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TO THE HOUSE COMMITTEE ON FINANCE

TWENTY-FOURTH LEGISLATURE
Regular Session of 2008

Monday, March 31, 2008
4:30 p.m.
Agenda # 3

TESTIMONY ON SENATE BILL NO. 3023, S.D. 2, H.D. 1 – RELATING TO INSURANCE.

TO THE HONORABLE MARCUS R. OSHIRO AND MEMBERS OF THE COMMITTEE:

My name is J. P. Schmidt, State Insurance Commissioner ("Commissioner"), testifying on behalf of the Department of Commerce and Consumer Affairs ("Department"). The Department strongly supports this Administration bill.

The purpose of this bill is to enhance Hawaii's position as one of the world's leading captive insurance jurisdictions by providing the opportunity for qualified captive organizers to pursue the securitization of insurance risks through a Hawaii-licensed captive insurance company and referred to as a "Special Purpose Financial Captive Insurance Company" ("SPFCIC"). This amended version also provides clarity on sponsored captive insurance companies. The passage of this bill is necessary to keep Hawaii at the forefront of the very competitive national and international captive insurance industry.

Securitization is a financing process that basically allows a company to obtain current funding from illiquid assets that cannot be readily sold or converted to cash. Large national and international insurance companies utilize special purpose vehicles, including SPFCICs, to issue securities to sophisticated capital market investors, and then use the proceeds from the securities to fund their respective operations and/or reserves. This measure proposes to add a new part to Hawaii's existing captive insurance laws to specifically provide for the organization, licensing, operation and regulation of SPFCICs in Hawaii.

The demand for implementing SPFCIC insurance securitization by domestic U.S. life insurers has been very strong over the last three years, with over two dozen transactions involving just over $10.5 billion. The demand for this type of transaction is anticipated to continue for the next several years as life insurers have to increase their reserves to meet new regulatory reserving standards, as well as catastrophic mortality risks prompted by terrorism and pandemics such as bird flu. SPFCICs are also being explored for other sectors including auto insurance, mortgage insurance and health insurance.

SPFCIC legislation has already been enacted in states that compete with us for captives. These states include South Carolina (enacted in 2002); Vermont, D.C., Delaware (enacted in 2007); Michigan, Utah, Missouri and Kentucky (just enacted in 2008). Thus it is very important for us to clarify our captive laws to specifically allow for this use of captives, and keep pace with this dynamic industry.

This amended version of the bill also provides an important and timely update for "sponsored captive insurance companies". Sponsored captives are organized by financially strong and operationally stable companies, and allow for the segregation of assets and liabilities ("cells") to insure the risks of the sponsor or those of its customers and clients. This type of captive was enacted in our captive laws in 1999 and was referred to as "Class 4 Leased Capital Facilities". At the time, our "Leased Capital Facilities" was one of the first of its kind in the U.S. and has been used by about 3 captives in Hawaii. However, as the U.S. captive industry has evolved over the last few years, these types of captives have been more commonly referred to as "sponsored captives". These types of captives can be used to insure risks of smaller companies and organizations that may not be large or sophisticated enough to fund their own captive.

Since the enactment of our initial captive insurance laws in 1986, Hawaii has developed locally based professionals with specialized expertise who prudently develop, manage and administer this special kind of insurance companies. These individuals are employed in the Hawaii offices of local, national and international companies that provide specialized captive insurance accounting, management, legal, insurance consulting, and banking and investment management services. It is estimated that there are in excess of 100 full time professionals who work directly in Hawaii's captive industry to develop, as well as, maintain compliance with our captive laws and regulations.

Our Captive Insurance Administration Branch has also evolved into one of the leading and respected regulators for captive insurance business, and has the organizational and operational structure to ensure a consistent and prudent regulatory approach for the long term. It is headed by a Deputy Commissioner with over 8 years in captive insurance regulation, and, prior to that, 15 years in insurance operations, captive management, and public accounting. The branch also has 8 full time examiners, including CPAs and CFEs, who work exclusively on the monitoring and surveillance of captive insurance licensees.

For the year 2006, there were 160 actively licensed captives that wrote $1.7 billion in premiums, and had total combined assets of $6.4 billion, of which about $1.1 billion was invested in or through local Hawaii banks and financial institutions.

With the continued foresight and support of this legislature, we can expect our captive industry to continue to be one of the top locations in the world for this special kind of business, as well as to contribute to sustained diversification of our State's economy and professional talents.

We thank this Committee for the opportunity to present testimony on this matter and ask for your favorable consideration.

