposes other than risk reduction and efficient portfolio management.

As for disclosure and related matters, ICP 13.6.7 provides as follows:

> Understanding the role of all the parties to the SPE arrangement is critical to understanding the underlying risks, particularly as these may be fundamentally different from those involved in a traditional reinsurance transaction. Supervisors should be in a position to understand, among other things, the:
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> - extent to which key parties have been fully disclosed (e.g. sponsor, (re)insured, investors, advisors, counterparties, etc.) and are known to the supervisor;
> - extent to which potential conflicts of interest between all parties to the SPE have been adequately disclosed and addressed (such as situations where sponsors also take a managing role);

- degree of basis risk that is assumed by the sponsor and to what extent this could have immediate ramifications for the sponsor's financial position in case of a loss;

- details of the SPE's management arrangements and key personnel;

- third party assessments of the SPE structure (e.g. by external agencies);

- expertise of the legal advisors involved;

- robustness of any financial or actuarial projections, if applicable (e.g. if triggers are indemnity based);

- disclosure of outsourcing agreements; and

- credit risk associated with key service providers, including financial guarantors used to protect the position of investors.

As can be seen from the ICPs, the IAIS guidance focuses on the "special features" of transactions using SPVs, and stresses the need for proper regulation and disclosure. They do not, however, set out a requirement, or even an implication, that an SPV must be treated as a commercial insurer.

Although the White Paper does not raise the use of SPVs in the European Union, those types of captives are specifically addressed in EU insurance laws and regulations. EU Directive 2005/68/EC of the European Parliament and of the Council of 16 November 2005 (the "Reinsurance Directive") is instructive. It first sets out a definition of a "captive reinsurance undertaking" as "a reinsurance undertaking owned either by a financial undertaking other than an insurance or reinsurance undertaking or a group of insurance or reinsurance undertakings …, or by a non-financial undertaking, the purpose of which is to provide reinsurance cover exclusively for the risks of the undertaking or undertakings to which it belongs or of an undertaking or undertakings of the group of which the captive reinsurance undertaking is a member." In this regard the Directive is substantially the same as the IAIS definition.

The Reinsurance Directive next defines the term "special purpose vehicle" as "any undertaking, whether incorporated or not, other than an existing insurance or reinsurance undertaking, which assumes risks from insurance or reinsurance undertakings and which fully funds its exposure to such risks through the proceeds of a debt issuance or some other financing arrangement where the repayment rights of the providers of such debt or other financing mechanism are subordinated to the reinsurance obligations of such vehicle." In this case, the Directive is addressing vehicles of the type discussed in the IAIS paper on life insurance securitizations.

Article 46 of the Reinsurance Directive provides that a Member State in which an SPV is to be established "shall lay down the conditions under which the activities of such undertaking shall be carried on," including: the scope of authorization of the SPV, mandatory conditions for its contracts, the qualifications of SPV managers and shareholders or members, sound accounting and administrative procedures, adequate internal control mechanisms and risk management requirements, accounting, prudential and statistical information requirements and solvency requirements. As an example, the U.K.'s Financial Services Authority ("FSA") introduced a "fit-for-purpose regime" in which authorization and prudential requirements were to be proportionate to risks. The regime would require SPVs to provide less information than commercial insurers or reinsurers to become authorized, and FSA's regulatory focus would be on the ceding firm's risk management. Although the Solvency II Directive moves certain powers with respect to SPVs from member countries, they would continue to be permitted.

Conclusion

We believe that the White Paper raises a number of useful suggestions for the ongoing regulation of SPVs. We do not see, however, that the use of SPVs has produced a shadow insurance industry. As discussed above, these transactions are structured in the full view of the most directly affected regulators. It is always possible to improve regulatory oversight; that does not necessitate treating SPVs as the equivalent of commercial insurers or reinsurers. When SPVs are used for narrowly-designed purposes, such as financing XXX or AXXX reserves, they are not functioning as commercial insurers. Although there may be some practices currently permitted in XXX or AXXX transactions that merit further study, making the use of properly structured SPVs economically unfeasible does not serve the best interests of the industry, the regulatory community or the insurance consumer.