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SPECIAL PURPOSE FINANCIAL CAPTIVES

In May, Vermont enacted legislation authorizing the formation of Special Purpose Financial Captive Insurance Companies ("SPFCs"). The purpose of this new form of captive is limited to reinsuring the risks of a ceding insurer, usually as one part of a complex transaction by and through which the SPFC's reserves are securitized and transferred to third-party investors.

Life insurance companies, in particular, have engaged in SPFC securitization transactions to mitigate adverse financial impacts of redundant reserve requirements established for level-payment term-life and universal-life (no lapse guarantee risk) insurance policies, respectively referred to as XXX and AXXX reserves. However, the SPFC statute is broadly written to permit other forms of securitizations through a Vermont-domiciled SPFC.

Prior to the enactment, five securitization captives were formed in Vermont under existing law. The securitization application process for those captives provided important guidance to Vermont regulators

about the essential aspects of SPFC securitizations. These existing captives are now obligated to comply with the requirements of the SPFC statute and to follow guidelines established by the Department of Banking, Insurance, Securities and Health Care Administration ("BISHCA"). Compliance is expected to occur on or before December 31, 2007.

The SPFC statute incorporates Vermont's general captive licensing requirements, but also requires a proposed SPFC to provide additional information in connection with its application. First, an SPFC's plan of operation must include its proposed investment policy. Second, the president, a vice president, the treasurer, or the chief financial officer must submit an affidavit attesting to details of the SPFC's structure. Third, the application must also include an opinion of qualified legal counsel that the offer and sale of any securities complies with securities laws. The concept behind these additional requirements is to help regulators understand the underlying SPFC transactions and to permit efficient and proper licensing.

We have already been engaged to form several SPFCs under the new statute and

are assisting clients to bring existing securitization captives into compliance with the new statute.

JUDGE GRANTS WELLS FARGO'S MOTION TO STRIKE

In our last edition, we reported on several new class action cases alleging that certain lender-owned captive reinsurance arrangements violate RESPA, based on illegal fee splitting. We had suggested in our March analysis that plaintiffs would have a difficult time prevailing on issues of concealment and statutes of limitations, based on the captives' compliance with required borrower disclosures. We are pleased to report that on July 24, the United States District Court for the Northern District of California issued an order granting Wells Fargo's motion to strike plaintiffs' request for equitable tolling of the one year RESPA statute of limitations.

The Judge first considered whether the doctrine of equitable tolling – which allows abeyance of the statute of limitations – is available in a consumer RESPA claim. The Court concluded that equitable tolling is indeed available for RESPA claimants. Following further analysis, however, the Court concluded that in this particular case, plaintiffs could not avail themselves of equitable tolling. The primary reason was that plaintiffs were unable to establish that they could not have discovered the basis for their claim within the one-year statute. In addition, plaintiffs were not able to establish their allegation of fraudulent concealment. Wells Fargo had disclosed the reinsurance relationship involving its affiliated reinsurer, and that it would be bearing some of the risk of the underlying policy and receiving some of the related premium.

While this is not necessarily the end of the case, as plaintiffs have been permitted to amend their equitable tolling allegations, we believe the decision is well founded and will make it considerably more difficult for classes to be certified for purposes of challenging mortgage guaranty reinsurance arrangements.

If you would like to receive a copy of the Judge's ruling, please contact Jim Clemons.

LRRRA EXPANSION

We first reported on possible expansion of the Liability Risk Retention Act ("LRRRA") in 2002. Ever since the Act was amended in 1986 to allow coverage of all forms of commercial liability insurance (other than workers' compensation), there has been much discussion about further expansion to allow risk retention groups to issue other types of commercial coverages. Most prominent among these is property insurance, but there has also been interest in many other forms of casualty coverage.

Back in 2002, a broadly based coalition of large RRGs and captive associations worked together in an attempt to attach an expansion bill to the Terrorism Risk Insurance Act of 2002 ("TRIA"). TRIA, a response to the September 11 attacks, had the full attention of Congress and was seen as a good vehicle for expansion of the LRRRA. Although that effort gained significant momentum, it was ultimately unsuccessful.

