INSURANCE ADMINISTRATION

Report to Examine Methods to Establish and Properly Regulate a Captive Insurer Industry in the State of Maryland

December 2013

MSAR No. 9790

For more information concerning this document, please contact:

Karen Stakem Hornig
Deputy Commissioner
Maryland Insurance Administration
200 St. Paul Place, Suite 2700
Baltimore, Maryland 21202
410-468-2018

People with disabilities may request this document in an alternative format.
Requests should be submitted in writing to:

Director of Public Affairs
Maryland Insurance Administration
200 St. Paul Place, Suite 2700
Baltimore, Maryland 21202
410-468-2000
800-492-6116
800-735-2258 TTY

www.mdinsurance.state.md.us

TABLE OF CONTENTS

I. EXECUTIVE SUMMARY

Section 1, Chapter 407, 2013 Laws of Maryland (Chapter 407) requires the Maryland Insurance Administration (MIA) to examine methods to establish and properly regulate a captive insurer industry in the State and develop recommendations for whether Maryland should establish a captive insurance industry and, if so, how to establish, promote, and regulate that industry.

The purpose of this report is to provide information to the Governor, the Senate Finance Committee and the House Economic Matters Committee about the possibility of establishing a captive insurance industry in the State. In accordance with Chapter 407, the MIA was required to study:

- the models of regulation of captive insurance industries in other states, including the mechanisms for funding those regulatory models;
- the potential benefits of hosting a captive insurance industry in the State to different classes of insureds, and the associated costs of captive insurance compared with insurance procured through traditional insurance underwriting and brokerage;
- the impact on the State and the domestic insurance industry, both as to the potential expansion of the insurance industry and related professionals and activities in the State, and the effect of newly available captive insurance on existing traditional insurance underwriting and brokerage in the State;
- the need for different or additional consumer protections and financial controls for customers of captive insurers compared with customers of traditional insurers in the State;
- the effectiveness, cost, and long-term viability of alternative regulatory or market mechanisms addressing the same or similar markets that have been implemented or are being considered in other states; and
- any additional matters the MIA considers relevant to assessing the possibility of establishing a captive insurance industry in the State.

Further, Chapter 407 requires that the MIA develop recommendations for whether Maryland should establish a captive insurance industry and, if so, how to establish, promote, and regulate the industry.

The MIA recommends that the General Assembly forego captive legislation at this time because there is little demand for traditional captive insurers and because the industry has developed in ways that have caused considerable regulatory concern at the federal and state levels. To become a thriving captive domicile today, a state must be willing to relax important regulatory safeguards. Attractive new domiciles are those that have a high risk appetite, demand few hurdles to formation, have low premium taxes and fees, have minimal solvency and capital requirements, and require little in the way of reporting. Additionally, there is no evidence to support a conclusion that becoming a captive domicile would create actual economic benefit to Maryland.

If, however, the General Assembly chooses to pass captive legislation, it is recommended that the legislation be conservatively drafted to prohibit certain types of captives that are currently under scrutiny by the Internal Revenue Service and the National Association of Insurance Commissioners. Legislation should ensure that only legitimate insurance transactions are permitted and make certain that third party claimants are not put at risk.

II. Overview of the Study Process

This report includes a review of other states' legislative enactments, a review of the current captive insurance marketplace, a discussion of current regulatory issues related to the captive industry, and the costs, challenges, and potential benefits of establishing a captive domicile. As required under Chapter 407, the MIA also made recommendations to establish a captive industry including recommending draft legislation.

Chapter 407 permitted the MIA to secure the services of an independent consultant to assist with this report. After a competitive bid process completed in July 2013, a successful bidder was chosen. Pinnacle Actuarial Resources, Inc. has experience in helping to establish and evaluate captive insurers and also provide captive management services. The report developed by Pinnacle, entitled *Recommendations on the Enactment of Captive Insurance Company Legislation in Maryland* (Pinnacle Report), is included as Attachment 1.

III. Development of the Captive Insurance Industry

Captive insurance is a form of self-insurance. In its pure form, a captive insurer is a wholly owned subsidiary created to provide commercial insurance to its non-insurance parent company, which is the principal beneficiary. Originally established by large companies to provide insurance where coverage was unavailable or high-priced, a captive insurer operates like any commercial insurer: it issues policies, collects premiums, and pays claims. It does not offer insurance to the public.[1] It is not regulated like an admitted insurance carrier, but operates under relaxed rules governing the captive's formation, capitalization, and solvency.[2]

