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INSURANCE

DEPARTMENT OF BANKING AND INSURANCE

OFFICE OF SOLVENCY REGULATION

Captive Insurance

Adopted New Rules: N.J.A.C. 11:28

Proposed: September 6, 2011 at 43 N.J.R. 2269(a).

Adopted: April 23, 2012, by Kenneth E. Kobylowski, Acting Commissioner, Department of Banking and Insurance.

Filed: April 24, 2012 as R.2012 d.100, **with substantial changes** not requiring additional public notice and opportunity for comment (see N.J.A.C. 1:30-6.3).

Authority: N.J.S.A. 17:1-8.1, 17:1-15e, and 17:47B-1 et seq.

Effective Date: May 21, 2012.

Expiration Date: May 21, 2019.

Summary of Public Comments and Agency Responses:

The Department of Banking and Insurance (Department) received three timely written comments from Prudential Financial Inc., the Surety and Fidelity Association of America, and Dewey and LeBoeuf LLP.

COMMENT: One commenter stated that the Department's proposed regulations which implement P.L. 2011, c. 25 (N.J.S.A. 17:47B-1 et seq.) establish a regulatory framework for captive insurers. The commenter stated that proposed N.J.A.C. 11:28-1.3 sets forth the admission requirements of a captive "that intends to be formed and licensed to do business in any of the lines of insurance authorized under N.J.S.A. 17:47B-1 et seq." The commented noted that

N.J.S.A. 17:47B-2 establishes the lines of business that a captive may write. The commenter stated that a captive, "may apply to the commissioner for a license to do business in any of the lines of insurance in subtitle 3 of Title 17 of the Revised Statutes … including contracts or policies of life insurance, health insurance, annuities, indemnity, property and casualty, fidelity, guaranty and title insurance." The commenter noted that missing from the list of specific lines of insurance is surety. The commenter contends that surety may not be written by a captive insurer. The commenter stated that as initially introduced, the legislation included surety in the list of insurance lines that captives may write (AB 2360, introduced February 25, 2010). However, surety was deleted from the list subsequently and does not appear in the legislation as enacted. Therefore, the commenter contends that the Legislature did not intend to include surety as a line that captives may write.

The commenter further stated that pursuant to N.J.S.A. 17:47B-2 a pure captive insurance company, an association captive insurance company, and an industrial captive insurance company may not insure risks other than those of its affiliated entities or member companies. A surety bond is a three-party contract under which the surety secures the obligation owed by one party (principal) to another party (obligee). The principal obtains the bond from its insurance company and furnishes it to the obligee to secure the obligee's risk. The commenter further stated that the obligee is facing the risk of unfulfilled performance of the obligation by the principal and requires a bond to secure that risk. In the context of a captive insurance company, the risk that would be covered would not be a risk borne by the captive's affiliates (as principal), but a risk borne by another party. Thus the commenter contends that surety likely would be excluded under the provisions of N.J.S.A. 17:47B-2.

The commenter recommends for the sake of clarity that proposed N.J.A.C. 11:28-1.3 explicitly state that a captive insurer may not write surety. The commenter believes that this would bring greater certainty to the marketplace and avoid the need for the Department to make any subsequent clarification in the future.

RESPONSE: The Department agrees with the commenter with respect to the fact that surety was deleted from the list in the original legislation indicating what insurance lines a captive may write and that, consequently, the Legislature did not intend to include surety as a line that captives may write. Based on the legislative history and the omission from the statute, the Department does not believe that it is necessary to amend the current language in the rule to specifically state that a captive insurer can not write surety.

COMMENT: One commenter expressed concerns with N.J.A.C. 11:28-1.8, the annual audit provision. The commenter stated that proposed paragraph (c)2 requires "A report of Evaluation of Internal Controls." The commenter contends that this report is not a requirement under statutory accounting as part of the Statutory Accounting Principles (SAP) audit. The commenter contends that it is strictly a Securities and Exchange Commission (SEC) requirement for Generally Accepted Accounting Principles (GAAP) audits. The commenter recommends that this requirement be stricken and that the provision be revised to require auditors to provide a report of Material Weaknesses in Internal Control.

