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Is Competition for Captive Regulation Good for the Industry?

A number of U.S. states are creating captive domiciles to compete with Vermont, South Carolina, Hawaii and other long-established leaders. We interviewed Richard Smith, president of the Vermont Captive Insurance Association, and Kevin Doherty, chairman/president of the Tennessee Captive Insurance Association, to explore the new landscape of captive regulation. Smith held senior positions in Vermont state government before joining VCIA. Doherty is a partner in the Nashville law firm Burr & Forman LLP and helped rewrite the Tennessee captive law in 2011.

RRR: Until recently, Vermont, South Carolina, and Hawaii were the leading U.S. domiciles. In the last few years, more states including Delaware, Kentucky, Montana, Nevada, Tennessee, and Utah have begun competing aggressively for captive business. How has this impacted the quality of captive regulation?

Smith: It remains to be seen how the quality of regulation will be affected by more states getting into the business. Competition is good for the industry, but states that seek to attract captives must invest in professional staffs with expertise in captive regulation. Here's my concern: we've seen instances where a state enacts a captive law with the objective of creating jobs and revenue, but the economic benefits don't meet expectations and the state decides not to put the time and resources into maintaining a strong regulatory structure. This gives the whole industry a black eye when something goes wrong due to weak oversight. Problems can also develop when a state loosens licensing standards to attract captives.

Doherty: Vermont remains the gold standard of the industry, but the competitive environment is improving captive regulation. Competition has increased the knowledge base of captive regulators and made states more receptive to keeping captive laws up-to-date with changes in the industry. Some states specialize. New York is a domicile for many very large companies. Since the Tennessee captive law was rewritten in 2011, we've licensed 14 captives and one risk retention group.

RRR: With nearly 100 captive domiciles around the world—including 35 U.S. states—what are the reasons companies choose offshore versus U.S. domiciles?

Smith: Incentives for captives to choose offshore domiciles have diminished over the years. The United States, Bermuda and the Caymans continue to be leading domiciles, but more companies have selected U.S. states since the tax incentives for offshore regulation were largely eliminated years ago.

Doherty: Today, more captives are choosing onshore domiciles because the laws governing captives are just as favorable to U.S. domiciles, licensing in a state is easier to justify to shareholders and onshore domiciles afford convenient contact with regulators. Some companies also are motivated to locate in their own backyard. Tax laws were changed in the eighties to make offshore captives subject to U.S. taxation unless all their business is done outside the U.S. So, tax treatment for most captives is no longer an issue in selecting a domicile.

RRR: Minimum capital/surplus requirements range widely from domicile to domicile. In your opinion, do capital/surplus requirements influence the decisions of captive sponsors to be licensed in a particular state or offshore?

Smith: Capital/surplus requirements can be a factor for some, but most sponsors are looking for quality regulation. You get what you pay for, which, in my opinion, is why we in Vermont continue to attract and keep the largest number of captives domiciled in any state. Our state regulators have the experience and expertise to regulate all types of captives. Unlike some states that hire outside examiners, Vermont conducts captive examinations internally at less cost.

Doherty: For smaller captives, minimum capital/surplus requirements are very important, but in reality the captive regulator may require a company to have more capital than the minimum based on a review of the financials. Risk retention groups must be licensed in a state and are subject to capital standards set by the National Association of Insurance Commissioners. In general, I don't think capital/surplus standards are a major influence on where captives choose to locate.

RRR: Is there an argument for captives to be domiciled in the state where they do business? If so, should all states enter the business of captive regulation?

Smith: Some make that argument, but if all 50 states become captive domiciles, there's a serious risk of widely varying regulatory standards that could damage the reputation of the industry. Most captives do business in many states and around the world, so I don't think there is a case for having captives licensed in their home state.

Doherty: Some captives locate in their home state to be close to the regulator, but others may prefer to separate the captive domicile from the headquarters of the core business. There's also some concern with respect to self-procurement taxes under Dodd-Frank, and there has been some thought that this might drive captive formations in the home states of many large companies. However, it is not clear at this point if these provisions will be applicable to captives. So it's not clear that this will have a major impact directly. Having said that, there are plenty of practical reasons to domicile your captive in your home state or at least in a neighboring or close state.