The International Association of Insurance Commissioners (IAIS) defines a captive as "an insurance or reinsurance entity created and owned, directly or indirectly, by one or more industrial, commercial or financial entities, other than an insurance or reinsurance group, the purpose of which is to provide insurance or reinsurance coverage for risks of the entity or entities to which it belongs, or for entities connected to those entities, and only a small part if any of its risk exposure is related to providing insurance or reinsurance to other parties." [3] Most Fortune 500 companies and many large non-profits use captives as a way to control insurance cost and to enjoy tax benefits resulting from deducting insurance premiums paid into a privately held insurance company.[4] Traditionally, industries with the greatest number of captives include

[1] Greg Taylor and Scott Soebel, *A Closer Look at Captive Insurance,* The CPA Journal, June 2008, at 1.
[2] Shanique Hall, *Recent Developments in the Captive Insurance Industry,* National Association of Insurance Commissioners (NAIC), January 2012 at 1.
[3] IAIS, *Issues Paper on the Regulation and Supervision of Captive Insurance Companies*, October 2006, at 4.
[4] Greg Taylor and Scott Soebel, *A Closer Look at Captive Insurance,* The CPA Journal, June 2008, at 2.

finance, real estate, construction, and manufacturing. More recently, there has been particular growth in health care, property development, and securitization for life insurers.[5]

A. History

While risk management developed for a particular business (e.g. maritime industry or textile manufacturers) or a group (e.g. religious denomination) has existed for centuries,[6] most sources credit Ohio insurance agent Frederic M. Reiss with establishing the first "captive" insurer in 1955.[7] His client, Youngstown Sheet & Tube Company (YST) owned mines that were used exclusively for YST and were referred to as "captive" mines.[8] The term was then used for the insurance company solely created to insure the mining operation. In 1958, Reiss founded American Risk Management and chose to operate offshore to avoid state regulation.[9]

Reiss founded International Risk Management Ltd. in 1962 in Bermuda, which remains the leading offshore captive domicile. In 1978, Bermuda passed the first comprehensive legislation to standardize captive licensing and oversight procedures.[10] The Cayman Islands followed and wrote captive legislation targeting the healthcare industry. Harvard's medical hospital formed one of the first pure Cayman Islands captives to supplement and control professional and medical liability risks due to increasingly expensive commercial market insurance and to improve claims and loss control.[11]

B. Current Captive Insurance Marketplace

The captive industry has grown dramatically in the last 30 years. While reports are not consistent, industry sources report that there are more than 6,000 captives that do business around the world in a variety of industries as compared with 1,000 in 1981.[12] Approximately 3,000 captives are domiciled in the Caribbean, 1,200 captives are domiciled in Europe and Asia, and the remaining captives are domiciled in the United States.[13] Numbers are estimated because

---

[5] Shanique Hall, *Recent Developments in the Captive Insurance Industry,* NAIC, January 2012 at 2.
[6] William R. Vance, Handbook on the Law of Insurance 8 (Buist M. Anderson ed., 3d ed. 1951); *The Early Days,* Lloyd's Corporate History, http://www.lloyds.com/lloyds/about-us/history/corporate-history/the-early-days; FM Global History, http://www.fmglobal.com/page.aspx?id=01070000; Sharon Thatcher, *The First 100 Years of Church Mutual Insurance Company*, Church Mutual Insurance Company, https://www.churchmutual.com/87/Company-History; *About Us,* Church Insurance Company, https://www.cpg.org/global/about-us/about-cpg/church-insurance/
[7] Insurance Hall of Fame, Frederic Reiss, Induction Year 2007, http://www.insurancehalloffame.org/laureateprofile.php?laureate=135.
[8] Jenna Jones, *Staying Power*, Captive Insurance Times, Issue 23 (May 29, 2013), www.captiveinsurancetimes.com.
[9] Julian M. Burling and Kevin Lazarus editors, *Research Handbook on International Insurance Law and Regulation*, Edward Elgar Publishing., Inc. 2011, at 560.
[10] Catherine Lapsley and Andrea Dismont, *Moments In Time: The Bermuda Insurance Market*, Bermuda Insurance Institute and Bermuda Foundation for Insurance Studies, http://www.bermudayp.com/momentsintimeinsurance.
[11] *History of Captives*, http://captiveexperts.com/History_of_Captives.html.
[12] Dan Berman, *More Employers Choosing Captive Insurance,* BenefitsPro, November 25, 2013. *But see*, Shanique Hall, *Recent Developments in the Captive Insurance Industry,* NAIC, January 2012 at 1 (reporting "...that there are more than 5,000 captives worldwide.").
[13] Shanique Hall, *Recent Developments in the Captive Insurance Industry,* NAIC, January 2012, at 2-3.

not only do some domiciles place a high value on the confidentiality of captive transactions, but there is inconsistency in how numbers are counted. For example, the Pinnacle Report states that Delaware has 181 captives.[14] However, Delaware reported in August of 2013 that it "has over 550 active captives..."[15] which seems to indicate that Delaware counts each cell within microcaptives as a separate captive entity.