HAWAII CAPTIVE INSURANCE COUNCIL

P.O. Box 2815
Honolulu, Hawaii 96803

TESTIMONY IN SUPPORT OF
S.B. NO. 3023 S.D. 2

HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCE
Representative Marcus Oshiro, Chair
Representative Marilyn B. Lee, Vice Chair

Monday March 31, 2008
State Capitol, Conference Room 308

My name is Denys Kazama, Chair of the Legislative Committee of the Hawaii Captive Insurance Council. As a member of the Hawaii Captive Insurance Council ("HCIC") and Office Head of Marsh Management Services Inc., we thank you for the opportunity to provide this written testimony. HCIC's members represent 164 active captive insurance companies domiciled in the State of Hawaii, and many of the financial institutions, captive insurance managers, accountants, and other professionals and entities that service these Hawaii-domiciled captive insurance companies. Many of these service providers are Hawaii residents.

We strongly support S.B. No. 3023 S.D. 2, which would keep Hawaii competitive as a leading captive insurance domicile in the U.S. and throughout the world. Special Purpose Financial Captive Insurance Companies (SPFCIC) will allow national and international insurance companies to provide securitization of insurance risks through a Hawaii captive insurance company. Allowing SPFCIC's will demonstrate the State's continuing support of the captive industry by ensuring our captive laws reflect the flexibility and progressiveness companies seek when assessing domiciles. It will also allow Hawaii to remain competitive against other domiciles worldwide that have similar provisions for SPFCIC's in their law.

During the 20 years since the captive law was enacted, the captive industry has provided various benefits to the State of Hawaii. While the industry contributes to Hawaii's economy through the professional jobs created in the finance, legal and accounting industries and the billions of dollars in deposits with local financial institutions, it promotes an image of Hawaii as more than a visitor destination. It promotes our business environment as Hawaii is ranked as a one of the leading captive domiciles in the world. Prudent and flexible regulation by the Insurance Division has ensured the State of Hawaii a reputation sought after by today's corporations who are often concerned about corporate governance and perceptions.

Hawaii's captive infrastructure of experienced service providers monitor and assess the reasonableness of the captives proposed for the State prior to submitting business plans to the State of Hawaii. While the growth of the industry is an important factor to many of our members, we value the outstanding reputation Hawaii has as a well-regulated and flexible domicile. We recognize it is this reputation that ensures Hawaii's future growth.

This is a critical time for Hawaii's captive insurance industry. By passing this bill you will ensure that Hawaii's captive industry will continue to thrive and develop in an increasingly competitive marketplace. .

We are in strong support of this bill and urge the Committee to pass S.B. No. 3023. S.D. 2. Thank you for this opportunity to testify.

Respectfully submitted,

Denys Kazama
Chair, Legislative Committee, Hawaii Captive Insurance Council
Office Head, Marsh Management Services Inc.

TESTIMONY ON S.B. NO. 3023, S.D. 2, H.D. 1
RELATING TO INSURANCE

HOUSE COMMITTEE ON FINANCE
Rep. Marcus R. Oshiro, Chair
Rep. Marilyn B. Lee, Vice Chair

Monday, March 31, 2008, 4:30 p.m.
State Capitol, Conference Room 308

WRITTEN TESTIMONY ONLY

My name is Gerald C. Yoshida, an attorney in the Honolulu law firm of Char Hamilton Campbell & Yoshida. Our firm provides legal services to a number of captive insurance companies currently licensed in the State of Hawaii. I am also Chairman of the Hawaii Captive Insurance Council (HCIC), a trade organization of captive insurance companies and service providers who comprise and support Hawaii's captive insurance industry.

We strongly support S.B. No. 3023, S.D. 2, H.D. 1, which would promote the diversification and development of Hawaii's captive insurance industry by providing for the securitization of insurance risks through a Hawaii captive insurance company and clarifying the law with regard to class 4 or "sponsored captive insurance companies."

This bill authorizes the creation of Special Purpose Financial Captive Insurance Companies (SPFCICs), which would allow national and international insurance companies to provide the securitization of insurance risks through a Hawaii captive insurance company. As Hawaii faces increasing competition from other states, many of which already allow securitization, HCIC is concerned that the failure to pass this bill may jeopardize Hawaii's position as a leader in the captive arena.

During the 20 years since Hawaii's captive law was first enacted, the captive industry has provided numerous benefits to the State of Hawaii: through the generation of jobs requiring expertise in the areas of finance, law and accounting and through the investment of billions of dollars deposited with local financial institutions. As one of the leading captive domiciles in the world, the captive industry has helped promote Hawaii's image as more than a visitor destination. Prudent and flexible regulation by the Insurance Division has helped Hawaii secure a solid reputation as domicile that is sought after by many Fortune 500 corporations who are concerned about corporate governance and perceptions.

