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REINSURER CREDITWORTHINESS

The impact of the ongoing financial crisis on the condition of insurers and reinsurers highlights the importance of evaluating and monitoring the creditworthiness of potential or existing reinsurance partners. Many captive insurance companies rely on reinsurance to manage volatility of assumed risks, stabilize solvency, manage capital and expand underwriting capacity. Because insurers remain responsible for the full payment of obligations under direct issued insurance policies and do not have recourse to guaranty funds in the event of the insolvency of a reinsurer, a reinsurance partner's ability to pay claims now and in the future is of paramount importance.

Development of a sound reinsurance strategy begins at the top of the organization. The Board of Directors of a captive should at least annually review the company's reinsurance requirements and verify implementation of reinsurance strategy. The captive manager and/or a reinsurance broker often assist the Board and management in determining the appropriate amount of net retained risk and reinsurance protection to be purchased, the selection and ongoing evaluation of the reinsurer(s), and

collateral requirements, if desirable. The Board should also review the adequacy of the company's internal controls with regard to reinsurance claim reporting and the collection of payments from reinsurers.

Management should carefully review and report to the Board a potential or existing reinsurer's financial condition, reputation and operations. Most reinsurers are rated by independent statistical rating agencies such as A.M. Best, Fitch or Moody's. The ratings provided by such organizations are an indication of the financial condition of a reinsurer, but should not be considered as a guaranty of the ultimate ability of a reinsurer to pay claims. Reviewing a reinsurer's surplus position and financial ratios can provide additional insight. Management and the Board should also consider a reinsurer's reputation for paying claims and responding to claim notices in a timely manner. Newspapers, press releases and investor information provide additional valuable information concerning a reinsurer's legal and regulatory environment and will report material transactions that could impact a reinsurer.

If a captive does not have qualified in-house staff to evaluate potential or

existing reinsurance partners, it should consider engaging reinsurance brokers, intermediaries or consultants to assist with reinsurance placements and evaluation of new partners. Reinsurance brokers and intermediaries are obligated to place reinsurance with reinsurers which do not present solvency or credit risk to the ceding company. As such, they typically have security committees which are responsible for monitoring the financial condition of reinsurers. The committees maintain a list of reinsurers which satisfy security guidelines and from which the professionals make recommendations.

Management should also consider the regulatory environment of a potential or existing reinsurer's domicile. Some reinsurers not licensed in or accredited by a United States domicile may be subject to less stringent domiciliary capital and regulatory requirements which could raise additional questions about a reinsurer's ability to pay claims.

In order for a Vermont captive to take financial statement credit for risks ceded to a reinsurer, the reinsurer must be acceptable to the Vermont Insurance Department or post collateral. All companies licensed or accredited in Vermont are acceptable, as are many well known offshore reinsurers and captive facilities. Captives and companies not commonly providing reinsurance to Vermont captives must undergo a review and pay a modest fee to be added to the accepted list.

Alternatively, reinsurers not wishing to undergo a review, or which might not be acceptable to Vermont regulators if reviewed, can provide a letter of credit, establish a trust or agree to a funds

withheld arrangement for the benefit of the ceding company. The security requirement for such reinsurers reduces the counterparty credit risk of the reinsurance relationship and can be negotiated into reinsurance agreements even in circumstances where a reinsurer is otherwise eligible for statement credit from regulators.

We encourage clients to contact us with questions about reinsurance and the Board's role in oversight of this important area.

NEW MEDICARE REPORTING REQUIREMENTS

Section 111 of the Medicare, Medicaid, and SCHIP Extension Act of 2007 ("MMSEA") includes new mandatory reporting requirements for group health plans and liability insurers (including self-insurers). Under MMSEA, liability insurers will be required to report certain information to the Centers for Medicare and Medicaid Services ("CMS") when a claim made by a claimant who is eligible for Medicare benefits is resolved by way of a settlement, judgment or other payment by the liability insurer (regardless of whether or not there is a determination or admission of liability). Quarterly reporting in an electronic format designated by CMS will be required. On March 16, 2009, CMS released the initial version of its MMSEA Section 111 User's Guide (version 1.0), which describes the reporting process in detail.