Off shore jurisdictions remain the most popular captive domicile, with Bermuda and the Cayman Islands the two largest. Vermont, the United States' largest captive domicile, is third. These top three domiciles account for 36% of all captives globally. Trends indicate that businesses are now more likely to form new captives in the United States or in European Union countries than in other jurisdictions.[16]

While most captives insure only the risks of its parent, variations have grown as captive managers and companies come up with new ways to use captives.[17] In addition to the traditional, single-parent captive, in which the captive insurer writes only the risk of the parent or its affiliates, there are, among others, group, association, agency and cell captives.[18] Since forming the Bureau of Captive and Financial Insurance Products in 2009, Delaware claims to be the 10th largest international captive domicile and 3rd largest in the United States, due to is specialization in microcaptives.[19]

C. Significant Regulatory Issues

While captives traditionally have been used as a risk management tool for large, often hard to insure commercial risks, the captive industry has spawned newer varieties of particular concern to federal and state regulators. "Microcaptives" are highly unregulated, private transactions that are insurance in name only and can be used to shield personal wealth from income tax. Special purpose vehicles are controversial transactions that shift life insurance reserves from a life insurance company's balance sheet, putting third party claimants at risk. There has been significant growth in the captive industry resulting from these two types of captives. The Internal Revenue Service, the Federal Insurance Office, the National Association of Insurance Commissioners (NAIC), and industry observers have raised serious concerns about these captive forms. Unlike more traditional captive forms, critics claim this new breed of risk-shifting vehicles are more like the high risk transactions that contributed to the 2008 financial crises.[20]

1. Section 831(b) "Microcaptives"

Insurance companies, other than life insurance companies, generating annual premiums of $1.2 million or less can elect to pay federal tax based only on their investment income (as

---

[14] Pinnacle Report, Ex. 1, at 2.
[15] Steve Kinion, *Courting Controversy*, August 2013, www.captivereview.com.
[16] Marsh Risk Management Research, *2013 Captive Benchmarking Report*, April 23, 2013, at 6.
[17] *Id.*
[18] A listing of various types of captives and their definitions are in the Pinnacle Report at page 8.
[19] Steve Kinion, *Courting Controversy*, August 2013, www.captivereview.com.
[20] New York State Department of Financial Services, *Shining a Light on Shadow Insurance,* June 2013.

opposed to the taxable income of a corporation) under § 831(b) of the IRS code. Increasingly, midsize and small companies are entering the captive marketplace by forming "microcaptives" to take advantage of the tax benefits of making a § 831(b) election. Microcaptives have been the key to growth in the newer captive domiciles of Delaware, Kentucky and Utah.[21] Microcaptives are not limited to a particular captive form, but are often formed as a type of "cell" captive.[22] Cell captives are a group of captives designed to be legally separate entities with separate assets and liabilities.[23]

The IRS is actively investigating the use of microcaptives and the aggressive marketing by some captive managers and financial advisors of § 831(b) tax benefits to high wealth individuals. Some microcaptives are taking advantage of the tax treatment of being an insurance company without meeting one or more of the basic requirements of an insurance transaction. To be a legitimate § 831(b) captive insurance company, there must be an actual insurable risk and the actual transfer of risk. The IRS is focusing on questionable pooling mechanisms used to provide risk distribution, inflated premiums, fraudulent transfer of assets out of the captive to off-shore accounts, and dubious insurance risk having a very low likelihood of resulting in a claim.[24] Currently, "the IRS has more cases pending in tax court against captives than ever before – and the growth of the sector means the IRS will be tasking more resources toward abusive practices." [25]

2. *Life Reinsurance Captives and the "Shadow Banking" Debate*

Some life insurance companies started using a type of captive for reinsurance and securitizations that is referred to as a special purpose vehicle (SPV) to distinguish it from traditional self-insurance captive insurers. SPVs developed in response to the NAIC Valuation of Life Insurance Policies Model Regulation (Model #830) adopted in February of 2001. Model #830 requires conservative assumptions and valuation methodologies for determining the level of statutory reserves for life insurers. These conservative assumptions can result in higher reserve levels than were previously maintained by insurers. For term life products, the acronym "XXX" is used to denote these reserves, and for universal life products, the acronym "AXXX" is used.