Hawaii's captive infrastructure is composed of experienced and responsible service providers who monitor and assess the reasonableness of proposed business plans prior to submitting those plans to the State of Hawaii. While the growth of the industry is a priority to many of HCIC's members, we value and are proud of Hawaii's reputation as a well-regulated and flexible domicile. We recognize that it is this reputation that ensures that our industry will continue to flourish in an increasingly competitive marketplace.

Thank you for this opportunity to submit testimony.

Respectfully submitted:

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Char Hamilton Campbell & Yoshida
737 Bishop Street, Suite 2100
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TESTIMONY OF JASON L. PALMER, CPA

TESTIMONY IN SUPPORT OF
SB 3023, SD2, HD1

HOUSE COMMITTEE ON FINANCE
Rep. Marcus R. Oshiro, Chair
Rep. Marilyn B Lee, Vice Chair

Monday, March 31, 2008, 4:30 p.m.
State Capitol, Conference Room 308

My name is Jason L. Palmer, CPA, Managing Director of Willis Management (Hawaii), a division of Willis, the third largest global insurance broker in the world. Willis Management (Hawaii) serves as a consultant and captive manager to several captive insurance companies domiciled in Hawaii and in other US jurisdictions. In addition, I am a Director and Officer of the Hawaii Captive Insurance Council ("HCIC") and a Director of several captive insurance companies licensed in Hawaii.

We strongly support SB 3023, SD2, HD1, which would help Hawaii in continuing to be a leading captive insurance domicile worldwide and also ensure that Hawaii remains a competitive captive domicile in maintaining captive insurance companies already domiciled in Hawaii, and attracting new captive formations in the future.

During the 20 years since the captive law was enacted, the captive industry has provided various benefits to the State of Hawaii. While the captive industry contributes to Hawaii's economy through the professional jobs created in the finance, legal and accounting industries and the billions of dollars in deposits with local financial institutions, more importantly it promotes an image of Hawaii as more than a visitor destination. Hawaii is ranked as a one of the leading captive domiciles in the world. Prudent and flexible regulation by the Insurance Division has ensured the State of Hawaii a reputation sought after by today's corporations who are often concerned about corporate governance and perceptions.

Although Hawaii is the second largest captive insurance domicile in the United States, the State faces increasing competition from other states that have recognized the value of implementing captive insurance enabling regulations. While there were only a handful of captive insurance domiciles when Hawaii licensed its first captive insurance company in 1987, there are now over 30 U.S. jurisdictions that have enacted captive insurance legislation. Over the past several years, amongst this competitive landscape, Hawaii has clearly fallen behind, while new formations within the State of Hawaii have been weak, other jurisdictions such as Arizona and Nevada have had very strong results, exhibiting a more attractive captive domicile. While we understand and support the need for good regulation, it is our opinion that the proposed legislation still provides for such while providing the flexibility that our industry warrants.

We strongly support SB 3023, SD2, HD1, which would keep Hawaii competitive as a leading captive insurance domicile in the U.S. and throughout the world. Special Purpose Financial Captive Insurance Companies (SPFCIC) will allow national and international insurance companies to provide securitization of insurance risks through a Hawaii captive insurance company. Allowing SPFCIC's will demonstrate the State's continuing support of the captive industry by ensuring our captive laws reflect the flexibility and progressiveness companies seek when assessing domiciles. It will also allow Hawaii to remain competitive against other domiciles worldwide that have similar provisions for SPFCIC's in their law.

Hawaii's captive infrastructure of experienced service providers monitor and assess the reasonableness of the captives proposed for the State prior to submitting business plans to the State of Hawaii. While the growth of the industry is an important factor, most so we value the outstanding reputation Hawaii has as a well-regulated and flexible domicile. We recognize it is this reputation that ensures Hawaii's future growth.

SPFCICs have become a common form of captive organization and reflect the growing use of capital markets and securitization strategies by captive insurers. Unfortunately, since Hawaii Revised Statutes do not specifically allow for the formation of SPFCICs, Hawaii is currently unable to compete with other captive domiciles for this type of business. If this law is not passed, Hawaii will inevitably fall behind other captive domiciles that currently allow the types of structures contemplated by this legislation.

In 1999 Hawaii was one of the first U.S. captive domiciles to pass legislation allowing leased capital facilities (Class 4). Since that time the captive industry has migrated from "leased capital facilities" to "sponsored captives" and therefore we support the legislative action to update our current Class 4 captive language to that more commonly utilized in the industry. In addition, "sponsored captives" are more predominantly utilized by smaller companies. We feel that this may increase access to a captive insurance alternative risk vehicle to middle market clients (many of which are located here in Hawaii and/or in Japan).

