Captives Facing Legislative, Regulatory and Financial Obstacles in 2016

2016 is looking to be an active year in the captive industry, with a continuing soft market, persistent scrutiny by the Internal Revenue Service (IRS) and the National Association of Insurance Commissioners (NAIC), captives will likely have a challenging year. In addition, there is still a decision to be made by the Federal Housing Finance Agency (FHFA) whether or not to exclude captives, as well as legislation that will bar the agency from doing so. Congress has several legislative measures before them that could affect captive formation and regulation.

In speaking with a number of captive professionals, from regulators to attorneys to managers, the consensus is that conventional captives, pure captives and long-standing captives, will likely be untouched by many of the issues likely to come up in 2016. However, niche captives and small captives, will be bearing the brunt of any inquiries or legislative changes. Small captives and group captives are most likely to feel the effects of the soft market.

Another Year for a Soft Market

The continuing soft market is one of the key issues captives will face in 2016. In this soft market, well-capitalized traditional insurance companies are able to

Written by Karrie Hyatt

keep premiums low. When traditional insurers can offer low premiums, captive programs can lose their appeal.

According to Sandra A. Bigglestone, director of captive insurance, Vermont Department of Financial Regulation, "Captives will continue to contend with the soft market cycle and some captive programs may shrink as a result. The soft market may be a bigger problem for group captives as it may grow more difficult to keep membership engaged."

"The continuing soft market is keeping premiums at historic low levels. Many of the admitted carriers are very well capitalized and can afford to compete on price," said Christina Kindstedt, senior vice president, Willis Management (Vermont), Ltd. "Captives, with their capital requirements, will have a hard time competing on pricing alone with well-capitalized admitted carriers."

While the continuing soft market is affecting all aspects of the insurance market, Robert H. Myers, Jr., partner with Morris, Manning & Martin, LLP believes that the captive industry will see growth but at a slow rate.

Kevin M. Doherty, director of the Tennessee Captive Insurance Association (TCIA) and partner with Nelson Mullins Riley & Scarborough LLP, agrees that the soft market does not warrant unnecessary concern. "No one has expected this soft market to last for so long. It doesn't concern me that much. To me, people are forming captives for the right reasons – for the benefits of good financial management – not for the tax incentives. Captive growth is not being driven by a hard market."

"Tennessee is about to license its 100th captive," continued Doherty, "Which will happen before the end of [2015]. Add in the protected cells and incorporated cells and that number is then pushing 300. All this growth in spite of the continued soft market."

Inquiry Into Captives by Agencies and Associations

IRS In February 2015, the U.S. Internal Revenue Service name captives to its "Dirty Dozen" list – an annual list issued by the department naming financial vehicles that are under scrutiny for illegal tax avoidance activity. The IRS singled out captives filing under the 831(b) designation, specifying that companies are using the designation to avoid taxation.

Captives will most likely once again be named to the "Dirty Dozen" list which could translate into more scrutiny of all captives. According to Bigglestone, "Increased scrutiny will be a certainty. I believe the "Dirty Dozen" list was a warning that should be heeded. Industry consultants should carefully consider the risks when generating business that is not for risk management and risk financing reasons."

FHFA In 2014, the FHFA proposed substantial rule changes governing membership in the Federal Home Loan Bank (FHLB) system which would effectively bar captive insurance companies from participating. The insurance industry responded to the recommended changes in force, with the agency receiving more than one thousand responses. During 2015, the FHFA did not taken any action and new captive members have been accepted into the FHLB system. However, the issue is still on the table and no decision has been made.

"Given the volume of responses to the FHFA in support of captive insurers being included," said Bigglestone, "It's likely that captive insurers will continue to be allowed as members of the Federal Home Loan Banks. We support captives that want to be members of the FHLBs and hope they will continue to be allowed."

It is not only the captive industry that is working to block the change, members of Congress have also taken an interest. In October, H.R. 3808 was introduced in Congress by Rep. Blaine Luetkemeyer (R-MO), Rep. Dennis Heck, (D-WA), Rep. Patrick McHenry (R-NC) and Rep. John Carney (D-DE). However, since its introduction there has been no actions taken in Congress.

Gary Osborne, president of USA Risk Group, Inc. said, "I think the captive industry will succeed in resisting this change... The industry support for this facility is strong and seems to meet the intent of the loan program."