Model #830 sparked the creation of various SPVs to help companies circumvent the conservative reserving standards. Most of the securitization structures use a captive insurance company as a repository for the funds that were available from the securitization. An insurer or reinsurer ("ceding insurer") transfers the risk associated with policy liabilities to a captive reinsurer. As compensation for the assumed risk, the ceding insurer pays the capital, plus an

---

[21] Pinnacle Report, at 3.
[22] Pinnacle Report, at 8; IAIS Report at 8, 36-38.
[23] IAIS Report, at 38.
[24] Richard Klumpp, *The 3 Most Common Mini-Captive Scams*, Wilmington Trust Captive Insurance Brief (January 5, 2012), http://blog.wilmingtontrustcaptiveinsurance.com/blog/bid/75823/The-3-Most-Common-Mini-Captive-Scams.
[25] Jay Adkisson, *IRS Filling The Pipeline With Captive Insurance Cases And Focusing On Dubious Practices,* Forbes (September 9, 2013), www.forbes.com/sites/jayadkisson/2013/09/22/irs-filling-the-pipeline-with-captive-insurance-cases-and-focusing-on dubious-practices.

initial economic reserve, into the captive reinsurer. In return, the SPV issues debt securities in the capital market to finance the statutory reserve requirement exceeding the economic reserves. These developments have caused significant concern among state insurance regulators as it raises the question as to whether third-party insurance risk should be undertaken by a captive insurer.[26]

In July 2012, the New York Department of Financial Services (DFS) initiated an investigation into what it called "shadow insurance."[27] (Attachment 2.) DFS investigated the use of SPVs to free up a company's reserves that were supposed to be set aside to pay claims on a block of life insurance policies. The DFS investigation pointed out that there is no actual risk transfer in these transactions, that insurers have depleted reserves available to pay policyholders, and that these transactions "could potentially put the stability of the broader financial system at greater risk."[28] As part of the DFS final recommendation, it asked for state insurance commissioners to consider an "*immediate national moratorium*" on approving additional shadow insurance transactions until further investigations could be completed.[29]

Following the DFS report and articles in The New York Times[30] and the Wall Street Journal,[31] the NAIC formed the Captive and Special Purpose Vehicle Use Subgroup under the Financial Condition (E) Committee in early 2012. The Subgroup was charged with studying, "...insurer's use of captives and special purpose vehicles to transfer insurance risk, other than self-insured risk, in relation to existing state laws and regulations...". [32]

While the Subgroup's work continues, it has identified several regulatory concerns. These concerns do not relate to the traditional captive forms but, rather, to the use of SPVs. In addition to the lack of transparency or regulation surrounding these transactions, a primary concern is that these transactions are being used to circumvent statutory accounting reserve requirements. Of particular concern is the use of letters of credit and parental guarantees to capitalize or fund the surplus of captives. Statutory accounting requirements limit the types of assets that can count as admitted assets and a letter of credit is not an admitted asset under statutory accounting for a commercial insurer. However, some states allow SPVs to count a letter of credit or a parental guarantee as an admitted asset. Thus, a life insurer can improve its balance sheet and preserve capital resources by transferring the XXX and AXXX reserves to an SPV. A final report from the NAIC Subgroup is expected in 2014 and it is expected that it will have specific recommendations involving the modification of existing NAIC model laws and the drafting of new NAIC model laws.

On December 12, 2013, the Federal Insurance Office (FIO) of the U.S. Department of the Treasury issued a report pursuant to the Dodd-Frank Wall Street Reform and Consumer

---

[26] Shanique Hall, *Recent Developments in the Captive Insurance Industry*, NAIC, January 2012 at 6-7.
[27] New York State Department of Financial Services, *Shining a Light on Shadow Insurance*, June 2013.
[28] *Id.* at 1.
[29] *Id.* at 3 (emphasis in the original).
[30] Mary Williams Walsh, *Insurers Inflating Books, New York Regulator Says,* N.Y. Times, June 11, 2013.
[31] Leslie Scism and Serena Ng, *New York Probes Insurers' Dealings with Captives,* Wall St. J., August 5, 2012.
[32] NAIC, *2013 Committee Charges*, March 1, 2013, p. 37, http://www.naic.org/index_committees.html.