The intent of the new reporting requirements is to assist CMS in determining when Medicare is a secondary payor to commercial insurance or self-insurance and therefore able to recover claims it has paid. Under existing

federal law, Medicare's obligation to cover medical expenses for a beneficiary is secondary to certain group health plans and to liability insurance (including self-insurance), no-fault insurance and workers' compensation. If Medicare is a secondary payor, Medicare's coverage only extends to medical costs incurred by a beneficiary that are not paid or reimbursed by one or more of the specified primary payors. If a primary payor makes payment to a claimant for Medicare-covered medical expenses, Medicare is legally allowed to recoup prior payments and to avoid any payment for future medical expenses that are covered by the payment. The new reporting requirements do not change existing law in this regard, but are intended to ensure that CMS has all information necessary to determine when Medicare's financial responsibility is secondary, which will enable it to more accurately adjust claims and seek recoupment, when appropriate.

The party that is technically responsible for reporting payment information to CMS is the Responsible Reporting Entity ("RRE"). The RRE is the party that has the obligation to pay the claim. This means that if a captive insurance company provides coverage to its parent on a reimbursement basis only, then the parent is responsible for paying claims and will be considered the RRE. If, on the other hand, the captive provides coverage that obligates the captive to make payments to claimants on the insureds' behalf, then the captive will be considered the RRE. The same analysis applies to policies issued by risk retention groups to their members. An RRE may not contract with a third party to assume its reporting responsibilities, but can appoint a third party to prepare and file reports as its agent. The RRE is always responsible for

ensuring compliance with the reporting requirements.

The first step that RREs must take is to register on the CMS website with the Medicare Coordination of Benefits Contractor between May 1, 2009 and June 30, 2009. There will then be a testing period from July 1, 2009 through December 31, 2009, and submission of live claims data will begin on January 1, 2010. The permissible testing period was previously scheduled to run through September 30, 2009, but was extended by CMS on March 20, 2009. In the ALERT announcing the delayed implementation timetable, CMS also announced that there would be an interim reporting threshold for liability claims of \$5,000, which will then be reduced to \$600 by 2013.

MORTGAGE GUARANTY CAPTIVES – WHAT A DIFFERENCE A YEAR MAKES

Turmoil in the U.S. housing markets, marked by significant increases in default and foreclosure activity, has had significant impacts on one segment of the Vermont captive industry. Over the past decade or so, most of the larger mortgage lenders have formed or participated in captive insurance programs to reinsure a portion of the mortgage guaranty insurance on their loans. Most of these captives are now in run-off, and many are evaluating strategies that would permit a complete exit from the business.

Some of the primary mortgage guaranty companies formally announced in late 2008 that they would no longer offer "excess of loss" structures after December 31, 2008. For example, Old Republic issued a press release in September declaring Republic Mortgage Insurance Company's ("RMIC's") intent to

discontinue all excess of loss reinsurance cessions, on a run-off basis. The reasons cited by Old Republic included higher claims costs, reduced profitability, and capital inefficiency. Most of the other MI companies followed suit shortly thereafter. At this point, we believe that only United Guaranty continues to offer excess of loss programs, but on terms significantly changed from the prior standard program, which offered a 5% loss layer, excess of a first 5% loss layer, in return for 25% of the gross-written premium.

In its press release, Old Republic made clear that RMIC would continue to offer so-called "quota share" reinsurance arrangements to captives. A few of our clients have moved in that direction, but many are disinclined to take on the responsibility for first dollar losses involved in these arrangements. Interestingly, HUD's "Countrywide Letter," issued in 1997, identified quota share reinsurance structures as safe-harbors from risk-transfer and pricing questions raised under RESPA. Under such structures, the reinsurance company assumes a pro rata share of each and every loss, in return for a similar pro rata share of the gross-written premium, net of a ceding commission.

The net effect of these announcements and changes is that virtually all lender-owned MI captives are now in run-off. Under run-off, the ceding companies continue to remit premium to the captive for business already reinsured, and the captive remains obligated for capital requirements and reinsured losses. As capital requirements and losses mount, many of the captives are now evaluating complete exit strategies, including commutations. Under a commutation, existing reinsurance liabilities would be

returned to the ceding company, at a negotiated final settlement.

