The Use of Captives in the Life Insurance Industry

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On Tuesday, June 11, 2013, the New York State Department of Financial Services (NY DFS) issued a report highlighting captives, which *The New York Times* characterizes as "complex private deals that allow the companies to describe themselves as richer and stronger than they otherwise could in their communications with regulators, stockholders, the rating agencies, and customers, who often rely on ratings to buy insurance."

A link to the NY DFS report—"Shining a Light on Shadow Insurance: A Little-known Loophole That Puts Insurance Policyholders and Taxpayers at Greater Risk"—is below.

http://www.dfs.ny.gov/reportpub/shadow_insurance_report_2013.pdf

In the wake of the NY DFS report and related media coverage, M Financial Group has compiled this white paper to provide background information on the uses and mechanics of captives, and detail perspective from other interested parties, specifically rating agencies and carriers.

What is a Captive?

Captive insurance companies, as the name implies, insure or reinsure the risk exposure of their parent companies and affiliates. Captives are formed under specific laws that prohibit them from issuing policies directly to consumers.

Why Captives Are Used and How Captives Work

Captive insurance companies provide for the efficient aggregation and management of certain insurance risks by insurance companies when third party commercial reinsurance may not be reasonably available. Captive structures can be especially helpful in managing term life insurance and no-lapse guarantee UL risks. These products are subject to statutory reserve requirements that are widely regarded within the insurance industry as conservative, resulting in reserves that are commonly referred to as redundant; "XXX" reserves for term life insurance products and "AXXX" for no-lapse guarantee UL products.

Captive reinsurance transactions work very much like other commercial reinsurance transactions in that they must meet the same regulatory requirements for the insurance company to receive credit for reinsurance. Unlike commercial reinsurance transactions, each captive transaction is reviewed by regulators—both the insurance company's state of domicile and the captive's state of domicile review and analyze these transactions to ensure they meet regulatory requirements.

The life insurance company cedes risks and reserves to the captive entity. For the insurance company to receive credit for the reinsurance, the captive must either be an authorized reinsurer in the insurance company's state of domicile or post collateral that meets the regulatory requirements of the insurance company's state of domicile. Collateral can take the form of assets held in trust, a letter of credit (LOC), funds withheld, or, in some states, a parental guarantee. In the context of "XXX" and "AXXX" captive transactions, the insurance company will determine the economic reserves (or actual expected losses) associated with the obligations through actuarial analysis. The formula used to determine the economic reserves is reviewed by an independent third party actuary at inception and may be subject to an annual independent third party actuarial review.

The difference between the statutory reserves and economic reserves is the redundant reserves. In a captive reinsurance transaction, the ceding company will generally create a funds withheld account to hold assets backing the economic reserves or require the captive to establish a trust account to hold assets in that amount. The redundant reserve will often be backed by an LOC, issued by a bank for the benefit of the ceding company, and held by the captive. In states where the law allows, and subject to

certain requirements, guarantees from the ceding company's parent may also serve to back the redundant reserve.

Captives are beneficial in that they allow for efficient use of capital. By segregating the risk in a captive, companies are able to obtain third-party financing at a lower cost, which results in more consumer friendly pricing (i.e., more affordable insurance coverage). In addition, risk is spread as third-party financing partners are liable for the risks represented by the redundant reserve.

Potential Captive Abuses

The NY DFS report focused primarily on transactions where an appropriate third-party LOC is not secured. In these transactions:

- The LOC is contingent and may not provide the funds when needed by the insurance company, or
- The LOC is a wrap-around arrangement where the LOC cedes the risk back to the original ceding company—there are reduced reserves but no risk transfer.

Industry Response to NY DFS

A number of interested parties have responded to the NY DFS report to bring context and balance to the issue.

State Regulator Responses

While the NY DFS report has called for a national moratorium on captive reinsurance transactions, the National Association of Insurance Commissioners (NAIC)—the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia, and five U.S. territories—has been studying the use of captive reinsurers for more than a year and is taking a more balanced approach by advocating enhanced disclosure of the transactions.

