LIFE INSURANCE CAPTIVE REINSURERS ARE STEPPING OUT OF THE SHADOW

Written by: Karrie Hyatt

Since 2012, life insurance captive reinsurance companies, also known as special purpose reinsurance vehicles (SPRVs), have faced scrutiny from both the public and private sectors. 2016 saw several reports released about the sector and a lawsuit challenging the opacity of SPRVs. Critics are calling for transparency, similar to what is required of traditional insurers. The NAIC and domicile regulators are working to create more transparency, while still allowing SPRVs to function as alternative risk transfer vehicles.

The controversy surrounding SPRVs began with their rapid growth from 2002 onwards. In the early 2000s, the NAIC adopted Regulation XXX and Regulation AXXX requiring substantially higher reserves for companies writing premium term life insurance policies and some universal life policies with secondary guarantees. While these rules helped to stem strategies being used by some insurers to reduce statutory reserves, it created a discrepancy between product pricing and product reserves with some life insurance products requiring a statutory reserve many times higher than the reserves most actuaries would find necessary.

Due to this discrepancy, life insurance companies began looking for alternate ways of securing additional capital. Using special purpose financial vehicles was a financially sensible route for commercial insurers to take. Between 2002 and 2014, the niche sector grew from $11 billion to approximately $213 billion (some reports put it at closer to $350 billion).

Recent Developments

The NAIC began looking into SPRVs in 2012, when the association formed a subgroup to look into their activities. This was followed in 2013 when New York Department of Financial Services (NYDFS) issued a report calling them "shadow insurers." The NYDFS was the first to label SPRVs as a "shadow" financial company—a term used to describe a financial intermediary that is not subject to regulatory oversight. That term has become an epithet for SPRVs used by critics of the structure.

Even more attention was called to SPRVs in 2014 and 2015 when the NAIC's Financial Regulation Standards and Accreditation (F) Committee, in the process of revising the *Part A: Laws and Regulations Accreditation Preamble* sought to include SPRVs of life insurance products. After several revisions and dozens of comments from interested parties, the (F) Committee adopted the revised *Part A*, which includes these types of reinsurance captives. Captives are not usually subject to the NAIC's accreditation standards since they operate only in their domicile state. However, SPRVs sometimes will operate in states other than just their domicile. The (F) Committee's intention to include SPRVs in the accreditation standards is to make their transactions and regulation more transparent.

Also in 2014, the Federal Reserve Bank of Minneapolis released a report titled "Shadow Insurance" by Ralph S.J. Koijen and Motohiro Yogo. This report was highly critical of SPRVs indicating that left unchecked captive reinsurers could cause another financial collapse, similar to that in 2008. Although, the report did recognize that SPRVs allowed life insurance companies to grow where otherwise they would be hindered by capital requirements.

In 2016, the authors of the report released a revised edition. While still critical of SPRVs, the report was not so inflammatory as the previous version. The data the authors used for the updated report indicates that the sector may not be unstable, but that data used only accounts for a small portion of all active SPRVs. The report calls for more transparency in SPRV transactions in both the U.S. and globally.

Last year saw the release of a report by U.S. Office of Financial Research titled "Mind the Gaps: What Do New Disclosures Tell Us About Life Insurers' Use of Off-Balance-Sheet Captives?" which analyzed NAIC data on SPRVs for the 2014 filing year. About 55% of SPRVs were required to report that year due to exemptions in the reporting requirements.

