Shining a Light on Shadow Insurance

A Little-known Loophole
That Puts Insurance Policyholders and
Taxpayers at Greater Risk

New York State Department of Financial Services
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EXECUTIVE SUMMARY

In July 2012, the New York State Department of Financial Services ("DFS") initiated an investigation into "shadow insurance" — a little-known loophole that puts insurance policyholders and taxpayers at greater risk. This report details the initial findings of DFS's inquiry.

Insurance companies use shadow insurance to shift blocks of insurance policy claims to special entities — often in states outside where the companies are based, or else offshore (e.g., the Cayman Islands) — in order to take advantage of looser reserve and regulatory requirements. Reserves are funds that insurers set aside to pay policyholder claims.

In a typical shadow insurance transaction, an insurance company creates a "captive" insurance subsidiary, which is essentially a shell company owned by the insurer's parent. The company then "reinsures" a block of existing policy claims through the shell company — and diverts the reserves that it had previously set aside to pay policyholders to other purposes, since the reserve and collateral requirements for the captive shell company are typically lower. Sometimes the parent company even effectively pays a commission to itself from the shell company when the transaction is complete.

This financial alchemy, however, does not actually transfer the risk for those insurance policies because, in many instances, the parent company is ultimately still on the hook for paying claims if the shell company's weaker reserves are exhausted ("a parental guarantee"). That means that when the time finally comes for a policyholder to collect promised benefits after years of paying premiums (such as when there is a death in their family), there is a smaller reserve buffer available at the insurance company to ensure that the policyholder receives the benefits to which they are legally entitled.

Shadow insurance also could potentially put the stability of the broader financial system at greater risk. Indeed, in a number of ways, shadow insurance is reminiscent of certain practices used in the run up to the financial crisis, such as issuing securities backed by subprime mortgages through structured investment vehicles ("SIVs") and writing credit default swaps on higher-risk mortgage-backed securities ("MBS"). Those practices were used to water down capital buffers, as well as temporarily boost quarterly profits and stock prices at numerous financial institutions. Ultimately, these risky practices left those very same companies on the hook for hundreds of billions of dollars in losses from risks hidden in the shadows, and led to a multi-trillion dollar taxpayer bailout.

Similarly, shadow insurance could leave insurance companies on the hook for losses at their more weakly capitalized shell companies. The events at AIG's Financial Products unit in the lead up to the financial crisis demonstrate that regulators must remain vigilant about potential threats lurking in unexpected business lines and at more weakly capitalized subsidiaries within a holding company system.

DFS's Investigation into Shadow Insurance

Over the last eleven months, the New York Department of Financial Services has conducted an extensive investigation into shadow insurance at New York-based insurance companies and their affiliates. DFS's investigation revealed:

- ***$48 Billion in Shadow Insurance at New York-based Insurers and Their Affiliates Alone.*** New York-based insurance companies and their affiliates engaged in at least $48 billion of shadow insurance transactions to lower their reserve and regulatory requirements.

- ***Inconsistent, Spotty, and Incomplete Disclosures.*** New York-based insurance companies failed to disclose the parental guarantees associated with nearly 80 percent ($38 billion) of that $48 billion in shadow insurance in their statutory, annual financial statements. And where those companies did make disclosures, those disclosures were often spotty and incomplete.

- ***Reserves Diverted, Artificially Rosy Capital Buffers.*** Shadow insurance allows companies to divert reserves for other purposes besides paying policyholder claims. Those other purposes may include anything from an acquisition of another company to executive compensation to paying dividends to investors. In most cases, though, DFS's investigation revealed that insurance companies manipulated those reserves in order to artificially boost the risk-based capital ("RBC") buffers that they reported to regulators, investors, and the broader public — all without actually raising any new capital or reducing risk. In other words, shadow insurance makes a company's capital buffers — which serve as shock absorbers against unexpected losses or financial shocks — appear larger and rosier than they actually are.

- ***Weak Transparency, Regulatory Blind Spots.*** Most states have laws that provide for strict confidentiality on financial information related to shadow insurance. These confidentiality requirements thwart regulators from outside that state from having a full window into the risks that those transactions create. Indeed, the current lack of transparency surrounding shadow insurance is what, in great part, drove DFS to undertake this investigation.

- ***Regulatory Race to the Bottom.*** A number of the other states outside New York where shadow insurance is written permit the use of riskier types of "collateral" to back shadow insurance claims, including “hollow assets,” “naked parental guarantees,” and “conditional letters of credit” (each of which is described in further detail below). Those weaker collateral requirements mean that policyholders are at greater risk.

As part of its investigation, under Section 308 of the New York Insurance Law, DFS required all life insurers based in New York to provide information on shadow insurance transactions. The findings of this investigation and DFS’s authority under Section 308 are limited to New York-based life insurers. As such, the $48 billion in shadow insurance transactions DFS’s investigation uncovered are likely to be just the tip of the iceberg nationwide. There are almost certainly tens, if not hundreds, of billions of dollars of additional shadow insurance on the books of insurance companies across the country.

DFS’s Recommendations on Shadow Insurance

Given the troubling findings uncovered during its investigation, DFS is taking immediate action and making several recommendations to address the potential risks and lack of transparency surrounding shadow insurance:

- Through its authority under the New York Insurance Law, DFS will require detailed disclosure of shadow insurance transactions by New York-based insurers and their affiliates.

