Chapter 7

The Role of the Domicile Regulator

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I. INTRODUCTION

One of my favorite quotes that I have clipped to my PC monitor—I can't recall where I clipped it from for attribution—is “insurance departments should be concerned with creating a reasonable regulatory environment focusing on solvency and protecting the consumer and should not be the focus of economic development.” That's a laudable ideal, but legislatures that pass captive laws have certain expectations that captive insurance will be a boon to their economy, so regulators often find themselves acting in the capacity of promoters of their domicile, while simultaneously serving as the gatekeepers of the domicile’s business, and guardians of the domiciles’ reputation. If promotion focuses on the benefits of captive insurance to prospective captive owners, and if no one sets a target for numbers of licenses issued, the regulator can avoid creating a “come one, come all” environment and prudently license and effectively regulate the captives under his or her domain. The consumer protection focus of the traditional regulator can be relaxed in most captive situations, since the consumer owns the insurance company. Captive insurance companies rarely get complaints from their policyholders!

II. MISSION OF THE VERMONT DEPARTMENT OF FINANCIAL REGULATION

The mission of the Captive Insurance Division of the Vermont Department of Financial Regulation is to maintain a regulatory system that attracts quality business to Vermont, promotes our reputation in the industry, and ensures the solvency of captive insurers while recognizing the special purpose for which they were created. The division pursues this mission by:

- Attracting and licensing quality programs whose primary purpose is risk management or risk financing;
- Performing ongoing financial surveillance;
• Performing periodic financial examinations;
• Implementing and enforcing laws and regulations;
• Developing effective and reasonable policies and procedures; and
• Advancing the growth of Vermont's captive industry.

III. REGULATORY APPROVAL PROCESS

We attract and license quality programs whose primary purpose is risk management or risk financing with a rigorous application process.

A. Meeting with a Regulator

It starts with an in-person meeting with the regulator, the prospective captive owner, and in most cases includes the selected captive manager. Other key service providers such as auditors and actuaries may also be invited. The meeting is a chance for the regulator to learn about the parent company operations, and to ask questions about the parent company's need for a captive insurance company. The prospective captive owner should be able to detail the issues facing the business that lead to the need for its own insurance company. Discussions will address the particular concerns facing the parent company such as cost, availability, or capacity of the traditional market, or an opportunity for the captive to operate as a profit center (or conversely as a major cost saving), or both. There's no need to avoid discussion of taxes, but if it appears the chief driver of the captive is a tax benefit, the regulator will be on high alert. Regulators will be expecting to see either a history of losses or a clear potential for losses that would be threatening to the business. Lacking such a history or demonstrated risk, a regulator should be questioning the need for a business to form its own insurance company, and frankly, so should the prospective captive owner, who really must ask if the captive would make good business sense without the promised tax savings.

Usually, the result of the meeting is a green light to file an application, but there are occasions when we decline to accept an application, or insist on significant changes to the plan before we will accept it. Declinations are usually due to a poor fit with the domicile's ideals or statutes, and occasionally the regulator's preferences.

B. Feasibility Study

Each application must include a supporting feasibility study (discussed in Chapter 2). The submission of thorough and complete information in the study is vital to this process, as it forms the foundation of the application and demonstrates the economic viability of the captive. All financial discussions in the application must reference and closely correlate to the study findings. The application and other supporting documents form the business plan of the captive that regulators will use to track the captive's operations in the future. Broadly speaking, the study should address/include
Performing Ongoing Financial Surveillance

- An actuarial evaluation of the exposure to claims;
- The proposed premiums to finance the expected value of claims and expenses;
- The proposed capital to support the exposures to be underwritten. Generally speaking, the premiums will support the expected losses and operations of the captive, while capital will help it absorb shock losses or other adverse scenarios;
- A pro forma financial statement showing an expected and adverse scenario;
- A summary of coverages, policy forms, lines of business, limits, deductibles, reinsurance, and retentions;
- Summary of the source and nature of resources for premiums and capital (i.e., cash, debt, loans, LOCs, assessable policies, etc.); and
- Discussion of marketing and sales plans if applicable (mostly applicable to group captives).

The actuarial study should discuss the methods used to project the value of claims. Also, the actuarial study should discuss adjustments for trend, loss development, benefit level, relevance of benchmarks, discounting for the time value of money, retention for the projection, and risk margins. We expect these discussions to be documented in a report.

