



**KAREN WELDIN STEWART
INSURANCE COMMISSIONER**

CAPTIVE INSURANCE ADVISORY MEMORANDUM 2015-1

July 10, 2015

To: All Captive Managers, Auditors, and Actuaries Accredited in Delaware, and all Members of the Delaware Captive Insurance Association

From: Steve Kinion, Director, Bureau of Captive and Financial Insurance Products

Re: Explanation and Application of Amendments to the Captive Insurance Laws Contained in House Bill 15

The purpose of this advisory memorandum is to provide you the rationale for the amendments to the captive laws contained in House Bill 15 and to provide an explanation for how Commissioner Stewart's office will apply these amendments. HB 15 became immediately effective on June 24, 2015 when Governor Markell signed it.

This memorandum contains critically important information. Commissioner Stewart expects that all captive owners, service providers, and professionals such as accountants and attorneys representing captive insurers, will read this memorandum and be familiar with its contents. The contents of HB 15 originated in early 2013 through discussions with captive managers and members of the Delaware Captive Insurance Association. Through a series of one-on-one meetings with captive insurance company managers, directors, officers, and owners, as well as presentations at Delaware Captive Insurance Association meetings, the captive bureau staff built support for this legislation by explaining the necessity for the amendments. These discussions carried through mid-2014 when this legislation was finalized and readied for introduction in the Delaware General Assembly.

HB 15 makes the following changes to sections contained in Title 18 of the Delaware Code:

- a. Amends section 309 to add that the Commissioner may delegate certain authority to an authorized representative. This change codifies existing practice.

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- b. Amends section 330 to add liability protection to a person who communicates or delivers information to the Commissioner pursuant to an examination, investigation, or regulatory inquiry conducted by the Commissioner.

The rationale for this amendment is that it allows a person, such as a captive manager, to provide the Commissioner with information that relates to an examination, investigation, or regulatory inquiry. If the person does so in good faith and without fraudulent intent or without the intent to deceive, then that person cannot have a legal action brought against them or have any liability imposed upon them for providing the information. This section applies to any person who provides information to the captive bureau. The captive bureau's experience has been that sometimes persons in the captive insurance industry may have information related to fraudulent or suspicious activity. This amendment allows the person to share this information with the captive bureau without having the fear of being subject to a lawsuit.

- c. Amends section 6902 to add definition for (i) alien captive insurance company; (ii) branch business; (iii) a revised definition for branch captive insurance company; (iv) branch operations; (v) a revised definition for mutual insurer; and, (vi) adds definitions for series and series captive insurance company.

The intent of the amendments is to provide a definition for "alien captive insurance company" where previously the captive insurance laws contained this term, but had not defined it. The definition relating to branch captive insurer is to redefine "branch captive insurance company" and add new definitions for "branch business" and "branch operations." Over the past five years Delaware has seen an increasing number of redemestications from offshore to onshore as well as increasing interests for branch captive insurers in Delaware. These amendments are intended to facilitate the use of branch captive insurers.

The intent for the revised definition of "mutual insurer" is to facilitate the use of captive insurers for purposes of demutualizing insurance companies under Delaware's demutualization laws. Recently a foreign mutual insurer redomesticated to Delaware for the purpose of taking advantage of Delaware's favorable demutualization law. An innovative component of this transaction was the formation of a captive insurer as a "bridge" to facilitate the transaction. Revising the definition of "mutual insurer" is another example of Commissioner Stewart's ongoing goal to have the captive and traditional laws complement each other.