- NAIC President Jim Donelon stated that there appears to be no need to call for a moratorium on captives as requested by the NY DFS. In addition, Donelon commented that state insurance regulators are continuing to monitor the risks posed by captives and special purpose vehicles while working to implement principles-based reserving (PBR) for life insurers. The overwhelming majority of state insurance regulators believe the successful implementation of PBR will address the perceived reserving redundancies that have precipitated the use of captives for reserving purposes.
- The NAIC's Captive and Special Purpose Vehicle (SPV) Use Subgroup met after the release of the NY DFS report and agreed to submit a white paper—Captives and Special Purpose Vehicles—to the Financial Condition (E) Committee for their consideration. The white paper lists the following regulatory recommendations:
    - Disclosure and Transparency—enhanced disclosure in ceding company statements regarding the impact of the transactions on the financial position of the ceding insurers.
    - Uniform Standards—development of guidance in the Financial Analysis Handbook for the states' review and ongoing analysis of transactions involving captives and SPVs, including specific considerations of such transactions when performing holding company analysis.

- On July 1, 2013, North Carolina joined 31 other states and the District of Columbia as a captive domicile.

All captive transactions already require approval from the ceding insurer regulator and the captive regulator.

Rating Agency Responses

The NY DFS report implies that rating agencies do not consider captives as part of their assessment of insurance company financial strength. In comments issued following the release of the NY DFS (excerpts of which are provided below), this implication was incorrect. Rating agencies are aware of—and assess—captive arrangements, including the ultimate collateral backing the redundant reserves, with such analysis impacting insurance company financial strength ratings.

A.M. Best

- A.M. Best views as positive the continued industry discussions related to increased regulatory scrutiny and transparency surrounding life captive reinsurers.
- A.M. Best stated "it will continue to look through these transactions, and analyze groups on a consolidated basis using its capital model regardless of which affiliated entity assumes the risk."
- Furthermore, "A.M. Best will continue to monitor life insurers' reinsurance programs with respect to potential decreasing LOC capacity and/or increasing LOC costs in the marketplace."
- Moreover, A.M. Best believes there are notable differences in the quality of collateral involved in these funding solutions (e.g., reinsurance trusts, long-term LOCs, short-term LOCs, and contingent LOCs). These differences are incorporated in A.M. Best's overall evaluation of an organization's balance sheet strength.

Moody's

- Moody's believes a greater focus on captives by regulators is credit positive for the industry.
- Life insurers use captives to manage regulatory capital strain associated with life and health insurance products subject to what they perceive to be conservative reserve and/or capital requirements. They also use captives to manage the volatility of reserve and capital requirements associated with variable annuity guarantees. Both practices undermine the conservatism regulators have embedded in the reserving and capital regimes.
- Moody's analysis of life insurance companies' creditworthiness on an enterprise basis has determined that many companies' captives are capitalized at levels lower than standard operating companies, which tends to weaken overall capital adequacy. Moreover, transactions such as those identified by the NY DFS can lead to complex corporate structures and reduced investor transparency, both credit negatives.
- The attention placed on captives, not only by New York, but also by the NAIC, will likely be a positive development that will lead to more disclosure of transactions with captives.

ACLI Response

The American Council of Life Insurers (ACLI), which represents the interest of life insurance companies, continues to examine captives and their impact on carriers, policyholders, and the life insurance industry as a whole. Following the release of the NY DFS report, the ACLI issued the following statement:

> *"For more than one year, the 56-members of the National Association of Insurance Commissioners (NAIC) have been reviewing the issue of captive reinsurance transactions discussed in the report issued by the New York Department of Financial Services.*
>
> *Captive reinsurance transactions provide life insurers a means to spread the risks they assume. They also enable life insurers to deploy capital efficiently and, in turn, help them set prices as competitively as possible. Captive reinsurance transactions represent an important and positive element of a competitive life insurance marketplace and are, without exception, reviewed and approved by regulators.*
>
> *To help improve transparency and regulation, ACLI is working with the NAIC to enhance disclosures that will provide regulators with more access to information about the captive reinsurer transactions. With greater transparency, concerns about this vital risk-management tool will be addressed.*
>
> *ACLI fully supports national adoption of proposals to enhance disclosure involving these transactions."*

M Carrier Responses

M Financial requested and received commentary regarding captive transactions from the following M Carriers: ING, John Hancock, Lincoln Financial, Pacific Life, Prudential, and TIAA-CREF Life Insurance Company. The carrier-specific responses are provided in Appendix A.

According to their responses, all M Carrier captive transactions provide full risk transfer supported by high-quality assets or financing arrangements (such as banking institution LOCs), which provide reimbursement when needed.