Following the August 2005 release of a U.S. Government Accountability Office ("GAO") report on the implementation of the LRRRA, interest in expanding the LRRRA has re-emerged. Current discussions

include both responding to the GAO recommendations for enhanced regulation of RRGs (primarily to address issues of governance and solvency), and expanding the LRRRA to allow additional lines of coverage. The parameters are roughly parallel to those of 2002: to allow the issuance of all forms of commercial insurance coverages except workers' compensation.

Notwithstanding that Congress remains focused on national security and other major issues, there is growing interest in expansion of the LRRRA. In April of this year, Janice Abraham, CEO of United Educators Insurance, a Reciprocal Risk Retention Group, testified before the U.S. House of Representatives Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises. United Educators is one of many well-established RRGs, and Ms. Abraham offered strong arguments on the success of the LRRRA to date and the significant opportunities that expansion would represent for sophisticated self-insurance groups. No opposition was voiced by the traditional insurance industry at that meeting.

We believe that current National Association of Insurance Commissioners ("NAIC") efforts to address the governance and financial regulation issues identified by the GAO create a favorable climate and good platform for the expansion initiative. (See the following related article.) The NAIC efforts are a key component of the overall initiative, as Congress will likely want confirmation of effective and consistent regulation of RRGs before approving expansion.

The Property Casualty Insurers Association of America ("PCIAA"), a

traditional insurance trade association, has issued a position paper supporting expansion of the LRRRA. Although the PCIAA's support is conditioned upon changes to the solvency regulation of RRGs (including the application of traditional NAIC solvency ratios), and would preclude the coverage of certain contractual liabilities, such support is nonetheless important to this effort. We'll keep you posted.

NAIC ACTION ON RISK RETENTION GROUP MATTERS

In the wake of the August 2005 Government Accountability Office report on Risk Retention Groups, the NAIC has been reconsidering several aspects of RRG regulation, primarily focused on whether certain elements of traditional insurer regulation should apply to RRGs. These include model audit rules, governance standards, application of the Holding Company Act and credit for reinsurance rules.

Notably, the NAIC has no authority to impose regulations directly on RRGs. Rather, states must implement NAIC models through adherence to the NAIC Financial Examiners Handbook (amendments to which most states adopt automatically) or through administrative or legislative adoption of regulations and statutes. Individual state regulatory bodies are accredited by the NAIC, and failure to adopt current NAIC standards is counted against a state during the review. We do not believe any of the considered changes to RRG regulation have yet been added to the Examiners Handbook (the most expedient but least considered route to general application), and none have yet been separately adopted by individual states.

Nonetheless, Vermont's regulators have advised us that the enhanced governance standards could be required as early as January 2008, with full implementation to be achieved by January 2009. Credit for reinsurance discussions continue with no implementation date in sight. Given the importance of both issues for our RRG clients, we provide the following update.

Credit for Reinsurance. Back in May, we were asked by Vermont's captive regulators to provide information regarding the potential impacts to our clients of applying traditional insurance company credit for reinsurance rules to Vermont RRGs. We sent a memo to all our RRG clients soliciting input and received many helpful responses. These indicated that credit for reinsurance rules would not directly impact most RRGs, but would have substantial negative impacts on some — especially programs with offshore affiliates and start-ups accessing offshore reinsurers not otherwise doing business in the U.S.

The traditional insurer credit for reinsurance rules, if applied, would require reinsurers not licensed or accredited in Vermont to submit to significant added regulation or provide each ceding company with collateral to support assumed obligations.

With our clients' responses in hand, the Vermont Department's representatives attended the early June NAIC meeting and shared with the Task Force considering the issue the likely negative impacts and why the current standards, based on Commissioner discretion, are more appropriate to the regulation of alternative risk mechanisms. Representatives from Vermont, Hawaii and the District of Columbia have recently

presented to the Task Force their criteria, including the responsible exercise of discretion, and it appears likely something along those lines will prevail. We will update you on developments in this area as they arise.

Governance Standards. The governance standards under consideration by the NAIC would establish minimum thresholds for Board independence and Board oversight of service providers and material contracts. They would also require establishment of written policies in certain areas, including governance (election and compensation of Board, designation of management, etc.) and ethics.

We believe most of our RRG clients are already compliant with the Board independence provisions and the expectations for oversight of material contracts and service providers. Nonetheless, the formal adoption of the governance standards would require all RRGs to adopt the written policies or amend those already in place to specifically address the NAIC standards. Many would also have to amend their Bylaws.