Protection Act.[33] The report recommends ways to modernize and improve insurance regulation in the U.S. and one topic specifically addressed is captive insurers and their impact on the life insurance industry.[34] FIO encouraged states to "develop a uniform and transparent solvency oversight regime for the transfer of risk" to SPVs.[35]

IV. MODELS OF REGULATION OF CAPTIVE INSURANCE INDUSTRIES IN OTHER STATES

In the United States, 37 states have captive legislation.[36] Over the last five years, there have been a significant number of emerging captive domiciles including Oregon, New Jersey, Connecticut, Texas, and Louisiana. In addition, current captive states such as Florida, Tennessee, Oklahoma, and Maine are all looking at captive growth in their states and strategically amending their laws to be more accommodating and attractive to captive owners.[37]

Captive legislation addresses the types of captive forms permitted, formation requirements, types of coverages allowed, capitalization requirements, premium taxes and fees, solvency regulations (i.e. surplus requirements), reporting and examination requirements, and rate and premium setting requirements. The following discussion focuses on the top ten captive domiciles in the United States - Arizona, Delaware, the District of Columbia, Hawaii, Kentucky, Montana, Nevada, South Carolina, Utah, and Vermont - and their approach to capital and surplus requirements, permitted coverages, premium tax, and accounting standards.

Capital and surplus requirements vary by state depending on the type of captive. This variety is a key element of consideration for companies shopping for a captive domicile. Typically, minimum requirements for capital and surplus are as follows:

- pure captives require $250,000;
- association captives require $500,000;
- agency captive requires from $250,000 to $600,000;
- industrial captives require $500,000; and
- sponsored captives require $500,000.[38]

For those states that allow them, the minimum capital and surplus for SPVs vary from $250,000 to $500,000 in four states, and are at the discretion of the commissioner in two other states. A table comparing the capital and surplus requirements for various types of captives in the top ten U.S. domiciles is found at Attachment 3.

Most states prohibit captives from writing direct workers' compensation insurance, personal motor vehicle insurance, and homeowner's insurance. In addition to prohibitions for

---

[33] Federal Insurance Office, *How To Modernize and Improve the System of Insurance Regulation in the United States,* U.S. Department of the Treasury, December 2013.
[34] *Id.* at 32-36.
[35] *Id.* at 32.
[36] Pinnacle Report at 1.
[37] Marsh Benchmarking Report. at 2.
[38] A listing of various types of captives and their definitions are in the Pinnacle Report at page 8.

certain lines of coverage, state laws also dictate to whom insurance coverage should be provided. For example, many state laws provide limitations such as "a pure captive insurer shall not insure risks other than the risks of its affiliates and controlled unaffiliated business."[39] Finally, some states require that the insurance commissioner approve certain coverages. A table comparing the permitted coverages for captives in the top ten U.S. domiciles is found at Attachment 4.

Captive premium tax rates (typically, less than 0.40%) are significantly lower than the traditional admitted market premium tax rates, which typically range from 2% to 3% nationally.[40] Maryland's premium tax rate is 2%.[41] Captive domiciles take a variety of approaches to premiums taxation of captives. A few states, like Utah and Arizona, do not tax captive premium but impose an annual fee. Delaware imposes a flat rate of 0.2% for direct premium and 0.1% for assumed premium. For the majority of the domiciles in the top ten U.S. captives, premium tax is assessed according to "banded" premium levels. A table comparing the premium tax rates in the top ten U.S. domiciles is found at Attachment 5.

All top ten captive U.S. domiciles require a statement of actuarial opinion as part of the annual financial reporting requirement. Financial examination frequency ranges from three to five years except for Arizona, which does not require financial examinations for non-risk retention group captives. Regarding accounting standards, the top ten domiciles require the use of generally accepted accounting principles (GAAP) for financial reports. Some states' law gives the insurance commissioner the authority to accept financial statements using other standards. In regulating admitted insurance carriers, state regulators require the use of the NAIC's Statutory Accounting Principles (SAP), which industry considers conservative. A table comparing the accounting standards in the top ten U.S. domiciles is found at Attachment 6.

V. ALTERNATIVE REGULATORY OR MARKET MECHANISMS ADDRESSING SIMILAR MARKETS

Risk retention groups (RRGs) and purchasing groups (PGs) formed pursuant to the federal Liability Risk Retention Act (LRRA) are two primary alternative regulatory or market mechanisms.[42] RRGs and PGs are limited by the LLRA to offering or purchasing liability coverage such as general liability, errors and omissions, directors and officers, medical malpractice, professional liability, and products liability insurance. The LRRA excludes workers compensation, property insurance or personal lines insurance. The most important difference between an RRG and a purchasing group is that an RRG is an insurer that retains risk while a PG does not, because it purchases insurance from an insurer. The LLRA relies solely on state insurance departments for its implementation.[43]

---

[39] ARIZ. REV. STAT, § 20-1098.01(A)(1).
[40] NAIC, *Retaliation: A Guide to State Retaliatory Taxes, Fees, Deposits and Other Requirements*, 2013.
[41] MD. CODE ANN., INS. ART., § 6-103.
[42] 15 USC § 3902.
[43] *Id.*

Maryland law permits the formation of RRGs and PGs.[44] A RRG "has as its members only persons that have an ownership interest in the group and has as its owners only persons that are members of the group..."[45] Generally, a Maryland RRG is regulated like a traditional insurance company.[46] Maryland has 98 foreign RRGs authorized to write business in Maryland. There are currently no domestic RRGs. There are 539 PGs registered to do business in Maryland and of those nine are domiciled in Maryland.