- In the interest of national uniformity, the National Association of Insurance Commissioners (“NAIC”) should develop enhanced disclosure requirements for shadow insurance across the country.

- The Federal Insurance Office (“FIO”), Office of Financial Research (“OFR”), the NAIC, and other state insurance commissioners should conduct similar investigations to document a more complete picture of the full extent of shadow insurance written nationwide.

- State insurance commissioners should consider an *immediate national moratorium* on approving additional shadow insurance transactions until those investigations are complete and a fuller picture emerges.

I. DFS'S INVESTIGATION INTO SHADOW INSURANCE

A. Background/Objectives of the Investigation

The use of shadow insurance emerged in great part due to a desire from insurers to do an end-run around higher reserve requirements that states established for certain term and universal life insurance policies. The fact that certain insurers are inappropriately using shell games to hide risk and loosen reserve requirements is greatly troubling to DFS and caused the Department to launch an investigation.

On July 18, 2012, pursuant to Section 308 of the New York Insurance Law, DFS required all 80 life insurers based in New York to provide information concerning reinsurance with affiliated captive or affiliated offshore insurers, including those with parental guarantees ("shadow insurance").

The investigation also focused on the following additional areas of concern surrounding shadow insurance — each of which present serious potential risks to policyholders and taxpayers:

1. ***Conditional Letters of Credit.*** DFS examined whether any of those 80 New York-based insurers and their affiliates engaged in reinsurance transactions using "conditional letters of credit" (i.e., letters of credit that have stipulated conditions that must be met before they can be drawn upon). A conditional letter of credit is at greater risk of not being available to fund policyholder claims during periods of financial stress. New York requires that letters of credit used as collateral have unconditional terms. However, other states allow conditional letters of credit as collateral.

2. ***Two-step Transactions.*** DFS examined whether any of those 80 New York-based insurers and their affiliates transferred insurance to another insurer outside of New York, which then subsequently transferred that risk to a captive subsidiary affiliated with the original insurer (a "two-step transaction"). Two-step transactions are particularly problematic because, in some instances, although a New York-based insurer may not report any direct shadow insurance activity, the New York-based insurer is still ultimately on the hook for losses through a parental guarantee. This complex shell game obscures the risks that insurers are taking on through shadow insurance.

3. ***Hollow Assets.*** DFS examined whether any of those 80 New York-based insurers and their affiliates engaged in reinsurance transactions with affiliated captives or affiliated offshore reinsurers where a letter of credit with a parental guarantee is recorded as an asset on the books of the captive or offshore affiliate ("hollow asset"). In other words, the insurer counts the undrawn letter of credit as an asset — rather than a real asset that

it actually holds, such as cash or a bond. While New York does not allow insurers to count undrawn letters of credit as assets, other states allow such arrangements.

4. ***Naked Parental Guarantees.*** Through a "naked parental guarantee," a captive insurance subsidiary engaging in shadow insurance does not even bother to obtain a letter of credit — conditional or otherwise — as collateral. It simply promises that its parent company would cover potential losses, without identifying any specific, dedicated resources to pay for them. While New York does not allow insurers to back insurance claims with naked parental guarantees, other states allow such arrangements.

B. Summary of the Findings of the Investigation

As part of its investigation, DFS uncovered that 17 New York-based insurers used some form of parental guarantee to support collateral arrangements in reinsurance transactions. Those shadow insurance transactions together totaled more than $48 billion.

Eight of those 17 respondents reported direct reinsurance arrangements through a subsidiary operating in New York. Nine of those 17 respondents reported reinsurance arrangements solely through non-New York affiliates.

- Of the eight insurers that reported direct transactions, their parental guarantees totaled $14.9 billion in the aggregate. In addition, five of those eight New York-based insurers also reported that their non-New York affiliate insurers engaged in transactions that used some form of parental guarantee that, in the aggregate, totaled an additional $18.2 billion.

- Of the nine insurers that reported transactions only through non-New York affiliates in their holding company systems, the total amount of parental guarantees reported amounted to approximately $15.3 billion.

Specific details on the shadow insurance transactions at each of these 17 firms are available in Section I. D of this report.

Conditional Letters of Credit

Five New York-based insurers reported that non-New York-based affiliates within their holding company systems used conditional letters of credit, although only three insurers reported the amounts associated with those conditional letters of credit ("Conditional LOCs"). (*See* Table 1.)

Table 1: Insurers Reporting Conditional LOCs

Case	Total LOCs with Credit Reimbursement Agreements	Amount of Conditional LOCs, If Reported*
Case 3	$658,650,000	$391,000,000
Case 5	$4,322,570,267	0
Case 8	$1,911,071,300	$1,840,571,300
Case 10	0	0
Case 17	$450,000,000	$450,000,000
Totals	**$7,342,291,567**	**$2,681,571,300**

*For entries noted as zero in this column, the firms indicated that they have previously or intend to engage in these practices, but they are not currently active as of the date of the DFS's inquiry.

Hollow Assets

The Department's investigation further revealed that the captive reinsurers of 11 New York-based insurers reported LOCs as admitted assets in the cases where the reinsurers are located in the states of Missouri, Delaware, Iowa, South Carolina, Nebraska, and Vermont. These states — unlike New York — permit LOCs to be reported as admitted assets on the books of the captive reinsurers. All but one insurer that reported a captive with an LOC in the aforementioned six states specifically identified the amount of LOCs reported as admitted assets. The total amount of LOCs reported as assets is approximately $9.6 billion. (*See* Table 2 for a summary.)