M Financial Perspective

Because of our commitment to client advocacy, M Financial is focused on the scrutiny of captives and the impact captives may have on policyholders. Based on our understanding, which is supported by conversations with carriers and analysis of statements from rating agencies and regulators, captives can provide an appropriate and efficient vehicle for segregating and spreading risk, lowering the cost of reserve financing, and ultimately providing better pricing for consumers. Captive transactions that support redundant reserves backed by high-quality assets or financing arrangements (e.g., bank LOCs that provide reimbursement when needed)—with full transparency and disclosure, as well as review and approval by state regulators—would reasonably appear to provide the consumer protection intended by state regulators and provide the benefits of lower cost insurance products to consumers.

The use of captives is a direct result of current reserving requirements. Are required statutory reserves backing guaranteed products truly redundant or overly conservative? The adoption of PBR by the NAIC may implicitly suggest reserves backing guarantees are indeed redundant. If they are truly redundant, and PBR is implemented (as anticipated in 2015), there may no longer be a need for captives (and the issue may become moot). However, if required reserves are not redundant, then the discussion may

focus more specifically on the ultimate party or collateral backing the redundant reserve, not the use of captives themselves. It is important to remember that the economic portion of the total reserve is retained by the insurance company, or is fully collateralized with assets meeting regulatory requirements.

M Financial supports regulatory changes that provide more disclosure and transparency, uniform regulator review standards, and uniform standards for permitted assets and LOCs backing reserves. The NAIC is moving forward with regulatory changes via the Captives and SPV white paper.

With potential regulatory changes, it is possible that some insurance companies may be negatively impacted. However, based on the responses from M Carriers, it is anticipated there will be little or no impact to M Carriers.

Finally, alarmist tactics that seek to scare consumers are of little benefit. For example, to suggest that ratings agencies are not aware of the issues with captives, and are not reflected appropriately in their financial strength ratings, is irresponsible. As an alternative, M Financial supports an open dialogue, supported by disclosure and transparency that facilitates informed consumer decisions.

Additional information and analysis on this topic will be provided as relevant news and facts evolve over time. In the meantime, if you have any questions or comments, please contact Dan Byrne (503.414.7350 or dan.byrne@mfin.com) or Wayne Tonning (503.414.7430 or wayne.tonning@mfin.com).

APPENDIX A: M Carrier Responses

The following statements were provided in response to a request from M Financial Group. The comments provided represent each carrier's perspective on the use of captives.

ING

To Our Valued Distributors and Customers:

In July 2012, the New York State Department of Financial Services (DFS) launched an investigation into the use of captive reinsurance transactions. This month, the DFS issued a report of its findings, calling the use of these transactions "shadow insurance." In conjunction with the release of the DFS report, the New York Times ran an article on life insurance captives that referenced, with about eight other large life insurers, ReliaStar Life Insurance Company of New York, a member of the ING U.S. family of companies.

As part of the DFS investigation, ReliaStar Life Insurance Company of New York received a request for information. We fully cooperated with the DFS requests and we will continue to do so. A captive reinsurance company is a special purpose insurance company chartered under a state's captive insurance law. Forming a captive reinsurance company allows us to reinsure risks of our affiliated life insurers. Our captive reinsurance transactions are always reviewed and approved by two state insurance regulators – the regulator for the state in which the captive reinsurer is domiciled and the regulator for the state in which the ceding company is domiciled.

Captive reinsurance transactions permit the ING U.S. family of companies to better serve our customers, distribution partners and stakeholders by (1) ensuring that we at all times maintain a high degree of financial strength, which is critical to our ability to meet all of our obligations to our customers; and (2) using our resources – including capital – as efficiently and effectively as possible in order to offer competitively priced products to our customers.

Each of our captive reinsurance transactions is assessed by us, our state insurance regulators and our lending counterparties to ensure that our captive reinsurance companies are sufficiently capitalized, with capital that includes investment assets (such as cash and bonds) in addition to other assets (such as letters of credit from highly qualified banking institutions).

In our captive transactions, the reinsurance arrangement complies with the risk transfer rules and our LOCs are clean and unconditional as required by state regulations.

While the DFS has called for a national moratorium on approving captive reinsurance transactions, the NAIC (National Association of Insurance Commissioners), which has been studying the use of captive reinsurers for over a year, is currently taking a more measured approach and advocating for enhanced disclosure of the transactions. We, through the ACLI (American Council of Life Insurers), our industry advocate for public policy, have been working with the NAIC for the past year on more robust disclosure requirements with respect to these transactions.

We have and will continue to fully disclose our captive reinsurance transactions to our state insurance regulators who review and approve these transactions and will continue to support the NAIC's efforts to enhance the regulatory framework and provide insurance departments standardized tools and processes to review such transactions.