The amendments also clarify that a series may be licensed as a pure, association, industrial insured, special purpose captive insurance company, or series captive

insurance company. Commissioner Stewart's long-standing regulatory policy is that a captive insurer may select any form of legal organization allowed under Delaware law. Therefore, the intent of the change is to recognize that a series is a form of legal organization under Delaware law which can be licensed as a captive insurance company. Series are somewhat synonymous with cells, but there are major differences. Unlike a cell, which solely exists under the insurance laws of Delaware and most other jurisdictions, a series is the creation of Delaware's business entity laws. Thus, a series can legally engage in more activities than a cell. Industries such as real estate, securities, and others use series as means to segregate assets and liabilities and enjoy the rights and benefits of business activities well known under Delaware law. Without being subject to the constraints of a cell, a series licensed as a captive insurer is free to engage in activities in accordance with Delaware's freedom of contract rules, so long as the series' activities are solely related to assuming risk as a captive insurer. As of the date of this memorandum, the Delaware Insurance Department has licensed 754 series as captive insurers. The practical effect of this change is the codification of existing practice.

- d. Amends section 6903 to: (1) increase the application fee for all captive insurers from \$200 to \$300; (2) increase the application processing fee for all captive insurers from \$3,000 to \$3,200; (3) increase the annual license renewal fee from \$300 to \$400 for all forms of captive insurers; and (4) allows the Commissioner to engage assistants to review applications, to conduct investigations, or handle regulatory processing at the expense of the captive insurer. For number 4, the captive bureau typically only asks applicants for large captives to bear the expenses, but only on an agreed basis with the applicant. The rationale for the increase in the application, application processing, and annual license fees is that these fees have not changed in 10 years.
- e. Amends section 6905 by adding subsection (a)(10) which allows the Commissioner to establish the minimum capital and surplus for a series captive insurance company. While the minimum capital and surplus for a series captive insurance company requirement is subject to regulatory discretion, the captive bureau has long maintained and will continue to strictly uphold its regulatory policy that a series captive insurance company must maintain a premium to surplus ratio of 3:1. However, if the captive insurer using the series as its organizational form instead holds a certificate of authority as a pure, association, industrial insured, or any other type of captive insurer allowed in Chapter 69 that has a statutory mandated minimum capital and surplus, then the captive insurer formed organizationally as a series must maintain the same mandatory

minimum. In those cases where a series is licensed as a captive insurer that must maintain a statutory minimum capital and surplus, the captive bureau will allow the premium to surplus ratio to be as high as 5:1.

If the Commissioner permits a series captive insurance company to hold a minimum capital and surplus amount that is lower than any other minimum amount required in the captive insurance laws, there are reasonable limitations placed upon the series captive insurer's activities. For example, the captive bureau will impose more restrictive rules for the investment of assets when compared to the far fewer investment limitations imposed upon captive insurers licensed as pure captive insurers.¹ Furthermore, there are certain categories of insurance coverage, such as environmental and third-party liability, that a series captive insurer may not write. The Commissioner's position is that in return for allowing a reduced minimum capital and surplus, there must be reasonable limitations imposed. If a captive owner desires to own a captive insurer that is not subject to these restrictions, the captive owner has choices. The owner can opt for their captive insurer to be licensed as a pure or other type of captive insurance company that can provide them with greater flexibility. The supply design of Delaware's captive insurance laws is such that a captive insurance company owner has many options to find the best fit for their captive insurer. This amendment codifies existing practice.

- f. Amends section 6906(a) through (d) to allow a series of a limited liability company or statutory trust to be formed as a captive insurance company. This amendment codifies existing practice.
- g. Amends section 6908 by removing the references to sections 318, 320, 321, 322, and 330 of the Delaware Insurance Code. The reason for removing these sections is to harmonize the amendments with those in section 6916. Paragraph n of this memorandum explains the amendments to section 6916. The amendment to section 6908 does not remove the mandate for a periodic three to five year examination of a captive insurer. It is important to note that examinations are an essential regulatory tool and the captive bureau will continue to examine captive insurers because responsible regulation requires examinations. The primary focus of examinations is to verify an insurer's solvency and compliance with the law. An equal focus for many types of captive insurers is to examine the processes of the captive manager and to determine how well the manager is managing the captive. The captive bureau views captive management as a profession requiring unique skills. Both captive

¹ Pure, industrial insured, agency, special purpose financial, and branch captive insurance companies are not subject to any restrictions on allowable investments, unless the Commissioner determines that any investment threatens the captive insurer's solvency or liquidity.

owners and captive service providers made a voluntary decision to enter into a regulated industry and therefore must comply with regulatory standards. While the captive bureau's existing examination procedures will remain in place for the time being, the amendment allows for greater regulatory flexibility to be used responsibly under the appropriate circumstances.