Table 2: LOCs Reported as Admitted Assets

Case	Total LOCs with Credit Reimbursement Agreements	LOCs where Reinsurers Are Located in MO, DE, IA, SC, NE or VT	Amount of LOCs Specifically Reported as Assets**
Case 1	$7,109,685,769	$4,446,000,000	$4,446,000,000
Case 2	$216,000,000	$85,000,000	$85,000,000
Case 3	$658,650,000	$658,650,000	$658,650,000
Case 5	$4,322,570,267	$1,879,122,053	0
Case 8	$1,911,071,300	$1,840,571,300	$1,840,571,300
Case 9	$4,745,590,260	$727,000,000	$727,000,000

Case 10	0	0	0
Case 11	$130,040,984	$130,040,984	$130,040,984
Case 14	$1,173,300,000	$1,148,000,000	$1,148,000,000
Case 16*	$100,807,387	$100,807,387	$100,807,387
Case 17	$450,000,000	$450,000,000	$450,000,000
Totals	$20,817,715,967	$11,465,191,724	$9,586,069,671

*This represents a parental guarantee that was reported as an admitted asset.

**For entries noted as zero in this column, the firms indicated that they have previously or intend to engage in these practices, but they are not currently active as of the date of the DFS's inquiry.

<u>Two-step Transactions</u>

The Department's investigation also uncovered several "two-step" transactions where New York-based insurers transferred business to another U.S.-based life insurer outside New York, which then transferred the business to a captive or offshore insurer affiliated with the original New York insurer. Indeed, six New York-based insurers reported engaging in some sort of two-step transactions and, of those, five utilized parental guarantees.

<u>Table 3: Insurers Reporting Two-Step Transactions</u>

Case	LOCs with Parental Guarantees*	Surplus Note Guarantees*	Report LOCs as Assets?	Report Conditional LOCs?
Case 1	$7,109,685,769	$4,647,000,000	Yes	No
Case 7	0	0	No	No
Case 8	$1,911,071,300	0	Yes	Yes
Case 9	$4,745,590,260	$2,212,000,000	Yes	No
Case 10	0	$1,480,000,000	Yes	Yes
Case 14	$1,173,300,000	$127,769,311	Yes	No
Totals	**$14,939,647,329**	**$8,466,769,311**		

*For entries noted as zero in this column, the firms indicated that they have previously or intend to engage in these practices, but they are not currently active as of the date of the DFS's inquiry.

Two-step transactions are particularly problematic because, in some instances, although a New York-based insurer may not report any direct activity involving parental guarantees, the risks of the New York-based insurer are ultimately being guaranteed by the parent through retrocessions (i.e., reinsurance of reinsurance arrangements) within the holding company system.

Naked Parental Guarantees

The Department's inquiry also uncovered other kinds of arrangements, including "naked parental guarantees." In a naked parental guarantee, a captive insurance subsidiary does not even bother to obtain a letter of credit — conditional or otherwise — as collateral. It simply promises that its parent would cover any losses, without identifying specific, dedicated resources to pay for them.

In one situation, an insurer reported that a non-New York-based company entered into an agreement that used a "naked parental guarantee" for the amount of $1.6 billion. In another instance, a non-New York-based company used a similar affiliate guarantee (a "naked guarantee" from an affiliate, as opposed to the ultimate parent) for the amount of $100.8 million in a reinsurance transaction. (*See* Table 4.)

Table 4: "Naked" Parental Guarantees

Case	**"Naked" Parental Guarantee Amounts**
Case 5	$1,616,883,275
Case 16	$100,807,387
Totals	**$1,717,690,662**

New York regulations do not permit either a naked parental or affiliate guarantee as collateral in support of a reduction in a reserve liability because, in the event of financial difficulty of the reinsurer, there is no readily available assets to seize to pay claims. That type of arrangement puts policyholders at greater risk.

C. Diverting Reserves, Artificially Boosting Capital Buffers

As previously noted, shadow insurance allows companies to divert reserves for other purposes besides paying policyholder claims. Those other purposes could include anything from an acquisition of another company to executive compensation to paying dividends to investors. In most cases, though, DFS's investigation found that companies use those diverted reserves to artificially boost the risk-based capital (RBC) buffers that they report to regulators, investors, and the broader public — without actually raising any new capital or reducing risk. In other words, shadow insurance makes a company's capital buffers — which serve as shock absorbers against unexpected losses or financial shocks — appear larger and rosier than they actually are.

Regulators created RBC standards in the late 1980s were created to provide a capital adequacy standard tied to risk, raise insurers' safety nets, create uniformity among states, and provide regulatory authority for timely action. RBC represents the amount of capital, based on an assessment of risks, that a company should hold to protect customers against adverse developments. The RBC system was developed after the financial crisis of the late 1980s when state insurance commissioners took a fresh look at the low, fixed minimum capital requirements embedded in the various state insurance laws. Regulators throughout the country determined that a new approach was necessary to better protect policyholders and to raise the minimum capital requirements for insurance companies.

Because the RBC ratio is often interpreted as a measure of the financial strength of an insurer by rating agencies, regulators, company management, customers, creditors, and investors, insurance companies are motivated to engage in shadow insurance transactions — such as reinsurance with affiliated captives and offshore insurers with parental guarantees — to artificially boost their RBC ratio.