Typically, RRGs domicile in states with captive laws, because "[t]hese laws typically provide advantages that would not be available to an RRG if it formed under the states' traditional property-casualty law, including lower capital and surplus requirements, fewer restrictions on investments, and lower premium tax rates."[47] As a result, those states that have expanded their appeal to other captive types have attracted more RRGs.[48] In 2013, there have been notable RRG failures such as those seen in Utah and Delaware.[49]

VI. Discussion of Potential Benefits and Costs of Captive Legislation

The decision whether to permit the formation of captive insurers in Maryland requires consideration of the potential benefits and possible risks and costs to the State and its citizens. In terms of costs and benefits, Chapter 407 asked the MIA to consider:

- the potential benefits of hosting a captive insurance industry in the State to different classes of insureds, and the associated costs of captive insurance compared with insurance procured through traditional insurance underwriting and brokerage;
- the impact on the State and the domestic insurance industry, both as to the potential expansion of the insurance industry and related professionals and activities in the State, and the effect of newly available captive insurance on existing traditional insurance underwriting and brokerage in the State; [and]...
- the need for different or additional consumer protections and financial controls for customers of captive insurers compared with customers of traditional insurers in the State.

A. Potential Costs and Benefits to Insureds

While captives can provide benefits to insureds, on balance, the potential benefits to insureds do not outweigh the potential costs. In a traditional captive arrangement, captive insurance companies do not sell insurance to the public. The "insured" in relation to a captive is an employee or member of an entity or group that owns the captive insurance company. Captives can provide the benefit of a financially beneficial alternative insurance vehicle for

---

[44] MD. CODE ANN., INS. ART., §§ 25-101 - 25-111.
[45] MD. CODE ANN., INS. ART., § 25-101(j)(6)(i).
[46] MD. CODE ANN., INS. ART., § 25-102(a).
[47] Karen Cutts, *Not All Captive States Alike For RRGs*, National Underwriter Property & Casualty (April 15, 2004), http://www.propertycasualty360.com/2004/04/15/not-all-captive-states-alike-for-rrgs.
[48] *Id.*
[49] *Industry New Article Excerpts,* Risk Retention Reporter (December 2013), http://www.rrr.com/news/.

commercial entities. Today whether a state is a successful captive domicile depends less upon the number and type of businesses that exist within a state, but rather how attractive a state can make its regulatory environment for the formation of new, riskier types of captives.

Anticipating a significant number of redomestications of existing captive insurers is unrealistic. "While the formation of new captives is trending toward onshore domiciles, large scale re-domestication is not occurring among existing captives. Of the more than 1,220 captives under management at Marsh, only 16 re-domiciled to a new jurisdiction in 2012."[50]

A potential risk to insureds comes in the form of SPVs and other captive forms involving third party claims. As discussed in section III.C.2, these transactions can shift policy liability off of a life insurance company's balance sheet. These arrangements can put at risk both the ability to cover insurance claims and the financial solvency of the underlying life insurance company.

B. Potential Costs and Benefits to the State of Maryland

1. Premium Taxes and Fees

Captive legislation generally includes a method for funding the regulation of the captive industry. In most states, captive legislation sets up a regulatory fund into which captive premium taxes, fees, and penalties are deposited and ear-marked for the regulation of the captive industry. This type of regulatory fund is used in Maryland to fund the regulation of the admitted insurance carriers.[51] Typically, captive premium tax does not impact a state's general fund. Recently some states have revised their statutes to be more attractive to captive insurance companies by reducing premium taxes and fees. For example, Oregon no longer imposes premium taxes on captives, instead charging a $5,000 annual fee.[52]

The Pinnacle Report estimates that, by year three, if 30 Maryland captives are formed, which are not microcaptives or SPVs, the estimated premium tax would be $912,000.[53] However, this analysis seems to be based upon overly optimistic assumptions. For example, New Jersey passed a captive law in 2010 and currently has only five captive insurers.[54] Furthermore, the consultant's scenario assumes a premium tax rate (.40%) that is higher than that charged by Maryland's neighboring captive jurisdictions.[55] If one makes the more realistic assumptions of only five captive insurers by year three and reduces the premium tax rate by half (i.e. .20%), the anticipated total premium tax in year three only would be $80,000.[56] Under this