NAIC The NAIC will likely continue to focus on captives. After nearly two years, the Financial Regulation Standards and Accreditation (F) Committee has agreed on a new Preamble Part A for the accreditation standards that will regulate a small niche of captive companies – those that reinsure life insurance products – as multi-state insurance companies.

While many captive professionals begrudgingly accept the change, Vermont's Bigglestone sees it as an effort to increase transparency and understanding by state regulators. "As a result of initiatives already taken at the NAIC, life reinsurance captives are now subject to a set of rules to be applied consistently from state to state... . With defined standards... state regulators will achieve more uniformity, while maintaining some discretion for the assets allowed to support the excess level reserves under a state's credit for reinsurance laws."

Others, such as Osborne, see this as a step towards eliminating captives from insuring these products. He said it's likely that, "The reserving rules for life insurance will be amended to eliminate the benefit from using captives. New York and other states will attack this but change comes slow at the NAIC and there are now many more captive friendly states than previously."

"The NAIC attention to captives is unwelcome and unnecessary," continued Osborne. "Particularly their seeming desire to insist on "licensing" captive managers could be problematic in reducing competition and adding cost and administrative burden."

At the most recent meeting of the F Committee, in November, the committee began to consider additional changes to the Preamble Part A which would list risk retention groups as multi-state insurance companies. This will certainly be an issue to watch over the course of 2016.

On the recent efforts of the NAIC, Myers said, "Continuing to scrutinize the captive industry, the NAIC will likely dig deeper into how captive regulation differs from traditional insurance companies. They have experienced some success in probing into the use of life, annuity and long-term care captives. This is leading the NAIC towards seeking to regulate captives as traditional insurers in an effort to achieve greater "harmony" in regulation."

Election Year 2016

In addition to bill H.R. 3808, there are several other pieces of legislation up for consideration in Congress. In the spring of 2015, H.R. 1788 was introduced into Congress to amend taxation law 831(b) to exclude many captive companies. This bill had been introduced in a previous Congress, but had languished. This bill is likely to see the same fate. However, if it does gain traction it could prove to be a very contentious bill with the captive industry.

Legislation to clarify the Nonadmitted and Reinsurance Reform Act (NRRA), passed as part of the larger financial reform bill Dodd-Frank in 2010, in regards to captives was introduced last July into the Senate. S.B. 1561 was introduced by Vermont's Patrick Leahy and South Carolina' Lindsey Graham. The bill, Captive Insurers Clarification Act, would amend NRRA to exclude captives under the definition of non-admitted insurer.

According to Doherty, "If NRRA is applied to captives then they will have to domicile in the state where their

As a leader in Group Captives, Berkley Accident and Health can steer you in the right direction.

With EmCap℠, our innovative Group Captive solution, we can help guide midsize employers to greater stability, transparency, and control with their employee benefits.

With Berkley Accident and Health, protecting your self-funded plan can be smooth sailing.

Stop Loss | Group Captives | Managed Care | Specialty Accident

Insurance coverages are underwritten by Berkley Life and Health Insurance Company and/or StarNet Insurance Company, both member companies of W. R. Berkley Corporation and both rated A+ (Superior) by A. M. Best. Coverage and availability may vary by state.

BAH AD-2014-0141

www.BerkleyAH.com

BERKLEY
Accident and Health
a W. R. Berkley Company

headquarters are. This is not really effective as far as we are concerned. There are only a handful of good domiciles so forming captives in other states may be a disadvantage to good captive regulation."

Doherty, as part of TCIA, has been working with Vermont Captive Insurance Association and several other captive organizations to get this amendment enacted.

The problem getting it through Congress will be a matter of perception, continued Doherty. *NRRA was a completely separate bill that was tacked on to Dodd Frank and is now perceived as a law that was part of the larger financial reform bill. There is a lot of politics regarding Dodd Frank, on both sides of the aisle.*

Whether any legislative action on these bills comes this year is a matter of wild speculation. As Myers said, "As it's an election year, Congress's main job will be making sure incumbents get reelected, so legislation that could affect the insurance industry is less likely to be passed." ■

Karrie Hyatt is a freelance writer who has been involved in the captive industry for more than ten years. More information about her work can be found at: www.karriehyatt.com.