With formal adoption likely, we stand ready to assist clients in addressing the governance standards. We also recommend that clients undertaking new service relationships, Board restructuring or governance reviews keep the proposed standards in mind.

If you would like a copy of the most recent draft of the governance standards, please contact us.



ASK THE EXPERTS: A NEW FEATURE

With this issue we begin a new practice of publishing articles submitted by the many talented Vermont captive service providers. With the proliferation of captive domiciles, we believe the strength of Vermont's regulatory and service infrastructures continues to set it apart from the newcomers. We are continually impressed by the sense of teamwork that pervades the industry here. In our experience, managers, actuaries, auditors and lawyers work effectively together for the benefit of both individual clients and the captive industry.

The following article was authored by Patti Pallito, Deputy Managing Director of Aon Insurance Managers (USA) Inc., in response to our request for an overview of emerging financial reporting issues. Patti and Aon did not hesitate to allow us to include this article, closely based on their work, precisely because of their appreciation for Vermont's team approach. We hope you find it as informative as we do.

If you are interested in contributing an article to our Newsletter, please contact Jim Clemons or Kurt Lutes.

FINANCIAL REPORTING ISSUES

Risk Transfer. Last year, we reported that the Financial Accounting Standards Board ("FASB") undertook a project to review the criteria for the evaluation of the transfer of significant risk in insurance contracts. The purpose of this project is to improve the representational faithfulness of

accounting for insurance contracts by more clearly defining what should be classified as "insurance" or as deposits (loans or financing arrangements). The FASB believes the increased transparency will help users of an insurer's financial statements to better understand the economic impact of these contracts.

The FASB's focus is to propose editorial changes to Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, to clarify the minimum level of insurance risk transfer required for a contract to be accounted for as insurance for financial reporting purposes. Currently, Statement 113 does not quantify the definition, however, the industry abides by the unofficial "10/10 rule," in which a contract will meet the risk transfer requirements if there is a 10% or greater chance of incurring a 10% or greater loss under the transaction. The FASB will also develop additional disclosure requirements highlighting why and how the reporting entity uses insurance, if any risk-limiting features exist in the contracts, and what the effects of the insurance contracts are on the financial statements of the entity. Proposed changes should be available for discussion and evaluation soon.

FIN 48. In July of 2006, the FASB also issued Interpretation No. 48 ("FIN 48") to provide guidance for entities reporting tax benefits from uncertain tax positions. Because federal and state income tax rules are complex and subject to interpretation, the application of these rules to a taxpayer's particular set of circumstances may be unclear. When this is the case, tax positions are often taken that may later be challenged and

partially or completely denied by a taxing authority. Such positions are referred to as “uncertain tax positions.” FIN 48 changes the way these uncertain tax positions are to be reported in the financial statements.

FIN 48 defines uncertain tax positions as those that have the potential to be considered **not** more likely than not to be sustainable under examination and appeal. Reporting for these “uncertain” tax positions changes under FIN 48. In the past, the sustainability of a tax position was irrelevant; now, however, organizations are required to disclose these positions. If a tax position is more than likely to not be sustained under IRS examination and appeal, then the benefit can not be taken, and any prior benefits reported will have to be disclosed as a potential liability. If the organization has determined that it is more than likely that the position will be upheld, the benefit can be taken, however, it will have to disclose its assumptions. The adoption of FIN 48 is required for reporting years beginning after December 15, 2006.

We recommend that the potential ramifications of FIN 48 on captives be evaluated by a qualified tax advisor to ensure that any required disclosures are part of your captive’s 2007 audited report.

Valuation of Financial Assets and Liabilities. For fiscal years beginning after November 15, 2007, FASB Statement No. 159 will allow companies to measure many financial instruments at fair value. Entities that hold investment securities as available for sale and previously reported unrealized gains and losses as a component of equity will have the ability to record these gains and losses within the income statement.