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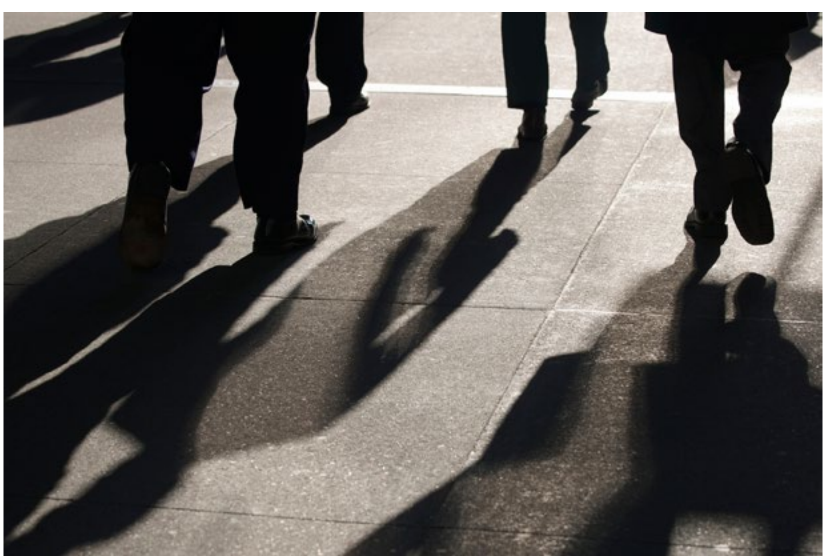
"Mind the Gaps" made the same endorsements as the "Shadow Insurance" report—SPRVs must be subject to more transparency through financial reporting. In addition to increased reporting requirements already requested by the NAIC in the last three years, "Helpful additional steps would be more disclosure and the adoption of asset quality requirements for captive use for other higher risk product lines, such as long-term care."

The report concluded that "Captives can be an integral part of a life insurer's operations. They can also cloud regulatory reporting of an insurer's financial position and create 'blind spots' in the monitoring of threats to financial stability."

The Lawsuit

More controversy along the same lines is brewing for SPRVS. Last summer, a lawsuit was filed in Iowa regarding "Shadow Insurers." In the suit, *Joseph M. Belth vs. Iowa Insurance Division and Nick Gerhart, Commissioner,* the Plaintiff accuses Iowa Insurance Division of deliberately withholding public information and seeks to have that information made available. The information sought are transactions and financial data from large SPRVs operating in Iowa, such as Transamerica Life Insurance Company.

Joseph M. Belth, Ph.D. is professor emeritus of insurance at Indiana University and is an author (Life Insurance: A Consumer's Handbook) and blogger. After being denied access to his request for public information, Belth called on Commissioner Nick Gerhart to release the information in accordance with an Iowa law that grants the Commissioner discretion to release such data.



The lawsuit states that Belth "Have access to information and documents related to certain kinds of now-secret financial instruments used in the life insurance industry that have the consequence of hiding critical information from policyholders, shareholders, and the public, of the life insurance companies' potential risks and also lowering the amount of capital that state regulators require life insurance companies to maintain."

According to Belth, as stated in the court documents, *Iowa Code § 508.33A: Limited Purpose Subsidiary Life Insurance Companies* allows life insurance companies to participate in risky practices such as transferring "substantial life insurance policy liabilities" to their captive reinsurance subsidiaries and then masking "liability exposure" with various types of letters of credit. On the books, this appears to show "excess capital" which in turn allows the life insurer to use "liquid assets away from the capital that is legally required." While the Iowa Insurance Division monitors such activities, Belth claims that in a "darkened regulatory environment" regulators aren't looking out for the interests of the public, policyholder, or taxpayer.

While the lawsuit is in Iowa and refers to Iowa laws, the case could have a much larger impact. Depending on how the suit is decided, it could become case law for either side of the issue. In many respects, the lawsuit is seeking the same thing that all critics of SPRVs are seeking—more transparency in SPRV transactions and financial disclosures.

Transparency

Captives are not subject to the same financial disclosures as traditional insurers and reinsurers. Therein lies the bulk of the problem. Critics of SPRVs believe them to be "shady" since their financial dealings are not generally released to the public. This leaves regulators reacting to satisfy critics' need for transparency and the ability for life insurers to make best use of SPRVs.

The NAIC's Financial Condition (E) Committee Reinsurance Task Force has made strides to improve the reporting of life insurance captive reinsurers, by requiring additional disclosures regarding asset information. Another method that is being implemented is to test an insurers financial standing without including any Letters of credit that are on the books for the SPRV. As state insurance regulators adopt these practices and more SRPVs are subject to increased financial disclosures, critics call for transparency will hopefully be met. However, treating SPRVs more like traditional insurers may have a detrimental effect and decrease their usefulness. ■

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.