RRR: The majority of states now authorize captive formation, but many have only small staffs dedicated to captive regulation. Some regulators are concerned that new captive domiciles will not have the structure and capacity to regulate captives rigorously and may run into trouble. Will this harm the reputation of the industry as a whole? If so, why?

Smith: A bad story in the media about a captive becoming insolvent because it was not adequately regulated hurts the industry as whole. We fight this battle every year. The mainstream media don't understand our industry. Some write about captives as a shadowy insurance market doing business in little known islands offshore. We need to do a better job of telling how captives operate, how they're regulated, and how they benefit companies and the economy as a whole. When a captive runs into trouble that could have been avoided by alert regulators, our entire industry suffers.

Doherty: There's a risk that domiciles without adequate regulation can overlook problems, but I don't consider it a major concern at this point. Captive sponsors look for states that provide good regulation because it's in their own interests. Consequently, the managers sort of self-regulate and generally locate in domiciles that are providing adequate oversight of captives.

RRR: What advice would you give to states that are thinking about getting into the captive business?

Smith: Commit for the long term. Be sure you hire people who know what they're doing. This is a highly specialized industry so it's important to have experienced regulators. Put financial resources into your captive division and maintain a budget that will support active—rather than passive—regulation. We've seen new captive domiciles where they're doing it right. That's good for the industry.

Doherty: You need a first-rate captive law, a strong commitment by state government to provide adequate resources to the insurance department for captive regulation and industry support in the form of an active association. If you lack any one of these, you will not be successful. Your state law should permit the greatest flexibility in forming captives subject to review of financial adequacy. In Tennessee, captive regulation is flexible to accommodate any type of captive in any kind of industry. The only impediment to forming a captive in Tennessee would be, "it doesn't make sense."

Are new captive domicile states prepared to provide the level of professional regulation that are required for risk retention groups?

Smith: States just getting into the business of captive regulation must develop expertise in regulating risk retention groups because RRGs operate under different rules than other captives. Most RRGs can benefit from strong regulation when they get into trouble. States with long experience in the business are alert to developing problems. In Vermont, we work with companies to fix potential problems before they become harmful.

Doherty: Some new states will be prepared to regulate risk retention groups and some won't. RRGs operate under different rules, so it's essential to dedicate adequate resources to regulate them properly.

RRR: Some states that have had captive laws for a while are known as specialists in one or two types of captive. As more states enact captive laws, could each domicile carve out a niche for certain categories of captive?

Smith: My answer is yes and no. It may be possible for some states new to the business to adopt a niche strategy. However, no state has cornered the market for licensing specific types of captive. In regard to healthcare captives, everyone talks about the Cayman Islands, and regulators in the Caymans do an excellent job. However, other states, including Vermont, also regulate many healthcare captives. We'll have to wait and see whether new captive states can succeed with a niche strategy.

Doherty: I think specialization can give a domicile an advantage in attracting captives but only if you have a good rationale. In Tennessee, for example, we're focusing on healthcare captives because our state is the home of major healthcare companies including HCA, the largest for-profit healthcare business in the country.

RRR: How will Vermont, South Carolina, and other long-standing captive domiciles be affected by the growing number of states entering the business?

Smith: Competition is good for the industry. It keeps us all on our toes, and gives potential captive sponsors the opportunity to evaluate the regulatory structures in a number of states before choosing where to locate. However, if in the rush to become captive domiciles, some states fail to provide the necessary resources and commitment, it will dilute regulation and hurt those states that have been effectively regulating captives for many years.

Doherty: If the new states do it right, others will respond. That's good for the industry. States that don't put adequate resources into captive regulation won't attract new captives. Captive sponsors want consistent, competent regulation. This will cause many to locate where they have other business relationships if the state commits to professional captive regulation.

RRR: Your thoughts on the state of the captive industry and captive regulation three to five years from now?

Smith: The fact that captives weathered the economic meltdown of 2008 and 2009 is a good sign for the future. I'm bullish on the alternative risk transfer industry. Look for steady growth over the next few years as companies big and small form captives to meet their insurance needs.

Doherty: I expect the industry to become stronger and more competitive over the next few years as captive sponsors have more options. Relations with the traditional industry also will improve as more insurers work with captives as fronting companies and offer reinsurance coverage.

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