Publicly traded companies disclose risk-based capital information in their filed statutory annual statements and 10-K reports filed with the U.S. Securities and Exchange Commission, and discuss risk-based capital at their annual investor days and on their public earnings calls. Additionally, regulators and rating agencies consider RBC as they determine a company's financial strength rating. Parent insurance companies that provide minimum capital guarantees for their subsidiaries or affiliate companies also usually tie the guarantees to a percentage of RBC (e.g., a guarantee to maintain 350 percent RBC-company action level).

Companies can use shadow insurance in a number of ways to artificially boost their RBC levels. In a common scenario, the insurer reinsures a block of policies with an affiliated captive. The original insurer then receives a commission, as well as other capital boosts, equal to the amount that the transaction has effectively lowered its reserve requirements. That commission is then counted as "retained earnings" for accounting purposes — which is a form of capital — even though the firm is essentially paying a commission to itself.

Specific details about the impact of shadow insurance on RBC levels at the 17 firms engaging in that practice are available in Section I. D of this report.

D. <u>Details of Findings</u>

1. <u>Insurers Reporting Direct Reinsurance with Affiliated Captives/Offshore Insurers</u>

As noted in Section I. B of this report, the Department's inquiry revealed eight New York-based insurers that reported direct reinsurance activity with affiliated captives and offshore insurers that involved some form of parental guarantee. The New York-based insurers reported direct transactions that used some form of parental guarantee which, in the aggregate, totaled nearly $15 billion. In addition, five of those eight New York-based insurers also reported that their non-New York affiliate insurers engaged in transactions that used some form of parental guarantee, which, in the aggregate, totaled an additional $18 billion. The activity of each of the eight insurers and their affiliates is described in greater detail below.

Case 1

A New York-based life insurer reported $1,184,000,000 in LOCs that were used by captives and offshore affiliates that were backed by "contractual parental guarantees" from its ultimate parent. In addition, this insurer entered into a treaty with a captive whereby the captive issued surplus notes in the amount of $1,850,000,000 to fund part of the transaction. The performance of the surplus notes was indemnified by the ultimate parent using a Total Rate of Return Swap. As a result of these transactions, the insurer improved its RBC by 109 percent as of December 31, 2011. The total amount of LOCs and surplus notes guaranteed represents about 22 percent of the New York-based insurer's capital and surplus as of December 31, 2011.

With respect to other non-New York-based U.S. affiliates in the same holding company system, the insurer reported $5.9 billion in LOCs that were issued by affiliated captives and offshore reinsurers that were backed by "contractual parental guarantees" from the ultimate parent. As a result of these transactions, the non-New York-based affiliates have increased their RBC ratios individually in amounts ranging from 211.3 percent to 634.0 percent as of December 31, 2011.

This insurer reported that on a consolidated basis its RBC increased 150.8 percent as a result of reinsurance with affiliated captive and offshore reinsurers.

In addition, the insurer also reported that its captive affiliates reported LOCs as an admitted asset in the amounts of $315 million for New York-based activity and $4.1 billion for non-New York-based affiliate activity.

Case 2

A New York-based life insurer reported $216,000,000 in LOCs that were issued by affiliated captives and offshore reinsurers and were backed by "contractual parental guarantees" from the ultimate parent. As a result of these transactions, the insurer improved its RBC by 294.5 percent as of December 31, 2011. The total amount of LOCs guaranteed exceeds the cedent's capital and surplus as of December 31, 2011. The New York-based insurer reported that $85 million of LOCs were reported as assets by the captive reinsurer.

Case 3

A New York-based life insurer reported $129,350,000 in LOCs that were issued by affiliated captives and were backed by "contractual parental guarantees." As a result, the insurer's RBC increased 538 percent. The total amount of LOCs guaranteed *exceeds the insurer's entire capital and surplus* as of December 31, 2011.

With respect to other non-New York-based U.S. affiliates, this insurer reported $529.3 million in LOCs that were backed by "contractual parental guarantees" and $391 million in conditional LOCs that they reported had no parental guarantees. The insurer reported a total increase of 137 percent in its RBC from these transactions.

Further, the insurer indicated that its captive affiliates report LOCs as an admitted asset in the states that allow such reporting.

Case 4

A New York-based life insurer reported $1.9 billion in LOCs that were issued by affiliated captives as collateral for two treaties and were backed by "contractual parental guarantees" from an affiliate. The insurer reported an increase of 127 percent in its RBC as a result of these treaties. The LOC amount represents about 41 percent of capital and surplus as of December 31, 2011. In addition, the New York-based insurer reported an $8.1 billion trust used for collateral for reserve credit, which has indemnification from an affiliate of the insurer used to hedge GMIB exposure.

Case 5

A New York-based life insurer reported $958,273,155 in LOCs issued by an offshore affiliate, where the parent is a co-applicant on the LOC. The New York-based insurer reported an increase of 97 percent in its RBC as a result of this treaty. The LOC amount *exceeds the insurer's entire capital and surplus* as of December 31, 2011.