Revised Auditing Standards. Beginning with 2006 independent audits, the standards setting body that governs auditors of publicly traded entities (the AICPA in partnership with the SEC) passed a set of new standards that significantly expands the procedures that must be performed. The primary objectives of these new standards are the following:

- 1) Auditors must gain a more thorough understanding of their clients’ internal control, including the control environment, key controls over significant transactions, and management oversight of the financial reporting process.
- 2) Auditors must obtain more detailed information about their clients’ operations, their business objectives and strategies, and the risks to achieving these objectives.
- 3) Client management must clearly accept responsibility for preparing all financial information and the company’s financial statements.

Beginning with 2007, these new standards will also apply to non-publicly traded entities.

What these new standards mean to captive insurers is that independent auditors will be required to perform more extensive and detailed procedures, and audit fees will likely increase as a result. They will also require that internal control procedures be evaluated more thoroughly and that captive managers maintain complete and updated written documentation of all internal control processes and procedures. To maintain this documentation, managers will need to have a thorough understanding of the

procedures that are handled by other vendors, such as third party adjusters and investment managers, as well as those handled in house by the client.



NEWS FROM THE VERMONT STATE HOUSE: LEGISLATIVE UPDATE

The Vermont General Assembly adjourned for the year on May 12, 2007. A one-day veto session was held July 11 to address two bills unrelated to captive insurance or financial services. The second half of the session will begin January 8, 2008. All bills not formally acted on this year remain pending until next year, although they will undoubtedly compete with new bills and priorities. With nearly eight hundred bills introduced this year and less than one hundred reaching the Governor, there will be plenty left for the Legislature to consider when it re-convenes.

Divided government was a factor throughout the 2007 session, with a strongly Democratic-controlled Senate and House and a Republican Administration. That formula produced gridlock on some issues, which continues in the wake of adjournment. "Spin" has reached new heights in Vermont as both the Legislature and Administration employ seasoned communicators to help frame their messages. Nevertheless, Legislative leaders and the Governor acknowledge that voters expect them to work together on issues that are important to Vermonters. By and large, it was this understanding that prevailed as compromises were reached on a number of potentially contentious issues, such as education finance and property taxes, public pre-kindergarten, higher education scholarships, workforce development, and

the promotion of broadband Internet across the State.

These and other priorities resulted in a quiet year for legislation related to financial services. One of the few bills to reach the Governor's desk was an omnibus bill containing a series of amendments to the captive insurance code, including a major new initiative addressing securitization as more fully described in the lead article above. On May 25, the Governor signed the bill, and its provisions related to captives became effective on July 1.

Among the amendments is a clarifying provision to the definition of an association captive providing that the association captive has authority to insure the risks of affiliated companies of the member organizations and the risks of the association itself. Second, existing authority for pure captives to write controlled unaffiliated business is now expanded to allow industrial insured captives to have similar authority to write third party business. Third, technical and conforming amendments were adopted to clarify that any captive other than a sponsored captive may form as a limited liability company. Fourth, an amendment clarifies the rules involving the consolidation of certain captive insurance companies for purposes of calculating premium tax. Fifth, a clarifying amendment provides the Commissioner with authority to require a captive to use statutory accounting principles in circumstances as may be established by the Commissioner. Sixth, the permitted types of entities that qualify to be a sponsor of a sponsored captive insurance company has been expanded to give the Commissioner discretion to approve any entity deemed appropriate. And finally,

express authority has been established to allow the formation of a special purpose financial captive insurance company to facilitate securitization transactions.

The second half of the biennium is already on the minds of many. In the coming months, interested parties will be invited to suggest additional amendments to Vermont's captive statutes, or to offer new ideas or concepts that may ultimately be considered in January or future Legislative sessions.

ANALYSTS FIND REAL BENEFIT IN MI CAPTIVES

We have reported often over the last ten years on the operation of lender-owned mortgage guaranty captives, entities that serve to reinsure policies issued by traditional mortgage insurers. These programs have been challenged from time to time, primarily in the form of class action suits alleging illegal fee splitting. (See related article on page 2.) In addition, we are aware of state regulatory inquiries related to the pricing of this reinsurance. We are also aware of two independent analyses that support the typical captive structures and find real benefit in these arrangements from the MI perspective.

In 2005, Milliman, Inc. conducted a study for a particular mortgage insurer to assess whether certain captive arrangements met risk transfer and pricing requirements. They also evaluated impacts on the MI company's rate of return after reinsurance, relative to rates of return before reinsurance.

