Opening Up

Robust state regulations are allowing special-purpose financial captives to be used by the insurance industry.

by Albert Pinzon, Geoffrey Etherington and Zachary Lerner

For more than a decade, offshore special purpose vehicles have been used to collateralize, secure and/or support reinsurance transactions.

Both life and property/casualty companies ceded reinsurance to SPVs for various reasons, including in the case of life insurers' elimination of XXX and AXXX reserve redundancies and acceleration of premium flows through embedded value transactions and longevity-risk catastrophe bonds.

Recently, health insurance carriers such as Aetna also have used SPVs to cover catastrophic exposure. Investors and counterparties provided the funding to SPVs to back reinsurance transactions through purchases of bonds, equity-like instruments or swaps. Perhaps the most common of these transactions are cat bonds. Capital markets participants, hedge funds and other investors have been interested in these structures because they provide opportunities to invest in identifiable and specific insurance risks, books or blocks.

Offshore SPVs were used because U.S. state insurance laws generally were not receptive to such structures. That began to change in 2002, when South Carolina took steps to authorize SPVs. South Carolina responded to domestic market demands for capital market solutions to fund redundant reserves as well as to address reinsurance, availability and pricing concerns by passing the Special Purpose Reinsurance Vehicle Model Act, opening the door for state-regulated securitization of reinsurance transactions. In subsequent years, a number of other states followed suit and life insurance securitization expanded.

Instead of SPVs being met with open arms because of the access to capital and reinsurance capacity throughout the industry, there has been a great deal of concern expressed by industry players, and skepticism by the National Association of Insurance Commissioners.

Last fall, the NAIC published the Captive and Special Purpose Vehicles Discussion Draft, noting in part that many industry specialists believe a "shadow insurance industry" has emerged, whereby novel actions are being unregulated in a similar fashion as displayed during the banking crisis.

Where many analysts and pundits fail in their critiques of the broadened use of SPVs is that, while regulatory failures or gaps in regulation with respect to certain activities arguably led to the financial crisis, regulatory supervision is the backbone of the new domestic SPV regime and is essentially the brainchild of the South Carolina Department of Insurance.

To truly appreciate the mechanics in place that provide for prudent, legitimate transfers of risk between insurers and reinsurance SPVs, this article analyzes the protections instituted in states leading the way in this sector of the industry, starting with arguably the most robust regime in the nation, South Carolina.

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Key Points

- **The Background:** At least 19 states have approved the ceding of risk by domestic insurers to special purpose financial captives.
- **At Issue:** The National Association of Insurance Commissioners has questioned the utilization of SPFCs to transfer risk.
- **Watch For:** The NAIC to become more accepting of the use of SPFCs.

South Carolina

Although South Carolina first embraced the concept of reinsurance securitization as early as 2001, the state faced many of the concerns echoed throughout the industry today. Such fears stemmed from the impression that the regulators lacked specific authority relating to the structure and supervision of these newly termed Special Purpose Financial Captives. Such uncertainty raised transaction costs for investors who had sought predictability and accountability under the new regime, and led to worries that regulators might not be active enough in the supervision of SPFCs.

This all changed in 2004 when South Carolina passed sweeping reform by codifying specific requirements for SPFC securitization transactions. Under chapter 90 of the South Carolina insurance code, specific safeguards were established to provide for enhanced regulation of SPFCs, including:

1. Minimum capital requirements of $250,000.
2. A requirement that the SPFC file an annual independent actuarial opinion on reserves.
3. A requirement that repayment of principal or interest on securities issued by the SPFC be tied to the performance of the reinsurance arrangement.
4. Establishment of trust accounts to secure obligations to the counterparties.
5. Director approval of dividends.
6. An analysis by regulators of the SPFC's affairs at least once every five years.

Furthermore, before the SPFC is granted a license, directors and officers must submit to background checks, and securities to be issued must be properly registered under applicable securities laws.

In addition, the director may require disclosure of facts it deems necessary to evaluate the SPFC, including the plan of operation, liquidity of assets relative to assumed risks, source of capitalization, proposed use of protected cells and a list of all material contracts. In short, regulators in South Carolina are aware of the SPFC's intentions and behavior both before the SPFC receives its license and after it has begun contracting business.

In spite of this comprehensive regulatory regime, critics continue to cry foul over the ability of SPFCs to "hide" their dealings from the public. Tom Gober, president of Palmyra, Va.-based Gober Forensic Accounting Services, has said that states like South Carolina "have bastardized the definition of captive by seemingly allowing unaffiliated risks ... to be dumped in a captive, and thereby hide the liabilities."