With respect to other non-New York-based U.S. affiliates in its holding company system, an insurer entered into three treaties with an affiliated captive that used a parental "indemnification" with respect to surplus notes issued by the captive in the amount of $1.9 billion to fund a trust, which, taken together, increased its RBC by 26 percent. The insurer also entered into a treaty with an affiliated captive that used a naked parental guarantee in the amount of $1.6 billion for support of reserve credit, which increased its RBC by 17 percent. There are also many other reinsurance transactions within this holding company system where the parent is a co-applicant for $3.3 billion in LOCs used as collateral for reserve credits that increased RBC by a total amount of 261 percent.

In addition, the insurer reported that its non-New York-based affiliates have used conditional LOCs. Further, the insurer indicated that its captive affiliates report LOCs and naked parental guarantees as admitted assets in the states that allow such reporting.

Case 6

A New York-based life insurer reported $408.7 million in LOCs issued by an offshore affiliate backed by a contractual parental guarantee. The LOC amount represents about 22 percent of this insurer's capital and surplus as of December 31, 2011.

With respect to other non-New York-based U.S. affiliates, $243 million in LOCs backed by a contractual parental guarantee were issued.

Case 7

A New York-based life insurer reported LOCs in the total amount of $154 million as of December 31, 2011 for two treaties. There is a contractual parental guarantee in the form of a capital maintenance agreement that requires the parent to adequately maintain the capital and surplus of the affiliate reinsurer (it is noted that capital maintenance agreements can exist separate from any reinsurance arrangement). Total RBC impact of the reinsurance was an increase of about 64 percent and the LOC amount represents about 17 percent of capital and surplus as of December 31, 2011.

With respect to the other non-New York-based insurers in the group, capital maintenance agreements were also used to support other collateral arrangements.

Case 8

A New York-based life insurer reported a LOC in the amount of $70 million as of December 31, 2011 for a treaty with an offshore captive that has a contractual parental guarantee.

With respect to the non-New York-based affiliates in its holding company system, an affiliate had several treaties with captives and offshore affiliates. The transactions included contractual parental guarantees in the amount of $1.8 billion, and $500,000 in LOCs and a $474 million trust with no parental guarantees.

In addition, this insurer reported that its non-New York-based affiliates use conditional LOCs. Further, the insurer indicated that its captive affiliates report LOCs as an admitted asset in the states that allow such reporting.

* * *

In total, eight New York-based insurers reported direct reinsurance with affiliated captives and affiliated offshore reinsurers involving some form of parental guarantee totaling nearly $15 billion.

Table 5 summarizes the artificial boosts in risk-based capital buffers from the transactions by the eight New York-based insurers that reported direct activity utilizing some form of parental guarantee (or credit reimbursement agreement).

Table 5: Direct Activity by Individual New York-Based Insurers

Case*	LOCs with Credit Reimbursement Agreements	Surplus Note Guarantees/ Trust Indemnification	Naked Parental Guarantees	Total Amount of Collateral/ Approximate Reserve Credit	Reported RBC Percent Increase
Case 1	$1,184,000,000	$1,850,000,000	0	$3,034,000,000	132%
Case 2	$216,000,000	0	0	$216,000,000	1,111%
Case 3	$129,350,000	0	0	$129,350,000	538%
Case 4	$1,908,005,543	$8,173,500,000	0	$10,081,505,543	127%
Case 5	$958,273,155	0	0	$958,273,155	97%
Case 6	$408,726,594	0	0	$408,726,594	0.62%
Case 8	$70,000,000	0	0	$70,000,000	1 %
Total	**$4,874,355,292**	**$10,023,500,000**	**0**	**$14,897,855,292**	

*Not included in this table is a case involving a capital maintenance agreement (*see* Case 7 above) that is explicitly tied to the affiliated offshore reinsurer's ability to secure a letter of credit.

The New York-authorized insurers that reported direct reinsurance with affiliated captives and affiliated offshore reinsurers reported direct reinsurance arrangements with guarantees ranging from $70 million to over $10 billion with increases in the RBC ratios up to more than 1,100 percent. The average increase of the RBC ratio was about 287 percent.

Five of the eight New York-based insurers noted above also reported non-New York affiliate reinsurance with affiliated captives and offshore reinsurers involving some form of parental guarantees totaling an additional $18 billion. (*See* Table 6.)

Table 6: Activity by Non-New York Affiliates of New York-Based Insurers

Case	LOCs with Credit Reimbursement Agreements	Surplus Note Guarantees/ Trust Indemnificatio n	Naked Parental Guarantees	Total Amount of Collateral/ Approximate Reserve Credit	Reported RBC Percent Increase*
Case 1 Affiliates	$5,925,685,769	$2,797,000,000	0	$8,722,685,769	758%
Case 3 Affiliates	$529,300,000	0	0	$529,300,000	85%
Case 5 Affiliates	$3,364,297,112	$1,891,474,947	$1,616,883,275	$6,872,655,334	304%
Case 6 Affiliates	$243,706,386	0	0	$243,706,386	0.94%

Case 8 Affiliates	$1,841,071,300	0	0	$1,841,071,300	33%
Total	$11,904,060,567	$4,688,474,947	$1,616,883,275	$18,209,418,789	

*Amounts are cumulative for all non-New York-based affiliates

The New York-authorized life insurers that reported direct activity (as shown in Table 5) that also reported activity by non-New York affiliates reported increases in RBC for their affiliates up to 758 percent in the aggregate. The average increase in RBC was about 236 percent.

