

NAIC'S IDENTITY CRISIS

Robert Myers of Morris, Manning & Martin, LLP provides his thoughts on the 'identity crisis' of the NAIC and what this means for captives

For the reasons set forth below, the National Association of Insurance Commissioners (NAIC) is about to undergo an identity crisis. Why should the captive community care?

Captives are self-insurance mechanisms, regulated by domiciles all over the globe. The NAIC is the association of US regulators and has no express regulatory power of its own. Nonetheless, its influence is pervasive.

Recently, the newly elected president of the NAIC, Adam Hamm, stated that "everything is on the table" in regard to captives, including development of uniform standards and even the prohibition of the use of captives. Hamm, also Insurance Commissioner of North Dakota, is just stating what many had already observed, i.e. that the NAIC is sceptical of captives and wants more control.

Several actions caught the attention of NAIC leadership. First, the work of the NAIC Captive and Special Purpose Vehicle (SPV) Use Subgroup had identified what they considered to be problems with life reinsurance captives or SPVs used to reduce the drain of "redundant" reserves under Regulation XXX. Some of the less attractive practices of some of these, such as parental loan backs and collateralisation of stated assets, were brought to light by the Subgroup and then highlighted by the study of the New York Department of Financial Services, not so subtly named "Shining a Light on Shadow Insurance". The implication to some in the NAIC leadership was that other types of captives engaged in practices that could result in the lack of adequate reserves when it came time to pay claims.



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Other matters arose, which also focused on captives. The long awaited Federal Insurance Office study of the insurance industry, while generally favourable to state regulation, concluded that the regulation of reinsurance captives could benefit from "uniformity" of regulation among the states. The OECD

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released a study (OECD Base Erosion and Profit Sharing Report), which characterised captives as a tax avoidance device employed by some multinational entities. And, the controversy over whether the Nonadmitted Risk

and Reinsurance Act applied to captives at all continues.

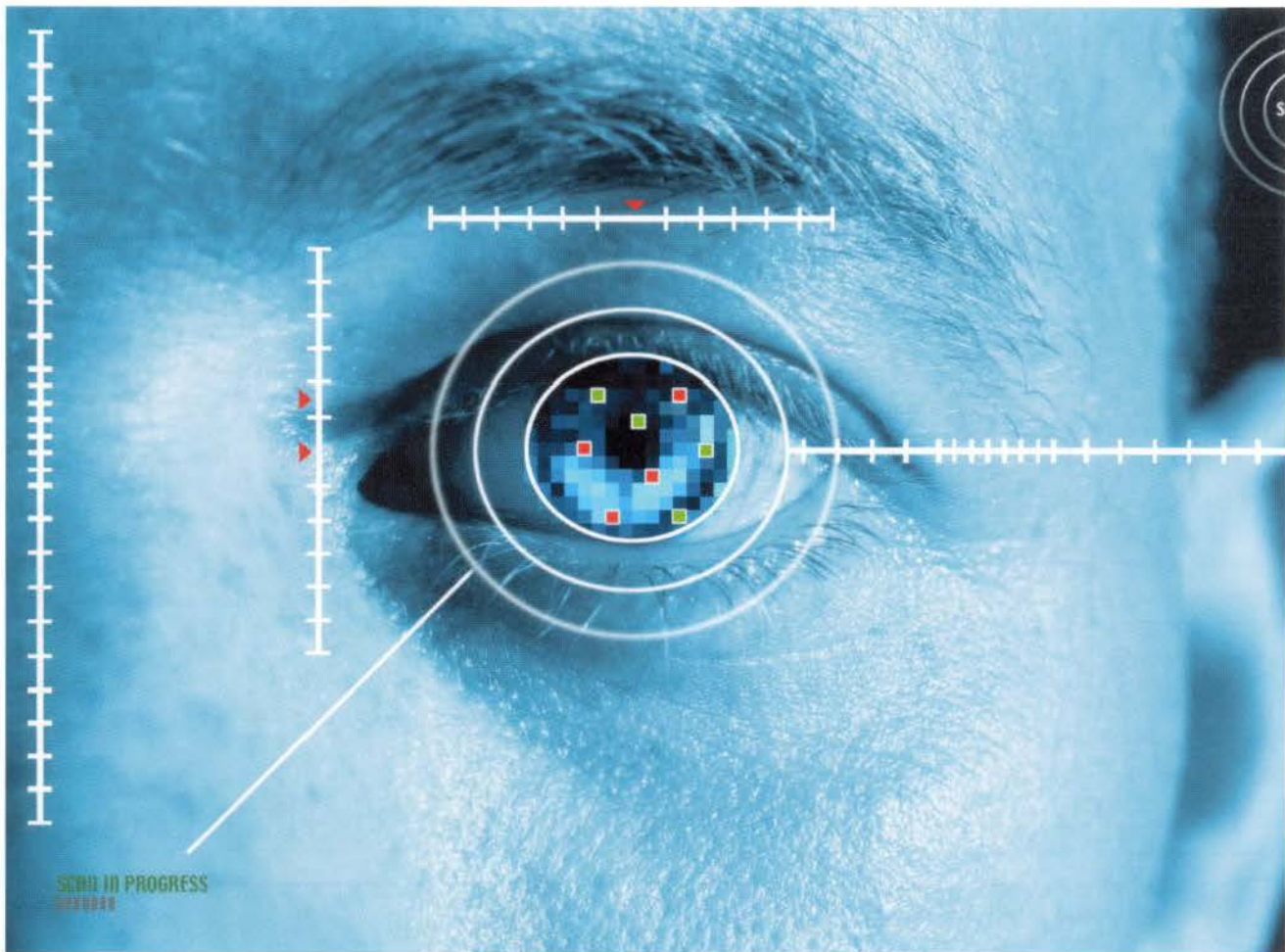
In recent years, the NAIC has emerged from its original purpose as an agent of the states, a forum where the states could get together to discuss common problems, try to find common solutions, and then develop model laws and regulations to be adopted by the states. Because it is the only repository of data about the national insurance industry, and because there is no governmental national regulator, the NAIC has stepped up to fill the void. It was a major participant in the debate leading to the enactment of both the Patient Protection and Affordable Health Care Act (Obamacare) and the Wall Street Reform and Consumer Protection Act (Dodd-Frank).

