memorandum

To: House committee on commerce and economic development
From: David Provost, Deputy Commisioner, Department of Financial Regulation
Subject: 2020 CAPTIVE BILL
Date: March 20, 2020
cc: Richard Smith, Vermont Captive Insurance Association; Ian Davis, Vermont Department of Economic Development

Following is an outline of proposed changes to Vermont's captive statute:

Section 1. – Agency Captive Disclosure Requirements

Background: When agency captives were added to the list of available captive types, statute required disclosure of the agency captive to the original policyholders. VCIA received feedback that potential agency captives were concerned that they needed to rework all their policy forms to outline the ownership of the captive to policyholders, which would require re-filing policy forms in other domiciles. DFR has been working with captive managers and others to develop a straightforward sample disclosure, based on disclosures required in captives that reinsured mortgage insurance.

Proposal: Amend statute to simplify the agency captive owner's disclosure requirement.

Section 2. –Dormant Captives

Background: Vermont adopted the concept of the dormant captive in 2013. The dormant captive is relieved of most reporting requirements and pays no tax while it remains dormant. The concept allowed captive owners to keep their captive intact at minimal cost, for future reactivation in Vermont.

One of the requirements of a dormant captive is to maintain minimum capital of $25,000. The original purpose of this requirement was to keep some of the capital that was in the captive available for regulatory costs in the event the dormant captive did not meet even it's minimal responsibilities. But some captives that have applied for dormancy were never capitalized or became operational in the first place, and at least one captive has been licensed to start out in a dormant status pending the death of the owner of the parent company – it make little sense to set aside funds to do nothing when there is so little risk for the regulator.

Proposal: Allow regulatory discretion in setting the capital of a dormant captive that had never activated and capitalized.

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Section 3. – Sponsored Captive Capitalization

Background: The current minimum capital – referred to as the core capital - for a sponsored cell captive is $250,000. Since the core cannot be accessed by the cells, which have their own capital commensurate with their risk, $250,000 is not really needed for regulatory purposes.

Proposal: Reduce the minimum capital for a sponsored cell captive to $100,000.

Section 3. – Minimum Capital Pursuant to a Plan of Dissolution

Background: When captives dissolve, they sometimes pass extended periods of time waiting for a small number of claims or other liabilities to be settled and paid. Under those circumstances, even the statutory minimum capital may be more than necessary to safely wind down the company, and large sums of cash may be tied up.

Proposal: Borrowing from the traditional insurance code, allow the commissioner to reduce or waive the minimum capital and surplus requirements pursuant to an approved plan of dissolution.

Section 3A. – Mergers of Non-insurance Subsidiaries

Background: Many risk retention groups and other group captives own subsidiaries through which they conduct portions of their activities. Often, these affiliates are legacies of earlier regulatory, tax or structural considerations made moot by current conditions, by redomestication of the captive program to Vermont, or combination of formerly separate insurance programs. To simplify regulation, corporate structure, financial recordkeeping and governance, captives routinely seek to close unneeded subsidiaries. Typically, the entities are consolidated with their parents and other affiliates for tax and financial reporting purposes such that the captive's owners and insurance program participants may not even be aware of the subsidiary's existence, even though they are the ultimate beneficial owners of it.

A captive can achieve affiliate closure via multiple means. It could dissolve the business entity, liquidate it and pay a final distribution to its owner. This requires only permission from the captive regulators and approval by the subsidiary's owner- typically represented by the captive's management, as authorized by its Board. However, in many cases, this could be less than ideal. In some jurisdictions where subsidiaries are domiciled (e.g. Bermuda or New York), the dissolution process is regimented and expensive. Also, in order to make the resulting distribution to its owner, assets such as investment securities must often be liquidated to cash, which can result in market timing losses. At a minimum, the ownership of the securities must be formally transferred. Finally, there can be uncertainties in addressing outstanding liabilities and tax filings resulting from dissolution and liquidation.