Since this is the bulk of the application, you can imagine that it's also the focus of our review. We spend a great deal of time cross-referencing the study and other components of the application for consistency (no Hobgoblins here, Mr. Thoreau!). Vermont has made it standard practice for many years to hire a consulting actuary to assist in the review of the application. The consulting actuary provides a second pair of eyes for the regulator, challenges the assumptions and judgments used, and ensures that the feasibility study has been conducted and reported in accordance with accepted actuarial standards of practice. Increasingly, particularly with small captives, the consulting actuary may challenge whether or not the captive business constitutes risk transfer, due to the paucity of historical loss information.

Insurance companies are regulated entities, so the potential captive owner must understand the regulatory environment of the selected domicile, and if there does not appear to be any regulation, all of the necessary alarm bells should be ringing. An entity that is about to receive a license to conduct the business of insurance, even if only with affiliated organizations, must expect a degree of scrutiny, skepticism, and due diligence from the regulator. Licenses should not receive a rubber stamp handed out through a drive-up window!

IV. PERFORMING ONGOING FINANCIAL SURVEILLANCE

Once the company is licensed, it is expected to operate as an insurance company would by issuing policies of insurance, prudently investing the premiums, timely paying claims, and keeping accurate books and records.
A. Required Filings
There are certain standard filings to be made. Here are Vermont’s basic reporting requirements; many domiciles will be similar:

- File an annual statement, using prescribed and permitted accounting principles, on the prescribed forms;
- File an audited financial statement each year, including a reconciliation to the annual statement, a report of evaluation of internal controls, accountant’s letter of qualifications, and certification of review of audit work papers;
- Submit a statement of actuarial opinion on reserves;
- Pay required premium taxes, and
- Submit to a regulatory examination every three to five years.

B. Annual Meeting
Most domiciles also require the board of directors of the captive to hold a meeting annually in the domicile. This is more than just a tourism generator or a chance to visit a nice place for pleasure trip at the business’ expense; it is a dedicated time each year to devote full attention to the captive and to sit down with the people that have been hired to help operate it. Captive owners should take this obligation seriously, and conduct detailed board meetings, and use the visit as a time for some checking up on their service providers. A critical legal consideration, often overlooked, for the annual domicile meeting is to demonstrate that the captive is conducting insurance business only where it is licensed. The annual meeting is an opportunity to review all of the captive's insurance operations, policies, and procedures. It can also be a time to refresh connections with the local regulator—our department is frequently invited to attend board meetings to speak and to listen, and we accept as many of those invitations as we possibly can.

C. Monitoring and Surveillance
It might sound like a spy novel, but “surveillance” is the accepted term for the regulator’s job of keeping a watchful eye on the companies under his or her purview. For single-parent captives, that entails a detailed review of the annual filings, and a regular monitoring of the parent company. We have adapted many of our surveillance procedures from standards developed by the National Association of Insurance Commissioners (NAIC). For certain types of captives, we follow NAIC rules to the letter, but for most pure (single-parent) captives, we modify the requirements to suit what we find to be sufficient. Regulators use a variety of tools, including ratio analysis or risk-based capital reports to effectively triage the annual filings so that attention can be directed first to those companies who might be exhibiting signs of difficulty.

Annual monitoring and surveillance activities include review of annual CPA-audited financials for both the parent company and the captive; review of the actuarial certification of loss and loss expense reserves for the captive; certification that a
qualified, approved CPA has reviewed the audit work papers for the audit submitted; and, opinion and internal control letters.

Monitoring of the captive parent company level is conducted through review of SEC filings, daily financial newspapers, trade papers, and other resources.

V. EXAMINATIONS

“Trust but verify” is the mantra of many regulators, and it applies equally to the captive insurance world. Every domicile should have some method for checking up on the insurance companies under their supervision. Some domiciles achieve this by direct regulation and auditing of the captive managers, but most U.S. domiciles conduct periodic examinations of the captive itself. Vermont examines each of its captives every three to five years, depending on our assessment of the company. The scope of the exam will vary with the type of captive. In the United States, risk retention groups are subject to the same examination rules as any traditional insurance company, and will undergo a risk-focused exam that follows the NAIC Financial Condition Examiners Handbook. At the other end of the spectrum, a single-parent captive will likely be subject to a much simpler exam, but still based on the best practices in the aforementioned handbook, proportionally applied.

