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Public Policy Issue Brief

CAPTIVE INSURANCE COMPANIES

BACKGROUND

Life insurers may establish captive reinsurers to manage risks effectively. Captive reinsurers are particularly useful in managing the long-term, yet predictable, risks associated with life insurance and annuity contracts. The use of captive reinsurers also allows insurers to access the capital markets efficiently for reasonably priced capital, allowing them to provide affordable insurance products to the public.

A life insurance captive is an insurer chartered under state law to reinsure risks ceded by an affiliated life insurer. The enabling law ("captive law") typically provides that the captive reinsurer will not otherwise be authorized to engage in the business of insurance. As life captives are fundamentally different from life insurers, captive laws are separate and different from the laws applicable to licensed insurers selling policies to the public. Nonetheless, the same state insurance departments that regulate life insurers that sell policies directly to the public also regulate captive insurers.

Some state insurance regulators have expressed concern about how life insurers are using captives to manage risk. The National Association of Insurance Commissioners (NAIC) began a review of captives in 2012 to affirm that they are being used appropriately and are properly regulated. In 2012, the NAIC formed a working group to study captives and adopted a Captives and Special Purpose Vehicles White Paper in July 2013. The NAIC also hired Rector & Associates, Inc. to assist with its consideration of recommendations for regulating captives. Rector & Associates issued its initial report to the NAIC in September 2013 and a revised report in March 2014.

On June 30, 2014, the NAIC's Principle-Based Reserving Implementation Task Force adopted the "conceptual framework" included in Rector & Associates' modified report. The conceptual framework contains high-level recommendations that give guidance to NAIC technical task forces and working groups for their use in developing enhanced regulation of Regulation XXX/AXXX-type captive reinsurance transactions.

The enhanced regulation is to increase uniformity of regulation amongst the states and enhance disclosure and transparency of these transactions.

In 2015, Professor Scott Harrington of the University of Pennsylvania's Wharton School of Business released a paper on captives, *The Economics and Regulation of Captive Reinsurance in Life Insurance.* The report follows his 2014 *The Use of Captive Reinsurance in Life Insurance* paper.[1] Professor Harrington studies how life insurers use captive reinsurance arrangements and whether they pose significant risk to policyholders and taxpayers. He concludes that captive reinsurance arrangements are an important tool for efficiently and effectively managing overall capital.

According to Professor Harrington, "the use of captive reinsurance arrangements has received significant scrutiny by regulators and rating agencies." He adds that, "the

[1] ACLI commissioned Professor Harrington to examine captives transactions. Professor Harrington exercised his independent judgment in producing the two reports.

arrangements require regulatory approval generally by two different regulators and often accompanied by independent actuarial analysis. Rating agencies have been considering the arrangements' potential effects on ceding insurers' financial strength for at least a decade."

Professor Harrington also noted that the use of captive reinsurance ensures lower prices and greater insurance protection for consumers without excessive solvency risk.

STATUS

By the end of 2014, the NAIC adopted the following in efforts to complete the conceptual framework: a new Actuarial Guideline (AG-48) detailing uniform financial requirements for new captive reinsurance transactions; new annual disclosure requirements for captive reinsurance transactions; and new guidance for the regulatory oversight of captive reinsurance transactions.

Federal and international bodies also have shown interest in monitoring this issue, including the Securities and Exchange Commission, Federal Insurance Office, Financial Stability Oversight Council, Federal Reserve, and International Association of Insurance Supervisors.

ACLI POSITION

ACLI supports life insurers' use of captives and their appropriate regulation. To create greater transparency, ACLI has proposed new mandatory enhanced disclosures relating to captives. To create more consistent regulation, ACLI has proposed the establishment of uniform guidelines for use by regulators when approving new captive transactions and reviewing existing captive transactions.

AT A GLANCE

- Captive transactions by life insurers are highly regulated by state insurance regulators. The state-based regulatory system imposes requirements on such transactions to ensure that life insurers fulfill their promises to policyholders.
- Captives have been used by life insurers for many years and are an important risk management tool.
- In most cases, two state regulators review captives transactions both when initial approval is sought and on an on-going basis.
- States that regulate captive insurers have the experience and technical expertise needed to ensure that the captive transactions do not reduce the ability of the ceding insurer to meet its obligations to policyholders.
- Life insurers' use of captives allows them to provide affordable products with long-term guarantees that protect families' financial security.
- Captives are an important and positive element of a competitive life insurance marketplace. Life insurers pay out $1.5 billion every day to American families and businesses. These resources provide financial and retirement security for 75 million American families.

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