Alternatively, a subsidiary can be "closed" by merging it with and into its parent or another affiliate. In such a case, ownership transfer of the subsidiary's assets

occurs by act of law, its liabilities become those of the merged entity and securities need not be sold. In difficult domiciles, the merger process is easier than liquidation. Tax advisors often recommend this approach. Though Vermont's corporate laws permit mergers between a subsidiary and its parent or affiliate, there remain process difficulties and uncertainties in corporate law and in Vermont captive statutes that make this more challenging here than in other domiciles.

Proposal: To address these possible impediments, the proposed text would amend the captive law to provide an opportunity for waiver with the approval of the Commissioner of both 1) the application of the traditional insurance company merger procedure, otherwise applied by reference, and 2) shareholder or member approvals otherwise required by applicable business entity law.

Such an approach involving exceptions for captives to corporate and insurance law is already common in the statutes. Other examples include existing available waivers of portions of the merger process and authority for non-profit corporations to issue distributions to owners. New provisions further easing the merger process when warranted make sense and would likely be used by many captives. And such provisions would depend on the proven good judgment of Vermont's regulatory staff.

Section 4. – Unaffiliated Business in Protected Cells of Sponsored Captives

Background: Protected cells are a popular alternative risk transfer mechanism worldwide and are a growth area for Vermont. Cells are more and more often operating like stand-alone captives, addressing similar issues and opportunities. Allowing some unaffiliated business within a cell will help keep the captive option open.

Proposal: Allow flexibility to insure unaffiliated business in a cell under the same circumstances as might be allowed in a stand-alone captive.

Sections 5 & 6. – Separate Accounts in Protected Cells

Background: One feature that is allowed in the captive law is the ability to establish separate accounts within a captive. Separate accounts allow the segregation of assets and liabilities within a company. Such segregation has been used by companies to apportion business for eventual sale (as might be appropriate in the divestiture of a subsidiary), or for business purposes such as to manage separate divisions or segments without the formality and costs associated with a separate subsidiary corporation. In keeping with the desire to allow cells to conduct business as any captive would, this section proposes to explicitly allow cells to form separate accounts within a given cell. The provisions mirror those applicable to standalone captives, and extends the protections of statutory clarity.

Proposal: Explicitly allow cells to form separate accounts within a given cell.

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Sections 7 & 8. – Legal Investments in Cells

Background: Certain captives are required to follow strict, prescriptive, investment statutes. Those statutes are from an old model law, developed for commercial insurance companies and don't always fit well with the captive insurance concept. Last year the legislature gave most companies the option to follow the old model, or to develop their own investment policy, subject to Commissioner approval. That option was not extended to sponsored cell companies but DFR considers it appropriate to do so now.

Proposal: Provide flexibility in investments by giving sponsored captive companies, and the cells within said companies, the option to follow the old rules, or develop a plan for DFR approval.

Sections 9 & 10 – Erroneous Statutory References

Proposal: Correct 2 erroneous statutory references.

Section 11. – Accreditation Standard for RRG Examinations

Background: Examinations of risk retention groups are conducted in accordance with NAIC accreditation standards which require among other things that DFR conduct the examination following the NAIC examiners handbook and file the report within 60 days of its completion. DFR has followed these standards for years but recently discovered that the statutory directive to do so, as required for accreditation, was missing.

Proposal: Incorporate sections 3573 and 3574 into Chapter 142

Section 11A. – Inclusion of Non-affiliated Risk in Affiliated Reinsurance Captives

Background: When an Affiliated Reinsurance Captive (ARC) is being formed anew, it's very simple to be certain that it only reinsures affiliated companies, as intended with the ARC law. However, if an ARC is being formed by conversion or redomestication of an existing company, the company may have accumulated small amounts of unaffiliated business during its past operations.

Proposal: Provide some discretion for the commissioner to permit up to 10% of the risk in an ARC to be assumed from unaffiliated companies.