VI. IAIS GUIDANCE

The United States has the NAIC to help develop high standards for the regulation of insurance companies. While the NAIC’s work is rarely applied directly to captives, it is useful as a starting point for adapting to captive-specific regulation. The rest of the world has a similar guiding body in the International Association of Insurance Supervisors (IAIS). Like the NAIC, the IAIS is a voluntary organization of insurance regulators, and includes members from more than 200 jurisdictions. Its mission, as stated on the IAIS webpage, in part, is to “promote effective and globally consistent supervision of the insurance industry.” The IAIS published its application paper on the regulation and supervision of captive insurers in November 2015. This document discusses the application of 18 insurance core principles (ICPs) to the regulation of captives. Included in those ICPs are many of the same things already discussed: licensing procedures, suitability of persons, corporate governance, risk management and internal controls, supervisory review and reporting, off-site monitoring and on-site inspections, and capital adequacy. Taxes are not mentioned in the paper. Any domicile regulator should be familiar with this document, and there should be corresponding similar provisions in the domicile’s statutes and regulations.
VII. CAVEAT EMPTOR

A captive insurance company can be a very effective way to help manage and finance risk of parent companies of any size. Smaller organizations are less likely to have professional risk-management staff, and thus are more likely to rely heavily on outside advisors. Business owners should still use their own judgment when deciding how to accept that advice, and keep in mind all of the old adages that warn you that if it sounds too good to be true, it’s probably trouble. Here are some specific questions for prospective captive owners to consider:

Was the captive presented as a tax savings, or as an insurance problem-solver? It’s the American Way to avoid paying unnecessary taxes, but there must be a demonstrable insurance purpose to the captive—it needs to make good business sense without tax considerations.

Does the advisor do business in multiple domiciles, both onshore and offshore? Is the selected domicile chosen because it suits your business . . . or his? Most captive managers operate in many jurisdictions to suit the best interests of their clients, and can provide a detailed side-by-side analysis of recommended domiciles for the client to choose from.

How many captives are in the domicile? What is the total premium volume? If you do the math, you will find that in some domiciles, total premium divided by number of captives miraculously (suspiciously?) yields $1.2 million. That sounds more like a tax haven than a captive domicile. You might also find their premium volume doubling overnight when the 831(b) election limit increases from $1.2 million to $2.2 million!

Is pooling being pushed? Pooling can help insurance companies stabilize losses, but if none of the pool members have losses, pooling may be just a ruse to achieve risk distribution for income tax purposes. Will the pool actually pay up, without strings, if you have a loss? Why spend thousands each year on consultants and captive managers, and add on the possibility of sharing someone else’s loss, if you expect no losses to share in turn?

What capital levels are being suggested? Each domicile has a statutory minimum capital requirement for all types of insurers, captive or traditional, but that is a solvency “floor,” and is rarely appropriate. The feasibility study should provide a documented recommendation for the captive’s initial capital needs, and that capital should support an adverse loss scenario.

Does the investment in a captive make sense? But for a tax benefit, would the allocation of capital and the premium volume be justified? The Risk & Insurance Management Society Inc. together with Advisen Ltd. conducts an annual survey of risk management professionals. The benchmark report defines “total cost of risk” as the cost of insurance plus the costs of the losses that are retained and the administrative costs of the risk management department. The average total cost of risk in 2014 was $10.80 per $1,000 of revenue, or 1.08 percent of revenue. Smaller businesses are likely to have a higher relative cost, but real questions should arise from both the potential captive owner and the regulator if the premiums to the captive alone are more than a few percentage points of revenue.
The captive should be an integral part of the business' insurance program, and (usually) augments, not replaces, traditional insurance coverage. How has the potential captive owner's consultants “fit” the captive into the rest of the insurance program? What changes are recommended to the purchase of traditional insurance as a result of forming a captive insurer?

If potential captive owners ask enough questions, they may help themselves avoid an untenable situation with the IRS. Does a family jewelry store really need its own insurance company? I'm skeptical.

Note: While Mr. Provost is employed by the State of Vermont as the chief regulator of captive insurance companies, this discussion does not necessarily reflect the view of his office, the Department of Financial Regulation, or the State of Vermont.