There have been two other related developments worthy of note. First, in late September of 2008 the United States District Court for the Eastern District of Pennsylvania dismissed a class-action claim against Countrywide Financial and its Vermont captive. Claimants had alleged violations of RESPA based on the structure of the captive's mortgage guaranty reinsurance program. The grounds cited for the dismissal included failure to show any actual injury to class members, as the rates they paid for private mortgage insurance were filed with and approved by state insurance regulators, making those rates per se reasonable under state law. The Court concluded that absent an overcharge, private plaintiffs did not have standing to sue under RESPA. We believe this, together with recent dramatic losses clarifying the "real" nature of the captive reinsurance in these arrangements will effectively end the class-action challenges to mortgage guaranty captives.

We previously reported on a joint investigation by the Minnesota state regulators and HUD office, apparently targeting the pricing and risk transfer attributes of the captive reinsurance structures. This has been a long and burdensome inquiry from the perspective of the MI industry. While no conclusion has yet been reached, we understand that settlement discussions are underway, and that some anticipate final resolution in the first half of 2009. Since the MI industry has largely retreated from the excess of loss arena, we believe whatever agreement may be achieved will be an anti-climax, particularly as recent economic conditions have confirmed the

value of captive reinsurance to the MI industry.

NAIC UPDATE

Governance Standards. As we previously reported, the National Association of Insurance Commissioners (“NAIC”) adopted *Governance Standards for Risk Retention Groups* (the “Standards”) on May 14, 2007, but did not provide for a mechanism to require Risk Retention Groups (“RRGs”) to comply with the Standards. Therefore, the Standards are not currently in effect. We understand the NAIC is considering various options to implement the Standards. Those options include enactment of the Standards by Congress as part of amendments to the Liability Risk Retention Act or promulgating a model law/regulation which would have to be adopted by individual states. There has been little progress on either of these fronts in recent months.

The NAIC’s Risk Retention Group (E) Task Force (“Task Force”) formally referred the Standards to the NAIC’s Property & Casualty (C) Committee to be incorporated into a model regulation at its July 18, 2008 meeting. Once the model regulation is approved, states would be required to adopt it in order to maintain their accreditation. Formation of a working group for the purpose of drafting a model regulation was discussed at the December 7, 2008 NAIC meeting, but the Property & Casualty (C) Committee has yet to formally take up the matter.

State Accreditation Standards. The Task Force is now in the process of determining the applicability to RRGs of NAIC uniform regulatory standards (which states are required to comply with in order

to maintain their NAIC accreditation). The Task Force completed its review of the Part A (Laws and Regulations) Standards and referred its recommendations to the Accreditation (F) Committee, which adopted those recommendations and forwarded the Part A Standards to the Plenary. At the December 2008 NAIC meeting, the Part A Standards were formally adopted by the Plenary. States will be required to regulate RRGs in compliance with the Part A Standards, as modified, by January 1, 2011. However, one significant open issue relates to the application of risk-based capital ratios to RRGs.

The NAIC’s Capital Adequacy (E) Task Force, considering the matter on referral from the Task Force, has proposed a “Sensitivity Test” that subtracts letters of credit when calculating an RRG’s total adjusted capital. For an RRG that reports and records its financial results on a Modified Generally Accepted Accounting Practices (“Modified GAAP”) basis (rather than a Statutory Accounting basis), the subtraction of letters of credit from total adjusted capital could create the appearance that the RRG is insolvent or severely undercapitalized. The State of Vermont and the Vermont Captive Insurance Association have filed written comments objecting to the proposed Sensitivity Test on the basis that it does not reflect the true financial condition of RRGs that employ Modified GAAP.

The Task Force is now in the process of reviewing the Part B (Regulatory Practices and Procedures) Standards and the related Review Team Guidelines.