The commenter also stated that proposed subsection (f) requires that the "annual audit include a Certification of Loss Reserves and Loss Expense Reserves." The commenter recommends that such Actuarial Opinions should not be part of the annual audit but be provided

to the Commissioner under separate cover. The commenter contends that this is consistent with current statutory guidelines.

RESPONSE: The Department does not believe that any change to N.J.A.C. 11:28-1.8(c) is necessary. The current provision requires a full report of the annual audit which is currently what the Department needs to review.

The Department agrees with the commenter that the Actuarial Opinion for the loss reserve certification can be submitted under separate cover. Accordingly, the Department is amending N.J.A.C. 11:28-1.8(f) upon adoption to include language that clarifies that the Certification of Loss Reserves and Loss Expense Reserves can be provided under separate cover.

COMMENT: One commenter expressed concern with N.J.S.A. 17:47B-2.a(3). The commenter stated that an industrial insured group ("II Group") may prefer to structure an II Captive as a wholly-owned subsidiary of a separate entity that is, in turn, directly owned by the members of the group. The commenter noted that there are many reasons for the II Group to want to insert a holding company between its members and the captive. In addition, an existing insurer that qualifies as an II Captive itself may wish to form a separate captive subsidiary for designated lines or classes of business written for the II Group. The commenter contends that the Legislature did not intend a captive to be disqualified from licensing in these circumstances. The commenter recommended that the definition of II Group be added to the Department's proposed rule, with the clarification that an II Captive may be *indirectly* owned by its industrial insureds comprising the II Group. Specifically, the commenter recommended adding the following revised statutory definition to the proposed rules (addition underlined):

"Industrial insured group" means a group of industrial insureds that collectively:

(1) own, control, or hold with power to vote all of the outstanding voting securities of an industrial insured captive insurance company incorporated as a stock insurer;

(2) have complete voting control over an industrial insured captive insurance company incorporated as a mutual insurer; or

(3) constitute all of the subscribers of an industrial insured captive insurance company formed as a reciprocal insurer.

For purposes of this definition, ownership and control shall mean both direct ownership and control or indirect ownership or control through one or more subsidiaries.

RESPONSE: The commenter's suggestion addresses language found in the authorizing statute, N.J.S.A. 17:47B-2,a(3). Consequently, the Department believes that the appropriate means to address the commenter's suggested change would be through a statutory amendment.

COMMENT: One commenter expressed concern with the definition of industrial insured with respect to joint ventures. The commenter stated that industrial insured groups often own or operate major projects as joint ventures. An example would be a manufacturing plant or an offshore drilling platform. The commenter contends that the joint venture should qualify as an industrial insured, even though the joint venture itself might not have any employees. The commenter stated that N.J.S.A. 17:47B-1 et seq. permits an II Captive to insure a joint venture if the joint venture qualifies as an "industrial insured" owner of the II Captive or an "affiliated company" of an "industrial insured" owner. The commenter believes that it would be beneficial to potential New Jersey II Captives if the Department's proposed rules clarified that a joint venture qualifies as an "affiliated company." The commenter suggested modifying the definition

of “industrial insured captive insurance company” in the proposed rule as follows (addition underlined):

“Industrial insured captive insurance company” means a company that insures risks of the industrial insureds that comprise the industrial insured group, and their affiliated companies. For purposes of this definition, a corporation, partnership, limited liability company or joint venture that is 15 percent or more beneficially owned or operated by an industrial insured shall be considered an affiliated company of an industrial insured.”

RESPONSE: The definition of industrial insured captive insurance company included in the proposal tracks the definition of that term that is contained in the statute. Accordingly, as was the case with the previous Comment, the commenter’s suggestion would require a statutory amendment.