- h. Amends section 6910 to allow a captive insurance company to issue a surplus note in exchange for cash in order to allow a loan to be made to satisfy the minimum capital and surplus requirement. For guidance on the use of surplus notes, the captive bureau refers the reader to Statement of Statutory Accounting Principles No. 41. Additionally, the captive bureau's website contains a recommended form for a surplus note. The change codifies existing practice.

The amendment to section 6910 also places series captive insurance companies in the same category as association and special purpose captive insurers, as well as risk retention groups for the investment and management of assets. This means that captive insurers in these categories invest their assets in accordance with Chapter 13 of the Delaware Insurance Code. Captive insurers in this category may deviate from Chapter 13's requirements if, and only if, the Commissioner has approved an alternative investment policy. Existing approved investment policies will remain unchanged and will have "grandfathered" status. For series captive insurance companies licensed after the effective date of HB 15 and that will become another series within an existing "core" captive insurer, the Commissioner will apply the existing investment policy for the new series if the policy is approved. Furthermore, if an existing administrative order applies to any form of captive insurer, then the terms of the order will remain in effect. If an existing series captive insurance company does not have an approved investment policy in place, or an administrative order, then it must either have its investments comport with Chapter 13 or seek the Commissioner's approval of an alternative investment policy.

One of the reasons for HB 15 is that it decreases the necessity of administrative orders. Previously, the Commissioner had issued such orders to clarify the legal status of series licensed as captive insurers. Such clarification was needed because the captive insurance laws did not reference series in any manner.

- i. Amends section 6914(a) to raise the maximum premium tax payable on direct premium from \$125,000 to \$200,000. The effect of this amendment is minimal because well over 90 percent of captive insurers domiciled in Delaware do not receive enough taxable direct premiums to reach the new maximum premium tax threshold. The tax rate on direct premium is 2/10 of 1%. This rate remains unchanged.

- j. Amend section 6914(b) to increase the maximum premium tax payable on reinsured premium from \$75,000 to \$110,000. The effect of this amendment is minimal because well over 90 percent of captive insurers domiciled in Delaware do not receive enough taxable reinsured premiums to reach the new maximum premium tax threshold. The tax rate on reinsured premium is 1/10 of 1%. This rate remains unchanged.
- k. Amends section 6914(c) so that each series captive insurance company must annually pay a \$3,500 minimum premium tax. The premium tax maximum limits of \$200,000 and \$110,000 cited in this section are not applicable to a “core” captive structure in which series captive insurance companies are licensed. Thus, on March 1, 2016 and every March 1 thereafter, each series captive insurance company will file an individual premium tax report and pay the \$3,500 minimum premium tax. If the sum of the premium taxes paid by all series captive insurance companies under a single core exceeds \$200,000 or \$110,000, then the sum above these maximums is the tax amount to be paid. The rationale for establishing \$3,500 minimum premium tax per series captive insurance company is because such captive insurers previously did not pay a minimum tax. Accordingly, many series licensed as captive insurers were paying a premium taxes in amounts less than \$1,200. Furthermore, before HB 15’s enactment, captive insurers organized as series did not pay an annual license fee. This resulted in the cost of regulation equaling or exceeding the revenue received from a series. It also resulted in other forms of captive insurers that pay a \$5,000 minimum premium tax subsidizing the regulation of the series. As a result, HB 15 is intended to level the playing field in terms of captive insurance company premium taxation.
- l. Amends section 6914(d) and (e) by removing the common ownership tax allowance. Under previous law, if a captive insurance company owner owned two or more captive insurers, the premium tax due would have been based as if the owner owned only one captive insurer. In such situations, the captive bureau’s costs for regulating multiple captive insurers owned by one person exceeded the tax and fee revenue received. The changes to section 6914(d) and (e) are applicable to all captives and no form of captive insurer is exempt from this provision except those captive insurers qualifying under section 6914(h).
- m. Amends section 6914(h) so that any number of captive insurers under a common owner will continue to enjoy the common ownership tax allowance so long as one captive insurer employs at least 25 people in Delaware. In this instance, the maximum annual premium tax shall be \$50,000 regardless of the number of captive insurers under common ownership.