As always, thank you for your business. All of us at ING U.S. take very seriously, and look forward to continuing to protect the financial futures of millions of Americans.

Butch Britton, CEO, ING Insurance Solutions

John Hancock

John Hancock uses affiliate reinsurance to effectively manage our capital within the overall complex of Manulife and its insurance subsidiaries globally. These transactions are clearly identified in John Hancock's statutory financial reporting as affiliate reinsurance transactions.

John Hancock is a wholly owned subsidiary of Manulife Financial. In addition to NAIC regulatory oversight of John Hancock's US domiciled entities, all of Manulife Financial's operations around the world, including John Hancock and its affiliate reinsurers, are overseen by Manulife Financial's prudential regulator, the Office of the Superintendent of Financial Institutions (OSFI) Canada. This oversight includes subjecting all of our global insurance entities to the OSFI reserve and capital standards. Our capital ratios exceed those standards, and in fact, the presence of virtually all of our affiliates is already reflected in these publicly disclosed ratios.

All of John Hancock's affiliate reinsurance transactions are reviewed and approved by the Insurance department in the appropriate state of domicile (either Michigan, Massachusetts, or New York).

Any reserve credit that we take on our US NAIC financial statements as a result of our affiliate structures are supported by collateral. The collateral consists of a combination of assets held in trust for the ceding insurance company's benefit and clean, irrevocable letters of credit from highly rated financial institutions and conform to collateral requirements stipulated in the Credit For Reinsurance Model Regulation.

Lincoln Financial Group

Lincoln National Life (LNL) has issued term life insurance policies, universal life insurance policies, and annuities with various guarantees attached to them, a portion of which are ceded to reinsurance affiliates that are commonly referred to as "captives." These transactions are noted in LNL's statutory financial reporting.

Lincoln Financial Group (LFG) has established on-shore captives in South Carolina and Vermont, and uses one offshore reinsurance affiliate in Barbados. Life insurance business has been reinsured to the Vermont and South Carolina affiliates, while the annuity business has been reinsured to the Barbados affiliate. These entities, as well as the type and volume of business reinsured to them, are disclosed in our statutory financial reporting.

These reinsurance affiliates need to establish collateral supporting the reserves transferred to them, and such collateral must meet Indiana legal requirements as LNL's state of domicile. For collateral, the LFG captives use a combination of: funds withheld and held in a segregated account at LNL; assets held in a reserve credit trust; and letters of credit (LOCs). The LOCs are typically irrevocable and of relatively long duration (12–20 years). These LOCs may contain limited conditions that specify that other sources of funds available to the captive must be used prior to a draw occurring on the LOC.

The captives assume the significant risks of the business assumed as required under NAIC guidelines, and thus full risk transfer is achieved. In no situation is the risk transferred back to LNL.

All captive transactions are reviewed by the regulators of both the captive jurisdiction and the ceding company jurisdiction.

Pacific Life

Captive insurers are subsidiaries or affiliates of insurance companies that are established to reinsure a specific type of risk written by the insurer and for which commercial reinsurance may not be readily available. Captive reinsurance transactions provide life insurers a means to spread the risk they assume. They also enable life insurers to deploy capital efficiently and, in turn, help them set prices as competitively as possible. Pacific Life has formed captive reinsurance companies for three specific purposes:

1) To reinsure no-lapse guarantee benefits issued on Pacific Life's universal life products that generate redundant reserves. This business is reinsured by a captive domiciled in Vermont that holds assets in trust equal to the economic reserves and a long term LOC to back the redundant reserves. The LOC may be drawn to pay claims once the captive's other assets have been exhausted. The LOC provider's sole recourse is against the captive. Pacific Life cedes the extreme tail risk of its no-lapse guarantee benefits on an excess of loss basis to another Vermont captive reinsurer.

2) To partially reinsure the benefits provided by variable annuity contracts and contract rider guarantees and to allow for more effective hedging of those risks. Pacific Life has ceded a small percentage of this business to a captive domiciled in Arizona. The reserves for this business are backed by a funds withheld arrangement.

3) To facilitate the acquisition of Manulife Financial Corporation's life retrocession business in 2011. Pacific Life established a captive in Barbados to reinsure this business. This business is backed by a combination of funds withheld, LOCs and a reinsurance credit trust.

Each of these transactions is disclosed in our statutory financial reporting and each was subject to review by both Pacific Life's state of domicile, Nebraska, as well as the captive's domicile. Nebraska reviewed the transactions to ensure that there is actual risk transfer, with no possibility that the risk could be transferred back to the ceding company.