2. Insurers Reporting Only Non-New York Affiliate Reinsurance with Affiliated Captives/Offshore Insurers

As noted in Section I. B of this report, the Department's investigation revealed nine New York-based insurers that reported transactions only by non-New York-based affiliates in their holding company system that involved some form of parental guarantee. The total amount of parental guarantees reported by these nine insurers for their non-New York-based affiliates amounts to approximately $14.8 billion. Each of those instances is described below.

Case 9

The insurer reported about $4.7 billion in LOCs with parental guarantees and about $2.2 billion in surplus notes issued that were "indemnity guaranteed" by the parent.

With respect to whether the New York-based insurer engaged in any two-step transactions, the insurer stated:

> There is a treaty . . . whereby a non-domestic insurer assumed business from a domestic insurer which it then retroceded to an affiliated captive involving $95 million in contractual parental guarantees. There is second treaty . . . whereby the non-domestic insurer assumed business from the NY domestic which it then retroceded to an affiliated captive involving $400 million in contractual parental guarantees. There is a third treaty . . . whereby the non-domestic insurer assumed business from the NY domestic insurer which it then retroceded to an affiliated captive involving $232 million in contractual parental guarantees.

The above response makes clear that although the New York-based insurer did not report any direct activity involving parental guarantees by the New York domestic, risks of the New York-based insurer are ultimately being guaranteed by the parent through retrocessions within the holding company.

In addition, the insurer reported that its captive affiliates report LOCs as admitted assets in the states that allow such arrangements.

Case 10

A non-New York-based insurer that has a New York affiliate insurer entered into a treaty with an offshore reinsurer using a trust with collateral of approximately $362 million, $82 million of which would not meet either New York regulations or NAIC guidance for acceptable forms of collateral. However, the non-conforming collateral was accepted by the non-domiciliary state regulator because an affiliate guaranteed the $82 million in non-conforming collateral.

In three other treaties with an affiliated captive, the non-New York-based insurer used LOCs totaling $1.48 billion as collateral. The LOCs that were issued do not meet the requirements for an unconditional LOC, and would therefore be contrary to New York regulation, as well as NAIC guidance. Yet the domiciliary state regulator approved the LOCs as another form of acceptable collateral. Also, the state in which the captive is domiciled granted the captive a permitted practice to record the LOCs as an asset.

Further, the non-New York-based insurer entered into a reinsurance treaty with a captive using a trust for collateral that was funded by the issuance of $1.1 billion in surplus notes. The non-New York-based insurer entered into an agreement with the financial guarantor of the surplus notes to indemnify the captive, the financial guarantor, and other parties to the transaction.

The non-New York-based insurer also entered into another reinsurance treaty with a captive that used a trust as collateral, which was funded from the issuance of $315 million in surplus notes by the captive. The ultimate parent corporation then entered into a Liquidity Commitment Agreement with the captive and the capital market investors that guaranteed the market value of the assets held in the trust. In addition, the ultimate parent entered into a limited guaranty with the captive under which the ultimate parent guaranteed that the captive will receive a prescribed rate of return on certain Modco reinsurance assets. The intent of the limited guaranty is to mitigate credit/interest rate risk within the captive. The Department views these agreements as parental guarantees of the collateral used in the reinsurance transaction.

With respect to the question whether the insurer engaged in any two-step transactions, the insurer stated:

> The NY domestic cedes term business to an affiliate, who retrocedes the business to various captive reinsurers. All of the collateral used in the two-step transactions received either parental guarantee or indemnification . . . .

The above response makes it clear that although the New York-based insurer did not report any direct activity involving parental guarantees by the New York domestic, risks of the New York-based insurer that are reinsured to the affiliated non-New York-based insurer are ultimately being guaranteed by the parent through retrocessions within the holding company.

In addition, the insurer reported that its non-New York-based affiliates use conditional LOCs and that its captive affiliates report LOCs as admitted assets in the states that allow such reporting.

Case 11

A non-New York-based affiliate of a New York insurer entered into a reinsurance transaction with an affiliated captive reinsurer whereby an LOC in the amount of $130,040,984 was issued that had a contractual parental guarantee. The insurer reported an approximately 30 percent increase in RBC for this reinsurance.

Case 12

Two non-New York-based affiliates of a New York insurer entered into two separate reinsurance transactions with an affiliated offshore reinsurer whereby two LOCs totaling $198,000,000 were issued that had contractual parental guarantees. The insurer reported an increase in RBC of approximately 3.01 percent for these two transactions.

Case 13

A non-New York-based affiliate of a New York insurer entered into a treaty with an offshore affiliate using as collateral an LOC in the amount of $370 million and a trust in the amount of $2.08 billion, which was secured by a contractual parental guarantee and parental indemnification of the bonds issued to fund the trust. In another transaction, the same affiliate entered into a treaty with an affiliated captive reinsurer whereby the collateral in the form of a $1.2 billion trust was funded by the issuance of debt that was ultimately guaranteed by the parent corporation. In addition, a transaction between a different non-New York-based affiliate and an offshore affiliate reinsurer used an LOC in the amount of $213 million, which was secured by a contractual parental guarantee. The insurer reported no RBC impact on the first transaction, and a 208 percent and 63 percent increase for the last two treaties, respectively.