- n. Amends section 6916 so that additional provisions from Chapters 3 and 27 of the Delaware Insurance Code apply to captive insurers. These additions are:
 - 1) Except for sections 331, 332, and 333, the amendment applies Chapter 3 to all captive insurers.
 - 2) Section 2716 requires that policies issued by captive insurers be signed by an officer, attorney-in-fact, representative, or employee. The rationale for this amendment is that nearly every state insurance code mandates the execution of policies. This is a common requirement for insurance policies and policies issued by captive insurers should not be different.
 - 3) Article 16A, which is the Producer Controlled Insurer Act. The addition of this article only applies to risk retention groups and is mandatory in order to satisfy an NAIC accreditation requirement.
- o. Amends section 6974 to clarify the annual financial reporting requirements for alien and foreign captive insurance companies licensed as branch captive insurers in Delaware. Please see subparagraph c on page 2 for the the rationale for this amendment.
- p. Amends section 6975 to clarify the regulatory examination requirements for alien and foreign captive insurance companies licensed as branch captive insurers in Delaware. See subparagraph c on page 2 for the rationale for this amendment.
- q. Adds a new section numbered 6981 which permits captive insurers to apply for and become members of the Federal Home Loan Bank system. This new section is important for two reasons. First, from a state statutory perspective it clarifies that captive insurers may become members of an FHLBank. Second, it supplements legislation codified in 2014 related to membership in an FHLBank. The 2014 legislation lessens the barriers for insurance companies of all types to borrow from an FHLBank. Prior to the 2014 amendment, Delaware's laws governing FHLBank lending to insurance companies differed from federal banking laws governing FHLBank lending to depository institutions such as banks. This difference resulted in Delaware domiciled insurance companies having to post more liquid collateral to secure a borrowing and thus borrowing on less advantageous terms than banks. The 2014 legislation removed these disadvantages by equalizing the treatment of FHLBanks when lending to insurance companies and depository institutions. The equalization gives FHLBanks the same treatment and protections under state insurance insolvency laws as those enjoyed by the FHLBanks under federal banking laws when lending to FDIC insured depository institutions. The practical effect is that when an insurer falls into an insolvency proceeding, a judicial stay order is issued which halts the movement of the insurer's assets. This stay suspends the insurer's

activities so that the insurance company receiver can assess the insurer's business operations. Under prior law, this meant that an FHLBank had to suspend for an indefinite period of time its investment activities for any collateral it held and that was pledged by an insurer as collateral in return for borrowing from the FHLBank. As a result of the 2014 amendment, the stay order no longer applies to the collateral held by FHLBanks. Furthermore, the 2014 amendment also exempts FHLBanks from what are known as the preferential transfer provisions in insurance insolvency laws. This amendment removed any potential questions of collateral valuation and the uncertainty in timing of the FHLBank's access to the collateral securing the FHLBank's loans in the event of any insurance company's failure. These factors are no longer negative considerations working against Delaware domiciled insurance companies when seeking to borrow from an FHLBank. Unlike Delaware, the majority of states continue to have laws in place that make borrowing from the FHLBanks less advantageous.

If you have any questions about this memorandum or how HB 15's amendments affect you and your clients, please do not hesitate to contact me. During the Delaware Captive Insurance Association meeting on November 12, I will discuss these amendments.

Thank you for selecting Delaware as your choice for a captive insurance domicile.