---

[50] *Marsh Benchmarking Report* at 6.
[51] MD. CODE. ANN., INS. ART., § 2-505.
[52] *See* Oregon Captive Insurance Division, http://www.cbs.state.or.us/external/ins/captive/taxes_fees.html.
[53] Pinnacle Report at 25.
[54] Captive Insurance Companies Association, http://www.cicaworld.com/Resources/world-map/DomicileByState.aspx?id=99.
[55] Delaware has a flat 0.2% rate to a maximum of $125,000 for direct premium. The District of Columbia has a banded tax rate for direct premium with rates ranging between 0.05% and .250%.
[56] This scenario assumes that by year three Maryland would have five captives with $8,000,000 in average premium per captive for a total captive premium volume of $40,000,000. This amount taxed at a rate of .20% would yield an estimated total premium tax of $80,000.

more realistic scenario, projected revenue would not cover the cost of staffing and marketing. *See* section IV.B.3.

2. Job Generation and Economic Benefits to the State

Job creation in a captive domicile involves primarily actuaries, lawyers, and others professionals who serve as captive managers. Captives may bring business into the state if captive legislation requires that a captive hire a captive manager, an actuary, legal consultants and other experts to assist with the formation and administration of the captive. These service providers are licensed by the domiciliary state and are generally required to have an office in the state. In addition, captives have capitalization requirements. These funds may be required to be deposited in State financial institutions. Further, collateral requirements may apply to reinsurance transactions and those funds also may be deposited in State financial institutions.

Although Vermont claims that the captive industry has created 1,400 jobs in the state, newer domiciles have not seen that level of job creation.[57] It is unlikely that Maryland would see significant job growth, even if the General Assembly decided to pass aggressive captive legislation with few regulatory limits. The MIA's research indicates that Maryland's legal and financial industry includes a number of actuaries, lawyers and managers already working in the State who have captive expertise. Furthermore, Maryland's close proximity to the District of Columbia and Delaware – domiciles with significant captive markets – may make it less likely that Maryland would attract significant numbers of captive-related firms and professionals.

An increase in hospitality and travel is often cited as a benefit to a captive domicile, if domiciles require significant business presence in the state such as annual board meetings. States are now encouraged, however, to consider limiting the statutory requirements that a captive have significant business activity in the state of domicile.[58] Requiring a captive manager to have a location in the domicile or requiring physical attendance of annual board meetings in the state makes a new captive domicile less attractive.

3. Regulatory and Marketing Costs

The State would have to provide two distinct functions for the captive industry: the regulatory function and the economic development function. Captive regulators with whom the MIA consulted confirmed that marketing a state's captive industry is a critical investment. The captive industry holds numerous meetings and conferences in popular off-shore captive domiciles and these meetings and conferences are considered important opportunities for selling a state's benefits and making important connections with captive managers and associations. A state with a new captive market must quickly recruit competent regulators and build a captive-savvy infrastructure within the insurance department at a time when states are under significant budget pressure. Because of growing competition among states, not only would Maryland have to commit to investing in experienced staff to work with companies interested in forming a captive, but must be willing to market Maryland as an attractive domicile. States spend from

[57] State of Vermont Captive Website, http://www.vermontcaptive.com/about-us/why-vermont.html.
[58] Pinnacle Report at 32.

$250,000 to $800,000 in startup costs.[59] Delaware's Captive Insurance Department suggested that Maryland budget $400,000 for marketing costs to launch a captive program. The needed growth of the MIA's budget for staffing to support the captive industry depends, in part, on the growth of the industry over time. However, the MIA estimates that a core regulatory staff of at least two individuals with a strong captive background would be required at the outset at a cost of over $225,000 for salary and benefits.

C. Potential Costs and Benefits to the Domestic Insurance Industry, Existing Traditional Insurance Underwriting, and Brokerage in the State

It is difficult to determine the likely impact of a captive law on the domestic insurance industry. If the General Assembly were to pass a fairly conservative captive law, there may be little impact on the domestic insurance industry. If, however, the General Assembly were to pass an aggressive captive law to attract small captives to Maryland, it is possible that Maryland's admitted insurance carriers, especially its small mutual insurers and the producers who work with them, could be negatively impacted. There is the risk that captives would compete with traditional insurers and reduce the need for commercial brokers/agents. It would be advisable to secure additional input from Maryland's admitted insurance carriers to gain their view on the impact on the domestic industry.