Case 14

A non-New York-based affiliate of a New York insurer entered into a treaty with an offshore captive reinsurer whereby an LOC in the amount of $25.3 million was used as collateral for reserve credit purposes that had a "contractual parental guarantee." The insurer reported an increase in its RBC ratio of 434 percent. In another transaction, the same non-New York-based affiliate entered into a treaty with a different offshore captive reinsurer, whereby a trust used as collateral in the amount of $127,769,311 was funded by surplus notes that had parental indemnification. The insurer reported an increase in its RBC ratio of 360 percent. Also, in another treaty between a non-New York-based affiliate and an affiliated U.S. captive reinsurer, an LOC in the amount of $1.14 billion was used as collateral for reserve credit purposes that had a "contractual parental guarantee."

Case 15

A non-New York-based affiliate of a New York insurer entered into a treaty with an offshore captive reinsurer whereby a trust in the amount of $813 million was used as collateral. The trust was funded from the issuance and guarantee of bonds by the parent of the cedent.

Case 16

Two non-New York-based affiliates of a New York insurer entered into two separate treaties with a U.S. affiliated captive. The reserve credit taken with respect to the two treaties was secured by an Affiliate Guarantee by an entity within the holding company system in the amount of $100.8 million. The amount of the Affiliate Guarantee was recorded as an asset in the financial statements of the reinsurer.

Case 17

A non-New York-based affiliate of a New York insurer entered into a treaty with a U.S.-affiliated captive whereby the reserve credit was secured by an LOC in the amount of $450 million. The LOC is conditional and has a partial contractual parental guarantee for payment of only the LOC fees. The LOC is recorded in the financial statements as an asset of the reinsurer. The insurer reported an RBC increase of 500 percent for this transaction.

* * *

In total, nine New York-based insurers reported that only non-New York-based affiliates in their holding company systems had reinsurance transactions with affiliated captives and offshore reinsurers involving some form of parental guarantee, totaling approximately $15 billion.

Table 7 summarizes the artificial boosts in capital realized from the transactions involving non-New York-based affiliates utilizing parental guarantees, as reported by nine New York-based insurers.

Table 7: Activity limited to Non-New York-Based Affiliates

Case	LOCs with Credit Reimbursement Agreements	Surplus Note Guarantees/ Trust Indemnification	Naked Parental Guarantees	Total Amount of Collateral/ Approximate Reserve Credit	Reported RBC Percent Increase*
Case 9 Affiliates	$4,745,590,260	$2,212,000,000	0	$6,957,590,260	30%
Case 10 Affiliates	0	$1,480,000,000	0	$1,480,000,000	-256%
Case 11 Affiliates	$130,040,984	0	0	$130,040,984	30%
Case 12 Affiliates	$198,000,000	0	0	$198,000,000	3.01%
Case 13 Affiliates	$583,000,000	$3,280,000,000	0	$3,863,000,000	271%
Case 14 Affiliates	$1,173,300,000	$127,769,311	0	$1,301,069,311	794%
Case 15 Affiliates	0	$813,000,000	0	$813,000,000	355%
Case 16 Affiliates	0	0	$100,807,387	$100,807,387	0%
Case 17 Affiliates	$450,000,000	0	0	$450,000,000	500%
Total	**$7,279,931,244**	**$9,167,797,695**	**$100,807,387**	**$15,293,507,942**	

*Amounts are cumulative for all non-New York-based affiliates

New York-based life insurers that only reported activity by non-New York-based affiliates reported increases in RBC for those affiliates ranging from 0 percent to 794 percent in the aggregate (excluding one outlier reporting negative changes). The average increase in RBC was about 248 percent.

II. INVESTIGATION INTO LACK OF TRANSPARENCY SURROUNDING SHADOW INSURANCE

A. Scope of Transparency Investigation

DFS required the 17 New York-based life insurers that reported reinsurance activity utilizing parental guarantees in connection with affiliated captive or affiliated offshore reinsurers to provide additional information. The Department sought to determine the extent that parental guarantees through shadow insurance are disclosed in publicly available documents. To that end, the Department requested the following information:

1. Whether the parental guarantees they reported were specifically disclosed in the ceding insurer's statutory financial statements; in those of any entity within the holding company system; or in any filing that is available to investors, policyholders, or any other segment of the public. If so, what these disclosures were and whether and to what extent reserves have been set aside to support those parental guarantees within the holding company system. If no disclosure was made, the Department requested a detailed explanation as to why not.

2. Whether information regarding the parental guarantees referenced was provided to the ceding insurer's certified public accountants ("CPAs") during their annual review and any such documentation or other information shared with the CPAs. If no information was provided to the CPAs, the Department requested a detailed explanation as to why not. The Department also requested the contact information for the insurer's CPA firm.

B. Findings of Disclosure Inquiry

Of the 17 insurers that responded, the Department carefully reviewed the adequacy and extent of the disclosure. The Department assessed the sufficiency of the disclosures by rating them as either good, fair, or poor. The evaluation criteria are set forth in the following chart.

