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SPECIAL PURPOSE FINANCIAL CAPTIVES SOUTH CAROLINAâS SUCCESS STORY

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Special Purpose Financial Captives South Carolina's Success Story

Over the years, many jurisdictions have developed and utilized captives in a traditional form. South Carolina has distinguished itself by allowing a captive to be used not only as an innovative and useful insurance mechanism, but for a variety of purposes, most specifically in accessing the capital markets.

Background

Initially, South Carolina passed a special purpose reinsurance vehicle act in 2002. This non-captive entity was the first attempt by the state to view the capital markets through the prism of an insurance entity. The idea developed into a Special Purpose Captive (*see* S.C. Code §38-90-10 (26)), which in 2003 was the captive structure first utilized as a vehicle to access the capital markets.

Thereafter, South Carolina developed the first and most comprehensive statutory framework for accessing the capital markets through its unique Special Purpose Financial Captive ("SPFC"), found in Article 3, Chapter 90 of Title 38 of the South Carolina Code. Since its promulgation, more than $20 billion has been accessed by insurers through their captive platforms, primarily from the capital markets. South Carolina successfully licensed over 25 SPFCs, each of which contributes sizeable deposit infusions into South Carolina banks, annual substantial premium taxes, as well as indirect economic benefits, such as travel and room nights in South Carolina, annual and quarterly Board Meetings and fees to service providers.

This article addresses some of the reasons for the success of SPFCs in South Carolina and how the state continues monitoring the activities of existing SPFCs, as well as future prospects for SPFCs.

What is an SPFC?

An SPFC is a captive insurance company formed specifically to reinsure the risk of an affiliate or parent, usually a life insurance company, to facilitate the securitization of the risk as a means of accessing alternate sources of capital addressing the burden of a reserving requirement. For Term Life products, the acronym "XXX" is used to denote these reserves, and for Universal Life products, the acronym "A XXX" is used. The required reserves are substantial and generally exceed expected benefits payable for term and universal life products. To date, South Carolina has successfully securitized term, universal life contracts and disability claims through a variety of different SPFCs for some of the major life and disability insurers in the U.S.

South Carolina has been successful because it has always viewed the SPFC as a true "insurance company," not simply a financial transaction. Under South Carolina's statutory framework, the SPFC is subject to careful ongoing scrutiny and reporting requirements, as the general life of the SPFC often exceeds twenty and sometimes thirty years. Once licensed, the SPFC is essentially put on autopilot, subject to a variety of control mechanisms described in this article.

Why Use An SPFC?

This fundamental question was posed by many interested parties during the early phases of the program. The answer is that SPFCs provide simple and cost effective solutions to address reserve strains by isolating blocks of business for reinsurance purposes. This becomes more apparent when comparing SPFC solutions with other more temporary solutions for reserve relief.

First, there is the traditional reinsurance market. Reinsurance for XXX and A XXX reserves is expensive and extracts many of the economic benefits of the block. Further, buying reinsurance for the "excess reserves" exacerbates the problem of inefficient use of capital created by reserve redundancy. Also, reinsurance is more traditionally viewed as protecting term life blocks of business from adverse mortality and other aberrations in the block's performance. With some exceptions, it is generally not viewed as a cost effective or economically viable alternative for financing XXX or A XXX Reserves.

Another option has been the use of a letter of credit ("LOC") to finance XXX and A XXX Reserves. Though currently in vogue, this financial product is problematic in that LOCs are generally issued for short terms and generally expose the parent company to rollover, re-pricing, liquidity, credit and possible other risks. Until the recent implosion of the capital markets and because of the dangers that exist in counterparty exposure (using one bank's balance sheet to issue a letter of credit), there had been a reluctance to use LOCs to finance reserves. LOCs are also expensive, lock the insurer in with one financial institution for a lengthy period of time and are difficult to tailor to a XXX transaction.

The final method commonly used to finance XXX Reserves is internal funding. This is generally viewed as a very inefficient use of internal capital, since the invested funds are essentially idle and not directly related to selling life products, the core business of a life insurance company. Many term and universal life writers have been very successful in estimating their "economic reserves" (the reserves required to meet expected benefit payments). This has enabled these companies to avoid tapping their XXX and A XXX reserves. Internal funding proposals also presume the existence of an affiliate or parent that has sufficient cash to invest to meet the reserve requirements of the XXX or A XXX regulations.

For these reasons, and the simple desire to control one's own destiny, the SPFC came into existence. The capital markets contain trillions of dollars available for access through the SPFC mechanism. The aforementioned alternative solutions are limited not only in terms of size of the available market, but also in the number of participants, particularly in the LOC realm.

How Does it Work?

The principal component of the SPFC is isolation of segregated blocks of business, usually on a yearly basis, to finance the reserve requirements of that block. Through a reinsurance agreement with the SPFC, there can be a true separation of the reserves from the ceding company. This enables the parent company to achieve the operating leverage needed and treat the funds accessed in the capital markets as surplus, not debt. The capital markets transaction involves a number of protections to ensure that the market risk from issuance of the notes or securities used to finance XXX and A XXX reserves does not pass back to the captive. In other words, one of the strengths of South Carolina's program is that all of the reserves to date have been primarily financed through high quality assets, cash or other marketable securities, which are controlled by strict investment guidelines and placed in a specific trust arrangement to provide credit for reinsurance for the ceding company and protect the assets of the captive. To pay annual interest or periodic principal on the note, each SPFC license is accompanied by an Administrative Order, which utilizes a specific formula to allow the SPFC to apply for interest and/or dividend payments based on its annual performance. These formulas are a function of Risk Based Capital ("RBC") ratios developed by the NAIC. To date, no captive in South Carolina has ever missed an interest or dividend payment. In fact, most of the annual applications for dividend or interest payments far exceed the minimum RBC ratios set forth in their Administrative Orders.