The captives post collateral as required for Pacific Life to receive credit for reinsurance ceded to them. Collateral provided for the benefit of Pacific Life in these transactions meets the regulatory requirements governing credit for reinsurance.

Prudential

Prudential's Approach to Captive Reinsurance

As discussed on pages 178–179 of Prudential's 2012 Form 10-K Report, Prudential uses captive reinsurance companies in its domestic insurance operations to more effectively manage capital on an economic basis and to enable the aggregation and transfer of risks.

Prudential's captives hold appropriate assets backing their reserves. To support the risks they assume, the company's captives are capitalized to a level consistent with 'AA' financial strength rating targets of Prudential's issuing insurance entities.

Prudential benefits from using captives through efficiencies achieved by isolating and managing certain kinds of risk in separate entities. Prudential does not use captives to reduce either the reserves or capital that it holds.

Prudential does not use any offshore captives. Nearly all of its captives are based in the same states as the entities that are ceding the insurance risk to the captive. That helps provide transparency to regulators and ratings agencies. The company's captives comply with the laws of the states in which they are licensed, and all transactions with the captives are approved by state regulators.

Benefits for Consumers Holding Term and Universal Life Insurance Products

We share the common view that the required reserving methodology for term and universal life products is overly conservative, resulting in insurers holding reserves that exceed those reasonably expected to be needed for benefits and expenses.

Captive reinsurers allow companies to provide more affordably priced term and universal life products to consumers by isolating a portion of the reserve in a separate legal entity (the captive), and then obtaining assets to support these reserves with debt instead of higher cost equity, or higher policy premiums.

FAQ

Q: *What is a life captive reinsurer?*

A: A life captive reinsurer is an insurance company licensed to reinsure risks ceded by an affiliated life insurer. The captive cannot issue insurance coverage directly to the public and it cannot accept reinsurance directly from non-affiliates.

Q: *What types of business do Prudential's direct writing insurance companies reinsure to captives?*

A: Pruco Life of Arizona and Pruco Life of New Jersey cede term and most of their universal life business to captives. In addition, several Prudential companies cede living benefit risks on variable annuities to captives, and captives are used to reinsure certain other risks on policies written by Prudential's direct writing companies. In all instances the direct writing companies retain their full responsibility to pay claims to policyholders.

Q: *Why does Prudential use captives for term and universal life businesses?*

A: These products are subject to conservative reserve requirements that require the issuing insurance company to establish reserves higher than what our actuaries and other industry professionals believe are required to pay claims and expenses, even under moderately adverse conditions. The reserves that exceed the level of what is necessary are considered suitable for more efficient financing. By using captives, Prudential can isolate this portion of the reserves into a separate legal entity (the captive) by reinsuring the business with the captive. The captive reinsurer can then obtain assets, sometimes with external financing partners, to support these reserves.

Q: *Is there a benefit to the consumer for term and universal life captives?*

A: Captives enable Prudential to offer more competitively priced products to consumers.

Q: *Are other term and universal life carriers using captives?*

A: We believe that captives are used by most of the non-mutual insurance companies that issue individual life term and universal life policies.

Q: *Are Prudential's term and universal life captives financially secure?*

A: We believe that our captive reinsurers are capitalized consistently with "AA" ratings objectives. Assets held in these captive reinsurers are subject to NAIC ratings and are of high quality. We believe the captive will have enough assets to reimburse the issuing insurance company for all claims under the reinsurance agreement and pay ongoing expenses.

Q: *How are Prudential's term and universal life captives regulated?*

A: Captives are highly regulated insurance companies by the state they are licensed. Before receiving a license to establish a captive reinsurer, we submit a detailed application to the state regulator, including a business plan. Our regulator then continuously monitors each captive throughout the course of its existence by obtaining updates to its business plan, financial statements and actuarial opinions on the adequacy of assets to support liabilities. In addition, we receive specific approval for other significant transactions such as reinsurance agreements, inter-company agreements and external financing arrangements. Our captives are all domiciled in the U.S., and generally in the same jurisdiction as the ceding insurance company, so regulators can fully understand the transaction from the ceding and captive company perspectives.

Q: *Are reserves at Prudential's term and universal life captives lowered because a captive is used?*

A: No. When looking at the total of the term and universal life reserves at Prudential's issuing companies and captive reinsurers, the aggregate reserves at both entities combine to equal what is required by state reserving regulations.

TC Life

TIAA-CREF Life Insurance Company does not own any captives.