Milliman concluded that the reinsurance program under evaluation satisfied the transfer of risk requirements of FAS 113

since the probability of significant loss to the reinsurer was more than remote. Milliman also concluded that the pricing at issue was reasonable in relation to the risk ceded. Finally, Milliman concluded that the net risk-adjusted return on equity to the MI company remained reasonable while taking into account the reinsurance activity.

More recently, Standard & Poor's ("S&P") published a report in May which reached similar conclusions. It began by noting that the early profitability of the typical MI captive has enhanced overall financial strength, reducing earlier concerns about the ability of such captives to meet reinsurance obligations. It emphasized that the typical MI captive reinsures mostly prime quality loans, suggesting that the current sub-prime deterioration will have little impact on overall performance. S&P applied capital models to measure the level of benefit provided by lender-owned captives, and also assessed various historical data of the overall MI industry. It concluded that although through years 1980 to 2003 the MI industry had averaged a 4% loss rate, a worst-case scenario based on a nationwide recession could result in a loss rate of about 20%. It concluded that an MI company's return on allocated capital would improve with a lender-owned captive relationship when the loss ratio reaches 8%.

S&P also noted other benefits of the typical lender-owned captive arrangement, including capital relief to the ceding MI company (albeit modest, but potentially strategic); the alignment of interests between the MI insurer and the lender resulting in improved underwriting and loss results; and the increased use of mortgage guaranty insurance across the

board. The S&P report is available at www.standardandpoors.com/ratingsdirect.

We believe these analyses, both well-considered and thoroughly conducted, provide strong counterbalance to those who would challenge MI captive arrangements. They may also confirm the careful analysis conducted by the MI companies, the lenders and their actuaries at the time of captive implementation.

RECORD RETENTION REQUIREMENTS FOR CAPTIVES

Clients often ask us whether captives are subject to record retention requirements in Vermont. The short answer is yes. However, captives need not comply with the elaborate requirements applicable to traditional insurers under Regulation 99-1.

A captive insurance company should maintain sufficient records for the Vermont Department of Banking, Insurance, Securities and Health Care Administration ("BISHCA") to conduct a regulatory examination of the company's affairs and financial condition without leaving Vermont. This includes compliance with Regulation 81-2 and applicable provisions of corporate law. Additionally, captive owners should be cognizant of applicable statutes of limitation.

Records Necessary for Regulatory Examinations. As part of a regulatory exam, BISHCA reviews a captive's compliance with its corporate governance documents, underwriting and claims records, policy forms and material agreements, and all financial records since the last exam. Thus, a captive should retain all records likely to be

reviewed by BISHCA for an exam period. These include corporate governance documents, policy records, claims records, financial records, rating and reinsurance records, and retrocession agreements. Regulation 99-1, for traditional companies, can serve as a guide.

Regulation 81-2. Regulation 81-2 requires independent auditors to make work papers available to the Vermont Commissioner for a period of not less than five years after the period to which they relate. The term "work papers" includes schedules, analyses, reconciliations, abstracts, memoranda, narratives, flow charts, copies of company records or other documents prepared or obtained by the accountant in the conduct of its audit.

Corporate Law. All Vermont corporations must keep permanent records of minutes of Board of Directors and Shareholder meetings, actions taken without such meetings, and actions taken by committees of the Board if taken on behalf of the Board. A corporation must also maintain copies of the following records at its principal office: (i) articles of incorporation, as amended; (ii) bylaws, as amended; (iii) shareholder/member rolls; (iv) written communications to shareholders within the past three years, including financial statements furnished to shareholders; and (v) a roll of current directors and officers. Nonprofit captives and other mutual programs must retain substantially similar corporate records as those required for business corporations.

Statutes of Limitation. Vermont statutes of limitation should also be considered when developing a records retention policy. The statutes applicable to contracts and

general civil actions are both six years. To the extent that a captive maintains litigation or other records related to covered claims under its insurance policies or reinsurance agreements, the statutes of limitation established under other states' laws may also guide the captive in developing its retention policy.

Please contact us if you have specific questions regarding your captive's document retention policy.

E-MAIL OPTION

If you would prefer to receive Primmer Piper Eggleston & Cramer's *Captive Newsletter* by e-mail, please contact Kurt Lutes at (802) 223-2102 or by e-mail at klutes@ppeclaw.com.

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