MEMORANDUM

TO:	SENATE COMMITTEE ON FINANCE, HOUSE COMMITTEE ON COMMERCE AND ECONOMIC DEVELOPMENT
FROM:	DAVID PROVOST, DEPUTY COMMISSIONER, DEPARTMENT OF FINANCIAL REGULATION
SUBJECT:	2019 CAPTIVE BILL
DATE:	FEBRUARY 15, 2019
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. – Dividends & distributions

Background: Title 11B strictly limits distributions from nonprofit corporations. Captives formed as nonprofits often accumulate significant surplus that can be returned to further the nonprofit objectives of the parent. Therefore, such limitations need not apply to captives, and the captive statute has allowed for distributions that conform with the purposes of the nonprofit captive, with approval of the commissioner. This change extends that allowance to cells formed as nonprofit corporations.

Proposal: Amend statute to clearly identify nonprofit incorporated protected cells as eligible for dividends or distributions with commissioner approval.

Section 2. –Captive Formation

Background: Whenever Vermont allows a new form of corporate entity under the law, we have to adapt the captive bill.

Proposal: Allow captives to use any organizational form permitted by Vermont law; the captive law will automatically stay current, and DFR still has plenty of opportunity to decline an application or reject a business form if not appropriate for an insurance company, or for a particular circumstance. This change also simplifies the captive bill.

Section 2. – Attorney-in-Fact Bond

Background: One of the attractions of the reciprocal form is that any taxable income of the reciprocal may be allocated back to the members; if the members are nonprofit entities, no tax will be due on that income, so many of the country's churches, hospitals or colleges form reciprocal insurers. This is the desired result – the nonprofit entities are not taxed for managing their risk, and it allows nonprofit entities to accumulate surplus in their captive.

Reciprocal insurers are unincorporated associations for the purpose of the reciprocal exchange of insurance contracts. In the formal legal sense, the exchange is accomplished by an intermediary, the Attorney-in-Fact (AIF). In a typical captive reciprocal, the AIF is there as a legal technicality with no practical operational function.

The AIF of the reciprocal is required by the state to post a bond for the protection of policyholders. Since the policyholders of a reciprocal captive are also the owners of the captive, and are typically sophisticated insurance buyers, DFR does not find that there is a need for the AIF to post a bond. We wish to eliminate the AIF bonding requirement for captives whose membership consists of such sophisticated buyers (using the industrial insured statute for such qualification) or for a reciprocal that is formed as a cell of a sponsored captive, since the sponsor has control and incentive to ensure proper operation.

It should be noted that no other type of captive or captive service provider is required to post such a bond.

Proposal: Allow the commissioner to exempt the attorney-in-fact from the bonding requirements under specific circumstances.

Section 3. – Examinations

Background: DFR conducts examinations of all captives. The current statute requires an exam every 3 years, which can be expanded to 5 if the captive is audited. We typically examine all single parent captives every 5 years, and prioritize group examinations every 3 to 5 years based on our assessment of their financial condition. The vast majority of companies are on the "5-year plan." In addition, as companies enter runoff, we often grant waivers of annual audits for economy, which unnecessarily forces DFR to examine the company every 3 years.

Proposal: Modify the examination schedule from "3 years to maybe 5" to "5 years or more frequently as needed." There is no practical effect; the default will be 5 years instead of three, but will still be priority based. It reflects actual practice.

Section 4. – Investments

Background: We require certain captives to follow strict, prescriptive, investment statutes. For risk retention groups, NAIC accreditation standards require our statute to address diversification and liquidity of investment portfolios. Most accreditation standards have an accompanying model law. There are many different model laws on investments to choose from, and the accreditation standard does not require adherence to any of them. The current statutes are from an old model law, and can't possibly keep pace with the changes in the investment environment.

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

Sections 5 and 6. –Captive Formation (extension of section 2)
Background: Whenever Vermont allows a new form of corporate entity under the law, we have to adapt the captive bill.

Proposal: Allow sponsored cell captives, and the incorporated cells within, to use any organizational form permitted by Vermont law; the captive law will automatically stay current, and DFR still has plenty of opportunity to decline an application or reject a business form if not appropriate for an insurance company, or for a particular circumstance. This change also simplifies the captive bill.

Section 7. – Sole Proprietorships as Participants in Cell Companies
Background: Participation in a cell captive is an entry to captives for many smaller businesses, some of which grow to form their own separate captive. Adding sole proprietorships to the list of businesses allowed to participate in a cell captive makes it clear that they are eligible. "Other business entities" are allowed, but it is unclear whether or not that encompasses sole proprietorships.

Proposal: Specifically include sole proprietorships as eligible businesses to be cell participants

Section 8. – Accounting Standards for ARCs
Background: The ARC bill allowed for the choice of accounting principles. Accreditation standards require the use of NAIC Statutory Accounting Principles as codified in the Accounting Practices and Procedures Manual. Although ARCs are not necessarily subject to accreditation standards, we want them to comply in practice.

Proposal: Require NAIC statutory accounting for ARCs

Section 9. –RRG Independent Directors
Background: The legislature adopted governance standards for risk retention groups during the past two sessions. Since then, we have had some practical experience with the standards, and have found the definition of Independent Director to be cumbersome at best.

Proposal: Clarify the definition of Independent Director

Section 9. –Own Risk and Solvency Assessment
Background: An ORSA is an internal process undertaken by an insurer or insurance group to assess the adequacy of its risk management and current and prospective solvency positions under normal and severe stress scenarios. An ORSA will require insurers to analyze all reasonably foreseeable and relevant material risks (i.e., underwriting, credit, market, operational, liquidity risks, etc.) that could have an impact on an insurer's ability to meet its policyholder obligations.

The ORSA applies to any individual U.S. insurer that writes more than $500 million of annual direct written and assumed premium, and/or insurance groups that collectively write more than $1 billion of annual direct written and assumed premium. An insurer that is subject to the ORSA requirements is expected to: 1) regularly, no less than annually, conduct an ORSA to assess the adequacy of its risk management framework, and current and estimated projected future solvency position; 2) internally document the process and results of the assessment; and 3) provide a confidential high-level ORSA Summary Report annually to the lead state commissioner if the insurer is a member of an insurance group and, upon request, to the domiciliary state regulator.

The NAIC Model Law #505, implementing ORSA, was added as an NAIC accreditation standard in 2017, and is applicable to risk retention groups. Currently no Vermont risk retention groups meet the size threshold.

<u>Proposal</u>: Apply subchapter 7A of chapter 101 (ORSA) to risk retention groups