Underwriting, whether in the admitted or captive markets, should be actuarially sound taking into consideration the risk involved, premium received, and losses expected. Therefore, traditional insurance underwriting should not be impacted by captives. However, underwriting is an issue being addressed by the IRS with respect to microcaptives. The IRS has found cases in which microcaptives were charging premiums that were not actuarially justified for "dubious" insurance risks. [60]

It is also difficult to determine the impact of a captive law with respect to agents, brokers, or other professional who service the insurance industry (e.g. lawyers, lobbyists, actuaries). Captives require the use of captive managers, actuaries, lawyers, and other consultants to assist in the formation and administration of captive insurers. Currently, there are insurance professionals in Maryland who work in the captive market and additional service providers could come, in part, from the existing insurance industry.

D. Costs Associated with Captive Insurance Compared with Insurance Procured through Traditional Insurance Underwriting and Brokerage

It is difficult to compare the traditional and captive markets because of the different approaches to insurance. When an insured buys a traditional insurance product the insured does not take on the underlying risk, which is not the case with traditional captive insurance. To form

---

[59] Pinnacle Report at 2.

[60] Jay Adkisson, *IRS Filling The Pipeline With Captive Insurance Cases And Focusing On Dubious Practices,* Forbes (September 9, 2013), www.forbes.com/sites/jayadkisson/2013/09/22/irs-filling-the-pipeline-with-captive-insurance-cases-and-focusing-on dubious-practices.

a captive, a parent must create a subsidiary entity. There are numerous costs involved in forming that entity, capitalizing it, creating a business plan for the entity, and hiring certain managers, actuaries, and consultants to form and administer the entity. There is also the long term cost of taking on the underlying risk of loss. However, captives are promoted as having two major advantages: the tax advantages and the ability to better control the cost of insurance over the long term.

E. Impact on Consumer Protection for Customers of Captives Compared with Customers of Traditional Insurance Industry

Maryland has high standards of consumer protection for policyholders of traditional insurance products. Among other things, insurance regulation focuses on ensuring a marketplace free of discrimination, fair claims practices, protection from fraud, disclosure of actions taken by insurance companies, review and approval of rates and forms, and generally providing a certain level of transparency and equal treatment. This regulation stems from the MIA's authority to license insurers, brokers, and other insurance entities.

Under typical captive legislation, these protections do not extend to captive insurers. Captive laws do not focus on consumer protection because traditional captive forms do not sell insurance to the general public. Regulation is primarily focused on financial solvency and management competence. Because some states are allowing the growth of captives into lines of business long the exclusive purview of admitted insurance carriers, significant concern has been voiced by insurance regulators about captive insurance transactions and their impact on third-party insureds.

VII. RECOMMENDATIONS ON LEGISLATION

The MIA recommends that the General Assembly forego passage of captive legislation in the 2014 session. Because of the highly competitive environment among captive states, it is unlikely that Maryland could become an attractive captive domicile and maintain strong regulatory standards. Additionally, parts of the industry have drawn the negative attention of federal and state regulators for practices that may run afoul of applicable law. State insurance regulators are developing a strategy to deal with SPVs and their potential to destabilize the life insurance industry, and the IRS is giving unprecedented attention to microcaptives at this time.

However, if the General Assembly determines that it is in the best interest of the State to pass captive legislation, the MIA recommends that the legislation exclude microcaptives and SPVs and prohibit the use of captives for health insurance, workers compensation, personal lines, or other arrangements in which third party claims may be put at risk. A copy of a draft bill is found at Attachment 7.

The challenge for state insurance regulators is how to establish and nurture a captive insurance industry in the current "race to the bottom" regulatory environment.[61] States openly compete with one another to attract business by eliminating as many regulatory safeguards to attract business.[62] Many new captive domiciles that have experienced significant growth share certain characteristics. They have captive formation requirements that are quick and inexpensive and solvency requirements that are often described as "flexible," allowing intra-company letters of credit and loan-back arrangements. Information about captives and their transactions remain confidential, reporting requirements are minimal, and fees and premium taxes are low.

Measuring the ultimate success of a captive program will depend upon the primary reason for passing a law permitting the formation of captives. A primary goal of providing a legitimate and financially viable alternative insurance vehicle for large commercial entities could be achieved by passing a law that avoids some of the more controversial risk shifting vehicles. However, the market demand for this more traditional approach seems limited.[63]

---

[61] *See* Zachary R. Mider, *Apollo-to-Goldman Embracing Insurers Spurs State Concerns,* Bloomberg Businessweek Online (April 22, 2013), http://www.businessweek.com.

[62] Mary Williams Walsh and Louise Story, *Seeking Business, States Loosen Insurance Rules,* N.Y. Times, May 8, 2011.

[63] Pinnacle Report at p. 37.