Credit for Reinsurance. At the Spring 2008 NAIC meeting, the Task Force reached agreement on *Reinsurance*

Guidelines for Risk Retention Groups Licensed as Captive Insurers (the “Guidelines”) and formally referred the Guidelines to the NAIC’s Financial Regulation Standards and Accreditation (F) Committee to be incorporated into a model regulation. Among other things, the Guidelines approved by the Task Force include a prohibition against receiving credit when all policies issued by an RRG are ceded through 100% reinsurance and give authority to state insurance commissioners to establish a lesser percentage. The Guidelines also require that reinsurers maintain a ratio of net written premium, wherever written, to surplus and capital of not more than 3 to 1, and grant authority to state insurance commissioners to require an approved funds-held agreement, letter of credit, trust or other acceptable collateral based on unearned premium, loss and LAE reserves, and IBNR. However, the Guidelines grant state insurance commissioners authority to waive the 3 to 1 premium to surplus and capital ratio requirement and eliminate the requirement for collateral to be placed in trust in circumstances where the RRG or reinsurer can demonstrate that (i) the reinsurer is sufficiently capitalized based upon an annual review of the reinsurer’s most recent audited financial statements, (ii) the reinsurer is licensed and domiciled in a satisfactory jurisdiction, and (iii) the proposed reinsurance agreement adequately protects the RRG and its policyholders. The Financial Regulation Standards and Accreditation (F) Committee has yet to take up the matter of developing a model regulation consistent with the Guidelines. However, the Guidelines were incorporated into the Part A Standards adopted by the Plenary, which will be applicable to states as of January 1, 2011.

The Captive Division of the Vermont Department of Banking, Insurance, Securities and Health Care Administration issued a memorandum on March 16, 2009, reporting on the NAIC’s adoption of both the Standards and Guidelines, and indicating that it expects both will be adopted by Vermont.



**NEWS FROM THE
VERMONT STATE HOUSE:
LEGISLATING IN THE
MIDST OF ECONOMIC
UNCERTAINTY**

The 2009-2010 Vermont General Assembly began its biennium on a stormy day in early January. The weather symbolized the challenges facing the Legislature as it seeks to stimulate the State’s flagging economy.

Vermont is not immune to the economic challenges facing the nation. State revenues continue to roll in under forecast for the current fiscal year, and next year’s deficit amounts to approximately ten percent of the total General Fund budget. An unknown factor which looms large in the minds of Legislators and the Administration is what Vermont will receive from the federal government’s stimulus package.

To date, the Legislature has joined with the Governor in meeting the current deficits with reductions in State spending. However, a fundamental difference of opinion between the Governor and Legislature has emerged regarding fiscal matters. The Governor would address deficits through additional spending cuts alone. The Legislature, however, is increasingly hesitant to make cuts to services and programs, and will include increased taxes in its mix of proposals.

Although the economy is dominating the legislative agenda this session, other measures are also being addressed. The captive insurance industry, in conjunction with the support of the Captive Division of the Vermont Department of Banking, Insurance, Securities and Health Care Administration (“BISHCA”), has proposed several legislative amendments, currently contained in Senate Bill S.42, which has passed the Senate and is pending in the House Commerce Committee. Among them are amendments to enhance the segregation of risks assumed on behalf of each cell of a sponsored captive insurance company. Borrowing from revisions made last year for special purpose financial captives (“SPFCs”) formed as sponsored captives, the amendments clarify the application of insurance insolvency laws to sponsored captive insurance companies. The amendments also protect the financial interests of any solvent cell despite the insolvency of other cells in a sponsored captive.

Under the umbrella of economic development and the continued promotion of Vermont as a premier captive domicile, other amendments are intended to support the formation of captive insurance companies in Vermont, such as a premium tax credit for new captives, and enticements to existing captives to expand the amount of business they write,

such as limiting the tax liability allocated to members of a consolidated group in an SPFC. BISHCA also seeks to ensure that it has the necessary resources to effectively regulate Vermont captives by adjusting the percentage it receives from premium taxes paid by the industry.

An additional amendment would extend to branch captive insurance companies the same flexibility granted to other forms of captives by expanding the scope of financial institutions authorized to issue irrevocable letters of credit to meet capital and surplus requirements. Another amendment would permit the use of comprehensive basis of accounting methods, as approved by the Vermont Insurance Commissioner, in the preparation of the annual report of a captive’s financial condition submitted to BISHCA.

We will continue to report on the General Assembly and the status of captive insurance initiatives, including the elements of S.42, in future issues.

E-MAIL OPTION

To receive Primmer Piper Eggleston & Cramer’s *Captive Newsletter* via e-mail, please contact Kurt Lutes at 802-223-2102 or klutes@ppeclaw.com.