# MEMORANDUM

**TO:** Michael McRaith, Director, Federal Insurance Office
Members of the Federal Advisory Committee on Insurance

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

**SUBJECT:** Update on the Activities of the NAIC Captives and Special Purpose Vehicles Subgroup

**DATE:** June 7, 2013

***Introduction***

The National Association of Insurance Commissioners' Captives and Special Purpose Vehicle Subgroup of the Financial Condition (E) Committee prepared a draft white paper addressing the use of captives and similar alternative risk bearing entities by commercial life insurers in the United States. The white paper was exposed on March 15, 2013 and comments were due on April 29, 2013. On June 6, 2013 the Subgroup adopted the white paper, and referred it to the E Committee for consideration.

The Principle-Based Reserving Implementation (EX) Task Force, formerly known as the Principle-Based Reserving Working Group, (http://naic.org/committees_ex_pbr_implementation_tf.htm) will consider the recommendations in the white paper in the context of the proposed PBR system, and make further recommendations, if any, to the Executive (EX) Committee.

***Issues Raised and Recommendations Proposed in the White Paper***

The primary focus of the Subgroup was on U.S. commercial insurers' use of affiliated captives or special purpose vehicles or SPVs. The Subgroup determined that the majority use of captives/SPVs by commercial insurers was related to the financing of XXX and AXXX reserve redundancies. The Subgroup offered the following recommendations to address the issues presented in the white paper.

**1. Accounting Considerations**

As stated above, captives/SPVs have been used to address the XXX and AXXX perceived reserve redundancies. The Subgroup held a consensus view that the Financial Condition (E) Committee should form a separate subgroup to develop possible solutions for addressing the remaining XXX and AXXX perceived redundancies. Possible solutions include changes similar to the AG 38 solution, or disclosed prescribed or permitted accounting practices.

The NAIC should also consider modifications to the statutory accounting framework to recognize, in strictly limited situations, alternative assets, such as "tier 2" type assets" to support specific situations (e.g. less likely to develop liabilities) thereby eliminating the need for the separate transaction outside of the commercial insurer. 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 states.

**2. Access to Alternative Markets**

The Subgroup supports the use of solutions designed to shift risk to the capital markets or provide alternative forms of business financing. The NAIC's Special Purpose Reinsurance Vehicle Model Act (#789) was developed to provide a uniform framework for the implementation of capital market securitizations of commercial insurers' reserves. However, securitization solutions allowed for within the model are no longer being utilized as other solutions are preferred today. The NAIC should consider re-evaluating the model and updating it as necessary to reflect alternative markets solutions acceptable to state regulators to ensure there is a uniform framework for the implementation of alternative market solutions.

**3. IAIS Standards**

The Subgroup supports the IAIS Guidance Paper on the Regulation and Supervision of Captive Insurers which states in summary that insurer or reinsurer owned or common controlled Captives/SPVs, that are not otherwise self-insurance, should be subject to a similar regulatory framework as commercial insurers. The Subgroup believes that the use of captives should generally follow the international views contained within this guidance paper.

**4. Credit for Reinsurance Model Enhancements/Added Reinsurance Disclosure/Transparency**

Notwithstanding the Subgroup's support for the IAIS Guidance Paper on the Regulation and Supervision of Captive Insurers, the Subgroup recognizes that there will be situations where movement of the reinsured risk outside of the group may not be feasible, or practical. For such situations, the Subgroup recommends consideration should be given for ways to study the effects of and potential limits on the variability in qualified letters of credit or any other security that may not provide the intended protections provided within the NAIC Credit for Reinsurance Model Law.

**5. Confidentiality**

The Subgroup recommends that the Financial Condition (E) Committee study the issue of confidentiality related to commercially owned Captives and SPVs more closely. Such study would pursue greater clarity regarding the specific reasons for and against the use of confidentiality for such entities.

***Principles Based Reserving (PBR)***

The 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. Moreover, it is likely that future changes in market conditions and macroeconomic events will create a need for insurers and reinsurers to use alternative risk financing entities and mechanisms to remain competitive through the efficient use of capital.

**6. Disclosure and Transparency**

The Subgroup recommends enhanced disclosure in ceding company statements regarding the impact of the transactions on the financial position of the ceding insurer. Increased disclosure includes possible changes to Schedule S and Schedule F as proposed by Vermont or as similarly proposed by the ACLI. In addition, enhancement of Note to Financial Statement 10M should be made to provide for disclosure of non-trade-secret captive information and disclosure of the overall utilization of captives.

**7. Financial Analysis Handbook Guidance**

The Subgroup recommends the development of guidance in the Financial Analysis Handbook for states' review and on-going analysis of transactions involving captives and SPVs, including specific considerations of such transactions when performing holding company analysis. The guidance should be developed for perspectives of the ceding state, the captive state and the lead state. This guidance is intended to increase the consistency in procedures between states involved with such transactions.