Historically, the SPFC issued surplus notes to a purchaser who, in turn, utilized an investment bank to repackage those notes and sell them in the capital markets to sophisticated "Regulation 144A" Investors. Most early transactions were "wrapped" (guaranteed by financial guarantors such as MBIA, Ambac and others). These financial guarantors provided a "AAA" credit rating that many money market managers needed to ensure high quality investments in their portfolios. With the demise of these financial guarantors, greater emphasis has been placed on traditional rating agencies. In the current environment, many of the surplus notes issued by the SPFCs exceed the rating of the financial guarantors. This provides a unique opportunity in the XXX/A XXX world for "unwrapped" offerings.

The minimum capital, economic and excess reserves are also rigorously tested through a variety of actuarial stress scenarios involving mortality, interest rate fluctuations, and lapsation of insurance policies. This actuarial modeling provides confidence to the domiciliary regulator, the insurer, and investors that the captive will perform as expected. In some cases, these projections are now approaching 9 years, and with each passing year, experience shows them to be very precise and in line with actuarial modeling predictions. There is thorough ongoing regulation to ensure the proper performance of all of the insurance entities involved, with extensive annual reporting to South Carolina and domiciliary state regulators. The SPFC is generally subject to annual GAAP and statutory filings as well as an annual actuarial assessment of the performance of the block that has been ceded to the captive. This regulatory framework has worked extremely well and has provided comfort to knowledgeable investors who view these entities as safe and prudent investments. Finally, there are ongoing surveillance reviews by rating agencies, as well as careful monitoring by the insurance companies themselves.

Why The Success Story?

As stated above, South Carolina is by far the leader and recognized expert in the SPFC field. The controlling South Carolina statutes contain a variety of unique provisions protecting the investor and captive, some of which do not exist in jurisdictions that have replicated South Carolina's statutory framework. For example, South Carolina has a comprehensive Administrative Procedures Act to provide long term stability to the operations of the SPFC over its expected useful life. To implement this Act, South Carolina has a dedicated Administrative Law Court, with an agency and business focus, which provides a forum to expeditiously resolve any disputes that might develop and cannot be resolved with the Department of Insurance. Additionally, South Carolina, unlike most other states, has unique internal processes and resources to review applications, continually monitor the SPFC, and craft unique provisions in flexible Administrative Orders that are necessary to ensure the successful operation of the captive. Every South Carolina license is preceded by months of careful, detailed analysis and actuarial modeling. The ceding life insurance company's domiciliary state is also required to sign off on the SPFC reinsurance transaction. Domiciliary states have expressed their satisfaction with the careful regulatory environment in South Carolina. This has allowed some SPFCs to be deemed accredited reinsurers, which provides for even more financial flexibility for the affiliate/parent ceding company, especially in terms of valuation of assets held in trust. This view of SPFCs as true "insurance companies," and not simply financial transactions, is extremely important, particularly given the environment that currently exists in the regulatory and investment world.

The Future

In the wake of the capital markets downturn, some have misconceived the function and protection inherent in life insurance reserve securitizations. They are very different from most asset-backed securitizations. The misconceptions appear to be the result of a simplistic tendency to lump life insurance securitizations with other asset-backed securities. That, and the failure to take into account (much less explain) the significant differences between the regulatory and capital market aspects of these products contributes to this false perception. The risks involved for investors in asset-backed securitizations utilizing life insurance blocks of business are principally mortality, interest rate fluctuation and lapsation. With rigorous testing, long

experience, and a wealth of intellectual capital within the Department of Insurance, South Carolina's SPFCs have performed extremely well to date. This experience leads to the expectation that investors will view life insurance as a unique asset- backed security, since mortality risk is de-linked from the economy, and the reserve trust assets are carefully regulated by the Department of Insurance. Neither of these protections existed in the mortgage world, which one could say was one of the principal reasons for the collapse of the asset-backed securities market. Given this current unique investment environment, several new options are being considered by the Department for use of the SPFC. Specifically, there has been a great deal of discussion that the SPFC market needs to be "jump started" through some mechanism, either at the state or private level, to reinvigorate the interest of investors and term life providers in providing capital market based solutions. This could involve a variety of ideas, such as creation of an infrastructure bank or investment of state retirement funds in the program[1]. Further, considerations have been given to securitizing other types of insurance projects, such as variable annuities and even property and casualty risks.

Conclusion

As stated above, the real success story in South Carolina relates to innovative thinking, dedication, and a continued commitment to the captive program, as evidenced by the SPFCs that have been licensed to date. This reputation has enabled South Carolina to be a true success story in protecting term and universal life consumers by providing benefits through efficient use of capital, which transfers into safe, low cost products. It also gives insurers the comfort of knowing that the SPFC has completely segregated itself from the balance sheet of the parent, thereby enabling the parent to use its capital more efficiently to provide reserves for term and universal life products. The SCCIA will be featuring several panels discussing many of the above referenced topics at its annual meeting September 13th-15th in Charleston, SC. Please mark your calendars to attend. You won't want to miss what is happening in South Carolina.

Endnotes

1. Retirement funds have a unique interest in that the state retirement system views assets on a long term basis, which is one of the unique features of surplus notes issued by the SPFC.