COMMENT: One commenter expressed concern with the excess workers’ compensation insurance provision of N.J.S.A. 17:47B-2,a(6). The commenter stated that N.J.S.A. 17:47B-2.a(6) provides that a captive insurance company (which by definition according to the commenter includes a pure captive insurance company, an association captive insurance company, a sponsored captive insurance company, and an II Captive) *may* provide excess workers’ compensation insurance to “its parent and affiliated companies,” unless otherwise prohibited by law. The commenter stated that the term “parent” is in turn defined to mean “a corporation, limited liability company, partnership, other entity or individual that directly or indirectly owns, controls or holds with power to vote more than 50 percent of the outstanding voting: (1) securities of a *pure captive insurance company organized as a stock corporation*; or

(2) membership interests of a *pure captive insurance company organized as a nonprofit corporation*." N.J.S.A. 17:47B-1 (emphasis added). The commenter interpreted the Legislature's use of the permissive "*may*" in this subsection to mean that other categories of captives are not prohibited from writing excess workers' compensation insurance (compare the "*may*" in paragraph (6) to the "*shall not*" in paragraphs (1) through (5)). The commenter recommended that this should be clearly stated in the rules. The commenter suggested adding the following:

A pure captive insurance company may provide excess workers' compensation insurance to its parent and affiliated companies, unless prohibited by the federal law or laws of the state having jurisdiction over the transaction. A pure captive insurance company, unless prohibited by federal law, may reinsure workers' compensation of a qualified self-insured plan of its parent and affiliated companies. For purposes of this section "parent" means a corporation, limited liability company, partnership, other entity or individual that: (a) with respect to a pure captive directly or indirectly owns, controls or holds with power to vote more than 50 percent of the outstanding voting: (1) securities of a pure captive insurance company organized as a stock corporation; or (2) membership interests of a pure captive insurance company organized as a nonprofit corporation. Nothing in this section shall limit or restrict the authority of an association captive insurance company, industrial insured insurance company or sponsored insurance company from insuring or reinsuring excess workers' compensation insurance provided such insurance or reinsurance is authorized by the insurer's license and is written for member of the association, industrial insured group or sponsored captive participants, respectively.

RESPONSE: The commenter's suggestion is beyond the scope of this proposal, as no provision in the proposal addresses the statutory provision cited above. The Department will further consider the merits of the suggestion and whether such a rule would be consistent with N.J.S.A. 17:47B-2.a(6) before making a determination as to whether to propose a rule such as that suggested in the comment.

COMMENT: One commenter expressed concern with N.J.A.C. 11:28-1.14(a)1 that provides that "No credit shall be allowed [to a captive insurer] for reinsurance where the reinsurance contract does not result in the complete transfer of the risk or liability to the reinsurer." The commenter stated that this would restrict reinsurance arrangements in which only a portion of the risk insured by a captive is reinsured, such as quota share or excess of loss reinsurance or reinsurance with loss corridors and sliding scale ceding commissions, even when the reinsurance meets applicable accounting standards for risk transfer.

The commenter recommended that proposed N.J.A.C. 11:28-1.14(a)1 be deleted since risk transfer requirements are already embedded in accounting rules. Alternatively, the commenter recommended that the Department's proposed rules be amended to provide that "No credit shall be allowed for reinsurance where the reinsurance contract does not meet the applicable credit for reinsurance standards under Statutory Accounting Principles (SAP), Generally Accepted Accounting Principles (GAAP), or International Financial Reporting Standards."

The commenter noted that the Department's proposed rules are silent as to the circumstances under which collateral must be provided in order for a captive to take credit for reinsurance. The commenter stated that N.J.S.A. 17:47B-10.b provides that a captive insurer

