CAPTIVE REVIEW

AUGUST 2011

The essential guide to alternative risk transfer

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NEW WAVE

Do US domiciles' high growth figures flatter to deceive?

EDITOR'S VIEW

Things to come

Journalism is about change. The next big thing. As an arguably conservative niche of a conservative industry, captives don't always fit the bill.

But then someone trumpets big numbers, big growth, press releases are issued, and the likes of me get excited. As usual, the devil is in the detail.

The US 'new wave' *(page 23)* domiciles have recorded impressive growth figures recently, but the exact substance of this growth is still unclear to many industry figures I speak to. However, it should not be dismissed, because an understanding of such growth might indicate where one's own captive, and the industry as a whole, might be heading.

Marks & Spencer's profile *(page 18)* reminds us that older captives can be just as innovative as new ones. Some reports indicate that newer captives more regularly change their type and level of coverage, yet the retailer's captive has retained a flexibility many newer ones could learn from.

Environmental liability *(page 28)* is another reminder of the growing and changing tentacles of many risks. Once mainly the concern of large well-known polluters, such as oil companies, it now pervades over most companies.

Some risk managers have expressed a desire for their captive to not make a profit, because such profits would be taxed twice, both by their captive's domicile and also by its parent company's jurisdiction. As Dr Simon Johnson, of Aon, suggests, adding environmental liabilities (ELs) to such captives could well be a way around this. Increasing diversification in the build-up of the Solvency II Directive could be another motivation.

The pertinence of ELs to companies is tied to another uncertainty: regulation. Talk of regulatory convergence and harmonisation is common, almost trite, yet the reality seems more muddied.

In fact, for some organisations the trend is towards a more regionalised approach to risk management. BP's recent formation of a Vermont-based captive to cover US risks, to function alongside its Guernsey-based captive, may be an indicator of things to come.

Matthew Broomfield
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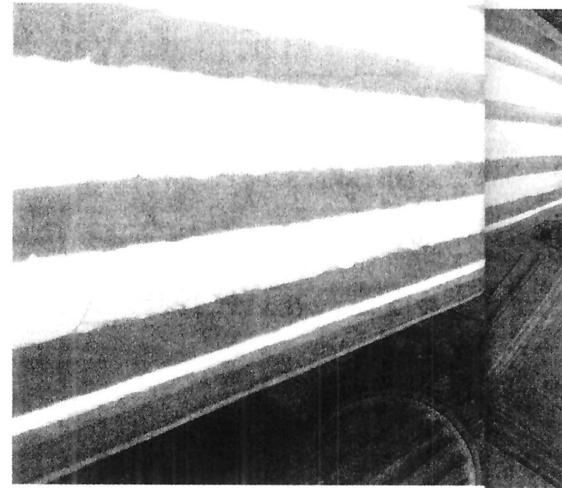
The FIO's future impact



Captive participation in the response to forth-coming reports by the FIO and FSOC is essential to prevent over-regulation, and make the US a more attractive jurisdiction

By ***Tom Cifelli managing editor of CaptiveExperts.com, part of the Crusader International Group, and Simon Kilpatrick, EVP Lionheart Insurance Group***

The Dodd-Frank Act's implications for the insurance industry have been widely reported. It created the Federal Insurance Office (FIO), the first ever US federal agency specifically established to oversee the insurance industry. All 50 US states have independent departments of insurance. While uniformity is a trend, there remains great differences among the various states that insurance companies, including captives, must navigate. The FIO will surely strive to increase the efficiency and global competitiveness of this complex state led regulatory system while maintaining consumer protections.

The new FIO office is part of the expanded Federal Reserve regulatory regime enabled by the Dodd-Frank Act designed to:

- Increase consumer protections,
- End "too big to fail" bailouts,
- Create an advanced warning system,
- Increase transparency and accountability of exotic instruments,
- Improve regulatory enforcement, and
- If you read the fine print, increase US global competitiveness (although it seems an oxymoron to suggest increased regulations can achieve this).

The Senate summary on the Dodd-Frank Act states the FIO "... will serve as the uniform, national voice on insurance matters for the United States on the international insurance stage."

Many believe this is a huge step in the right direction, including Ed Royce, Republican representative from California. Royce told risk managers attending the June 2011 Risk & Insurance Management Society annual RIMS on the Hill legislative conference, that in order to compete internationally, the US insurance industry needs to have a voice at the international level. "Your industry does not have a seat at the table," said Royce, adding that he hoped FIO would help change that.

The FIO director is appointed by the secretary of the Treasury. Royce shared with RIMS attendees that the first FIO director, Michael McRaith, "understands the market".

As detailed below, the FIO was given express pre-emptive regulatory power on international insurance matters by the Dodd-Frank Act. The FIO is also charged with facilitating state regulatory uniformity. While the transition from state to federal regulation of insurance will be a bumpy and burdensome ride on insurance companies, ultimately this should lead to efficiencies, is long overdue, and should help the US insurance industry compete globally.

Specific sections of the Dodd-Frank Act amending Title 31 of the United States Code direct the FIO to issue a series of reports on the insurance industry by these deadlines:

- 30 September 2011, the 1st State of the US General Insurance Industry annual report,
- 30 September 2012, the 1st State of the US and Global Reinsurance Market annual report,
- 1 January 2013, the 1st Impact of Non-admitted and Reinsurance Reform Act of 2010 on ability of state regulators to access reinsurance information.