It has assumed the posture of a national regulatory body. How has it done it? The adoption by the NAIC of the state accreditation programme was the first step towards a more uniform system of regulation on a national scale.

In order to be accredited, a state must adopt all of the laws, regulations and staffing requirements established by the NAIC. While the accreditation programme is entirely voluntary for the states, there is a penalty for failure to comply with all the accreditation standards, namely, loss of accreditation, which no state wants and no state has yet suffered. This raises the question of whether the NAIC is just influencing state regulation or whether it is either directly or indirectly regulating.

Will the NAIC continue its accretion of power and use it to impose its will upon the captive industry? Not necessarily.

At the winter meeting of the NAIC in



Washington, DC, Connecticut Commissioner Thomas Leonardi requested that the NAIC Executive Committee appoint an independent expert on corporate governance to examine the practices of the NAIC. Leonardi had just a few days earlier sent a letter to each of the insurance commissioners. The letter was critical of the NAIC decision making, governance and election processes. Without allowing all the commissioners the opportunity to speak, the executive committee assigned the issue to the NAIC's corporate governance committee.

The importance of this is twofold. First, it is clear that there is tension among the commissioners. Second, and more importantly, the examination of corporate governance is going to highlight an issue that the NAIC has heretofore avoided, namely: What kind of organisation is the NAIC?

The NAIC is both an association of insurance regulators and a tax exempt educational organisation. The NAIC has testified before Congress that it is a "national standard setting organisation". It has a budget of around \$80m and an existing surplus of around the same

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size. It represents itself as the most reliable source of insurance regulatory information and participates as a witness or advocate in federal rulemakings (e.g. HHS rulemakings on healthcare reform). Through the state accreditation process, it exerts substantial influence over each of the states. However, it takes the position that it is not an instrumentality of the states and, therefore, the state freedom of information acts do not apply.

So, what kind of entity is the NAIC? This is the conundrum that will be confronted by any expert on corporate governance. Stated otherwise, if the expert cannot determine what the NAIC is, he cannot determine how it should be organised and governed.

It is unlikely that Commissioner Leonardi's request for an examination of the NAIC will go away. This inquiry is likely to focus insurance regulators and the insurance industry on questions such as: What is the source of NAIC authority? Has it been acting beyond its authority? Should the NAIC be restructured?

The NAIC has assumed that it has the authority to set standards for captive regulation. It has even been importuned by the New York Superintendent of Insurance to prohibit the chartering of captives. The examination of the NAIC by an independent expert could result in a diminishment of the NAIC's desire to try to impose regulatory "uniformity" (in the words of the FIO) on the states. 