may take credit for ceded reinsurance in accordance with New Jersey's general credit for reinsurance statutes (N.J.S.A. 17:51B-1 et seq.). The commenter stated that those laws allow for full credit to be taken (1) for reinsurance ceded to a reinsurer that is authorized in New Jersey, (2) to the extent that the reinsurer's obligations are secured by collateral in the form of funds withheld, letters of credit or a qualifying trust account, or (3) if the Commissioner has allowed full or reduced collateral in the circumstances set out in N.J.S.A.17:51B-2.f. The commenter contends that under subsection f, the Commissioner may allow reduced or no collateral for reinsurance ceded to a reinsurer holding surplus or equivalent in excess of $250,000,000 upon considering ten factors. The commenter further noted that other states' captive laws allow reinsurers to take credit for reinsurance ceded to unauthorized reinsurers without collateral. (See, for example, DE Ins. Code § 6911(b), S.C. Ins. Code § 38-90-110(B)(3), VT Ins. Code § 6011(b).) The commenter acknowledged that the Department is developing regulations to implement N.J.S.A. 17:51B-2.f for general insurers. The commenter recommended that the Department's proposed rules be amended to provide that ceding insurers may take financial statement credit for reinsurance ceded to any reinsurer holding surplus or equivalent in excess of $250,000,000.

RESPONSE: The Department disagrees with the commenter's first suggestion with respect to N.J.A.C. 11:28-1.14(a)1. The Department notes that its current language is consistent with language used by other states that regulate credit for reinsurance for captives.

The Department agrees with the commenter's second comment that the rules are silent as to the circumstances under which collateral must be provided in order for a captive to take credit for reinsurance. Although the Department's rules are silent on this issue, captive insurers, pursuant to N.J.S.A. 17:47B-10, may take credit for the insurance of risks or portions of risks

ceded to reinsurers complying with the provisions of N.J.S.A. 17:51B-1 et seq., specifically N.J.S.A. 17:51B-13.2, Credit for reinsurance as an asset or deduction; ceding of reinsurance; filing requirements. The Department has concluded it is not necessary to amend its rules to state that the Commissioner may allow reduced or no collateral for reinsurance ceded to a reinsurer holding surplus or equivalent in excess of $250,000,000 because it is already addressed by this statute.

COMMENT: One commenter expressed concern with the redomestication of captive insurers. The commenter stated that N.J.S.A. 17:17-20 provides for "short-form" redomestication to New Jersey by providing, in relevant part: "An insurer that is formed under the laws of another state and is admitted to transact the business of insurance in [New Jersey] may become a domestic insurer upon the commissioner's determination that the company has complied with all applicable requirements of [the New Jersey Insurance Code] relating to the formation of a domestic insurer of the same type." The commenter stated that N.J.S.A. 17:47B-5.i provides that the procedures for carrying out a redomestication of a captive insurer shall be prescribed by the Commissioner by regulation. The commenter thinks that the two statutes are best harmonized by cross-referencing the "short-form" redomestication statute in the Department's proposed rules. The commenter contends that as applied to captives, the "short-form" redomestication statute requires a captive insurer seeking to redomesticate to New Jersey to (1) be admitted to transact business in New Jersey as a captive and (2) comply with all applicable requirements related to the formation of a New Jersey-domiciled captive insurer.

The commenter believes that the Legislature did not intend to restrict redomestication to captive insurers incorporated in a U.S. state and conferred on the Commissioner the discretion to

set the rules for redomestication that allow for redomestication to New Jersey from a foreign country. The commenter contends that the short-form redomestication statute does not define the term "state." The commenter recommended that the Department's proposed rules clearly state that the term "state," as used in the "short-form" redomestication statute, includes foreign jurisdictions, in addition to the various U.S. States and territories.

RESPONSE: The Department agrees with the commenter but notes that as used in N.J.A.C. 11:28-1.4, which addresses the redomestication of captive insurance companies, the term "State" refers to the State of New Jersey. The Department's rule currently permits a redomestication from a foreign jurisdiction, in addition to the various U.S. states and territories.

Federal Standards Statement

A Federal standards analysis is not required because the adopted new rules are not subject to any Federal requirement or standards.

Full text of the adoption follows (addition to proposal indicated in boldface with asterisks ***thus***):

11:28-1.8 Annual audit

(a) - (e) (No change from proposal.)

(f) The annual audit shall include a Certification of Loss Reserves and Loss Expense Reserves ***(which can be submitted separately)***.

1. – 4. (No change from proposal.)