Another section of the act, section 313 (p), gives an estimated date of 1 January 2012, for the FIO to issue a study and report to Congress on how to modernise and improve the system of insurance regulation in the US. It is this FIO report to Congress due by January 2012 that will have the most sweeping impact on the extent and timing of a shift from state regulation to expanded federal regulation of the insurance industry.

This little known report, when issued, will most likely heavily dilute the widely held view that section 313 (j), the "Savings Provision," and subsection (k) titled "Retention of Existing State Regulatory Authority," assure the FIO was not created as a step toward pre-empting state regulatory authority of insurance companies.

Other language in the portions of the Dodd-Frank Act applicable to the FIO clearly reflect an understanding that over time, reducing state roles and consolidating insurance regulation at the federal level will improve the US insurance industry's global competitiveness. If you read the text of the Dodd-Frank Act's provisions impacting insurance, they clearly express that the US Congress recognises uniformity of rules, avoidance of double premium taxation, and efficiency of reporting requirements are important to US competitiveness and in consumers best interest.

In all likelihood both sides of the isle will agree uniformity of rules, reduced

Supreme Court columns, Washington DC

> If state competition for insurance business declines, barriers to participation in captives could increase"

state regulation, and expanding the FIO role could help US insurers compete. Whether this actually proves to be the case is uncertain.

The FIO report due around the end of 2011 or early in 2012 should provide evidentiary ammunition for Congress to take overt steps into federal regulation of the insurance industry.

This FIO report is specifically directed to update Congress on these wide reaching areas:

- Identify gaps in state regulations;
- Evaluate the adequacy of capital reserves to meet expected liquidity requirements for the scope and duration of risks insured;
- Explain the degree of national uniformity of state regulations;
- Address the degree of international coordination on insurance regulation (the act elsewhere gives the FIO power to enter into Coverage Agreements with non-US jurisdictions that expressly do pre-empt inconsistent state rules and regulations);
- Identify potential costs and benefits of federal regulation of insurance;
- Discuss the feasibility of regulating certain lines of insurance at the federal level while leaving regulation of other lines to the states;
- Assess the feasibility of a federal regulator to provide robust consumer protection for policy holders.

The FIO's main stated objectives are designated in section 502 of the Dodd-Frank Act. To summarise, they are:

1. to monitor all aspects of the insurance industry;
2. to recommend what insurers they want subjected to the new non-bank financial company regulations;
3. to determine when state measures are pre-empted; and
4. to perform other related duties as assigned by the Secretary of the Treasury.

The FIO now has jurisdiction over all lines of insurance except health insurance, long-term care insurance (except to the extent part of life and annuity contracts), and crop insurance.

Regarding potential new reporting requirements impacting operating efficiency, section 313 (e) allows new data and information reporting to be required of insurers or any affiliate if the FIO director desires information not already available from other agencies or the state regulators. The FIO is to decide who qualifies as small insurers exempt from any increased reporting. They may follow some states lead and exempt companies with less than $1m in annual premiums. Perhaps they will follow the IRS 831 (b) lead and exempt insurance companies with $1.2m or less in annual premiums. We will know soon.

Section 313 (f) specifically addresses the FIO director's duty to monitor for and preempt state measures determined to result in less favourable treatment of a non-US insurer domiciled in a foreign jurisdiction and subject to a covered agreement if inconsistent with that covered agreement. The FIO is empowered to enter into such covered agreements. This should be an area of interesting developments next year.

State Based Insurance Reform is addressed in Title V, subtitle B, of that portion of the Dodd-Frank Act known as the Federal Insurance Office Act of 2010. Section 511 says subtitle B should be cited as the "Nonadmitted and Reinsurance Reform Act of 2010," and it is effective 12 months after enactment of the Dodd-Frank Act. Most provisions in these sections of this legislation aim to prevent conflicts between states and overlapping duplicate reporting or taxes. They lend further evidence of the long-term intent to create more uniformity and efficiency of regulation between the states through the NAIC and eventually expand the FIO's rule making and regulatory power and authority while decreasing state involvement.

The FSOC will also likely be making recommendation to the states and NAIC to implement new and heightened financial standards, potentially impacting insurance investment programmes and reporting.

Summary

The FIO and FSOC reports coming later this year and next will lay the foundational arguments for expanded federal regulation of the insurance industry well beyond international insurance coverage agreements. Given the advisory role of the FIO director to the FSOC, any important initiatives of the FIO will likely find support within FSOC pronouncements making them almost certain to gain needed legislative support in Congress to expand FIOs official regulatory jurisdiction even over opposition of states. As long as state revenue streams are protected, this transition from state to federal regulation of insurance could occur more quickly than people suspect; especially if economic conditions do not dramatically improve since many states are experiencing budget pressure and looking for additional staff reduction opportunities. If state competition for insurance business declines, barriers to participation in captives could increase. Participating in the response to these reports by the captive industry is essential to prevent over-regulation, and to explore the opportunity to streamline captive regulations and make the US a more competitive jurisdiction. Taking advantage of increased competition among domiciles for new business may also be indicated to protect against captive formation barriers increasing.