While the public is not made aware of every fact surrounding SPFCs, in large part due to the legitimate concern of disclosing sensitive trade secrets, South Carolina regulators have unbridled access to such information. The SPFCs do not, and cannot "hide" liabilities from the system put in place to manage and regulate them.

Furthermore, under the applicable South Carolina statutes, information submitted to regulators is discoverable in civil actions if such information is relevant to the case, providing individual investors with protection if malfeasance has slipped through the system.

In addition, the director may also share such confidential information with South Carolina's securities commissioner, providing interdepartmental facilitation of information to enhance regulation.

Vermont

Vermont enabled securitization transactions through SPFCs in 2007. Subchapter 4 of Chapter 141 of the Vermont insurance laws is similar to South Carolina's statutes.

Among Vermont SPFC license requirements are:

1. A plan of operation detailing all significant transactions and all parties involved.
2. Disclosure of sources of capital and surplus.
3. Descriptions of any proposed investment policy.
4. Hypothetical income statements describing potential adverse scenarios.
5. Copies of any reinsurance contracts.
6. An opinion of counsel that all securities are sold in compliance with applicable securities laws. Furthermore, the statutes allow the Vermont insurance commissioner to require an SPFC to take any action "reasonably necessary" to bring it into compliance with applicable laws.

In addition, SPFCs must file annual reports in a form established by the insurance commissioner and must at all times maintain their books, accounts and agreements within the state for continuous inspection at the insurance commissioner's discretion.

Just as in South Carolina, Vermont's laws providing for SPFC securitization transactions relieved uncertainty in the markets and increased efficiency and predictability both for industry insiders and sponsors. Derek White, Vermont state director of captive insurance, has noted that "the trouble was the law did not specifically spell out that securitization was allowed ... it did not say it was not allowed but some of the big law firms—especially in New York City—felt uncomfortable rendering an opinion that it could be done when the law did not specifically say it could."

Of course, critics continue to point to an alleged absence of transparency. However, as David Provost, deputy commissioner at the Vermont Department of Banking, Insurance Securities and Health Care Administration has noted, much of the information of interest to investors, including information relating to amounts ceded to SPFCs, can freely be found in the ceding insurers' audited financial statements and accompanying footnotes. The mandated public disclosures under Vermont's statutes, along with thorough internal regulation, serve as a double layer of protection against abuse.

State of the Industry

Increasingly, states are becoming more inclined to allow for the use of SPFC securitization through cession of risk to captives or SPVs.

In a March 2012 survey conducted

by the NAIC, 19 states had expressly approved cession of risk by domestic insurers to captives or SPVs, whereas only 16 had commented that they had not approved of such practices.

In addition, the Captive and SPV Use (E) Subgroup within the NAIC continues to revise its white paper after a host of comments were expressed during the NAIC 2012 Fall National Meeting. Of particular concern to some regulators was the use of "shadow industry" language and the general feel that the white paper may be an attack on the captive industry as a whole.

While concerns still exist among regulators surrounding confidentiality issues and evasion of regulation, it is hoped that the next draft of the white paper will take a more neutral tone with respect to the captive industry, indicating that the general mood of the community may be shifting in favor of the emerging regime.

It appears SPFCs are here to stay, unless the NAIC renders parts of their utility moot. Indeed, during the 2012 Fall Meeting, the goal was set for principles-based reserving to be presented as a package to the NAIC in 2013. If PBR is adopted by the states, the standards for reserves within the life insurance industry would vary on a case-by-case basis according to actuarial analyses and past performances of each insurer. The result could mean the elimination of perceived "redundant" reserve requirements that SPFCs conveniently address through raising funds in the capital markets.

Yet, even if redundant reserves are reduced through augmentation of accounting standards, states like South Carolina and Vermont have illustrated that insurers can efficiently and safely connect with the capital markets. The system is by no means perfect; some states, like Texas, allow for reinsurance parental guarantees to serve as collateral for reserves (although this concern is partially offset by the fact that Texas has a comparatively large $10 million capital requirement).

However, when professionally regulated, access to capital markets creates value, provides additional investment access for consumers and supplies jobs. So long as regulators make sure that cessions to captives or SPVs do indeed represent true transfers of risk backed by sufficient and dependable assets or other realizable security, the link between the insurance industry and the capital markets is one that should not break anytime soon.

Finally, with reinsurance rates projected to level off in 2013, the use of SPVs to facilitate the convergence of insurance and capital markets continues to represent a cost-effective and diverse method for various forms of risk to be transferred or supplemented in a manner that has proved transparent, and to enhance capital surplus. BR