Disclosure Evaluation Criteria

Type of Disclosure	Information typically included:
"Good"	• Tables (or another clear format) identifying reinsurers in the holding company system that were using LOCs as collateral for reinsurance transactions with affiliates; • Expiration date of the LOCs; • Each reinsurance affiliate's borrowing capacity for LOCs; • Amount of LOCs issued for each reinsurance affiliate; • Amount of draw downs to date on each LOC; • Amount of unused commitments; • Committed borrowing facilities that are used for collateral for affiliated reinsurance liabilities, and lists the fees paid for such facilities; • Identification of the entity that is the ultimate guarantor of the issued LOCs; and • For collateral financing arrangements, description of the reinsurance transaction in detail, the risk-takers and financial institutions involved, financing interest rates, surplus note arrangements, pledges or guarantees, and repayment methods.
"Fair"	• Description, in paragraph form, stating that the ultimate parent maintains LOC facilities with third-party banks to support the reinsurance obligations of onshore captive subsidiaries and/or offshore affiliates. Includes total amounts for all reinsurance captives and how much has been utilized and how much is guaranteed; • Description, in paragraph form, of total amounts of all collateral financing arrangements for all transactions whereby the ultimate parent is the guarantor; and • Moderate detail of certain transactions, but not in an easily understood tabular format.
"Poor"	• Description in paragraph format of the existence by the ultimate parent of credit facilities for general corporate purposes with total amounts committed and utilized; and • Very brief description of reinsurance transactions that are indemnified, or guaranteed by the ultimate parent.

The following table summarizes where the disclosures were made — the statutory annual statement, SEC reporting, and/or consolidated annual report — as well as the amounts of the associated parental guarantees. Only three of the 17 reporting insurers made disclosures in all three places (i.e., statutory statement, SEC filing, and annual report). And only three other insurers made disclosures in even two of the three statements (SEC filing and annual report).

Table 8: Disclosure Request Responses

Guarantee Amounts (Approx.)	Statutory Statement Disclosure	SEC Disclosure	Consolidated Annual Report Disclosure
$12 billion	None	Yes/Good	Yes/Good
$216 million	None	Yes/Good	Yes/Good
$659 million	None	None	None
$10 billion	None	Yes/Fair	None
$2 billion	None	None	None
$8 billion	Yes/Poor	Yes/Poor	Yes/Fair
$652 million	Yes (cedent)/Good	Yes/Good	Yes/Good
$130 million	Yes (parent)/Good	None	None
$1.5 billion	Yes (cedent/reinsurer)/Good	Yes/Poor	Yes/Poor
$450 million	None	Yes/Good	None
$198 million	None	Yes/Good	None
$6.5 billion	None	Yes/Fair	None
$4 billion	None	Yes/Poor	Yes/Poor
$1.3 billion	None	None	Yes/Poor
$813 million	None	None	None
$100 million	Yes (reinsurer)/Fair	None	None
Used Capital Maintenance Agreement	None	None	None

Twelve of the 17 responding insurers stated that they made no disclosure in the statutory financial statements filed with state insurance regulators, *each generally claiming that disclosure of the guarantee obligations of an insurer's ultimate parent company is not required by applicable statutory accounting guidance.*

DFS's investigation revealed that New York-based insurers and their non-New York-based affiliates failed to disclose nearly 80 percent ($38 billion) of the $48 billion in reserve collateral secured by parental guarantees in their statutory annual statements. And even where disclosure may have been made in some form to state insurance regulators, most states have laws that provide for strict confidentiality of the financial information of a captive.

Only five of the 17 responses showed any disclosure in either the cedent's, reinsurer's or ultimate parent's statutory financial statement filed with state insurance regulators. And of those, only three made what DFS considers "good" disclosure.

Ten of the 17 responding insurers asserted that their holding company made relevant disclosures in SEC filings. DFS reviewed those SEC disclosures, however, and found that only five of them were what DFS would consider a "good" disclosure. The other five disclosures were either "fair" or "poor." Seven insurers made no disclosure whatsoever of parental guarantees in any disclosures in their filings with the SEC.

Ten of the 17 responding insurers made no disclosure in their annual reports. While seven stated that they made some disclosure in the annual reports, only three of those were what the Department considers a "good" disclosure.

All 17 of the responding insurers reported that the information concerning their reinsurance collateral arrangements and parental guarantees was provided to their CPAs.

Perhaps most troubling, none of the 17 responses demonstrated that significant reserves or contingent liabilities have been established for the parental guarantees. Sixteen reported no reserves or contingent liabilities whatsoever. One responding insurer, which has about $1.5 billion in total parental guarantees, reported setting up a reserve of only $6 million for one of its guarantees. This lack of reserves for the parental guarantees is exceedingly troublesome because of the potential unfunded liability that would be incurred by the parent company should a drawdown of a letter of credit occur, which could lead to a liquidity issue within the holding company — and thus adversely impact policyholders with ties throughout the holding company system — should a bank demand immediate repayment from the parent company after the drawdown.

III. RECOMMENDATIONS

Given the troubling findings uncovered during its investigation, DFS is taking immediate action and making several recommendations to address the potential risks and lack of transparency surrounding shadow insurance:

- Through its authority under New York Insurance Law, DFS will require detailed disclosure of shadow insurance transactions by New York-based insurers and their affiliates.

- In the interest of national uniformity, the National Association of Insurance Commissioners ("NAIC") should develop enhanced disclosure requirements for shadow insurance across the country.

- The Federal Insurance Office ("FIO"), Office of Financial Research ("OFR"), the NAIC, and other state insurance commissioners should conduct similar investigations to document a more complete picture of the full extent of shadow insurance written nationwide.

- State insurance commissioners should consider an *immediate national moratorium* on approving additional shadow insurance transactions until those investigations are complete and a fuller picture emerges.