Hawaii has become one of the most respected captive domiciles in the world due to the common sense regulation and flexibility granted within our captive statutes by the legislature. This flexibility is absolutely necessary for these specialized types of insurance companies due to constantly changing environment that we work in, not to mention the growing sophistication of our captive owners. To not pass this bill at this critical juncture would send a message to the world that Hawaii no longer supports captive insurance companies.

This is a critical time for Hawaii's captive insurance industry. By passing this bill you will ensure that Hawaii's captive industry will continue to thrive and develop in an increasingly competitive marketplace. We are in strong support of this bill and urge the Committee to pass SB 3023, SD2, HD1. Thank you for this opportunity to testify in support of SB 3023, SD2, HD1.

Respectfully submitted:

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ARTEX

TESTIMONY ON S.B. NO. 3023 S.D. 2 H.D. 1

HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCE
Rep. Marcus R. Oshiro, Chair
Rep. Marilyn B. Lee, Vice Chair

31st day of March, 2008, 4:30 p.m.
State Capitol, Conference Room 308

My name is Fay Okamoto, Division Senior Vice President of Artex Risk Solutions, Inc., a subsidiary of Arthur J. Gallagher & Co., the world's fourth largest insurance brokerage firm. We currently serve as the captive manager of fifteen captive insurance companies domiciled in the State of Hawaii, writing close to $120 million in annual premiums.

We strongly support S.B. No. 3023 S.D. 2 H.D. 1, which would support the formation of Special Purpose Financial Captive Insurance Companies for national and international insurance companies to provide securitization of insurance risks through a Hawaii captive insurance company. This bill seeks to provide more specific language for this type of captive, which would be viewed favorably by organizers of these captives . There is increased interest in this type of captive in other captive domiciles.

S.B. 3023 S.D. 2 H.D. 1also includes an amendment related to Class 4 captives (formerly called "leased capital facilities, now proposed to be referred to as "sponsored captives"). This amendment again clarifies language related to this type of captive and reduces the minimum capital requirement from $1,000,000 to $500,000.

Hawaii has a solid reputation for fair and prudent regulation of captive insurance companies, supported by a knowledgeable infrastructure of captive managers and other service providers. There are many checks and balances operating in the current infrastructure, between the private sector and the captive regulatory branch of the Insurance Division to ensure that our captives operate in a prudent manner. Everyone involved in the industry recognizes the importance of maintaining that reputation.

At this juncture, Hawaii is faced with significant competition to attract captive insurance companies to domicile in our state. It is critical that Hawaii maintains its status as a leading domicile for captives.

The Hawaii captive insurance industry supports and provides employment of accounting, insurance, legal, auditing, tax, and banking professionals. We respectfully request your continued support of this vital and ever-changing industry for the State of Hawaii. Thank you for this opportunity to submit testimony on this bill.

Respectfully submitted:

Fay Okamoto

Fay Okamoto
Artex Risk Solutions, Inc.

RAA
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COMMITTEE ON FINANCE, 2008
HAWAII HOUSE OF REPRESENTATIVES
March 31, 2008 (Agenda #3)

Testimony on **SB 3023**, Requesting Amendments

Mr. Chairmen and Members of the Committees:

On behalf of the members of the Reinsurance Association of America ("RAA"), we respectfully submit these comments on Hawaii House of Representatives bill S.B. No. 3023 (the "Bill").

The RAA is a national trade association representing property and casualty organizations that specialize in reinsurance. The RAA membership is diverse, including large and small, broker and direct, U.S. companies and subsidiaries of foreign companies. RAA underwriting members and their affiliates write more than two-thirds of the gross reinsurance coverage provided by U.S. professional reinsurance companies.

Background

Under SB 3023 "special purpose financial captives" or "SPFCs." would be permitted. These SPFCs would enable insurers to: (a) transfer certain insurance risks to the broader financial markets; and (b) get insurance financial statement credit for the risk transferred. Conceptually, increasing reinsurance capacity and spreading risk is good.

The Issue

The Bill gives the insurance commissioner essentially unlimited power to authorize special purpose financial captives to provide reinsurance to insurers. Captives, including special purpose financial captives, have a lower capital requirement and weaker financial standards than regular licensed insurers. Licensed insurers are subject to much more conservative financial standards. The apparent logic is that these captives are related to their policyholders in some way and that the policyholders know of the risk presented and are willing to accept it.

In the case of special purpose financial captives, the commissioner can authorize an SPFC to reinsure any or all insurance companies, despite having smaller capital requirements and weaker solvency standards. The RAA believes such discretion is only appropriate where there is a significant connection or nexus between the ceding insurer and the SFPC. Such a connection lessens the likelihood that the SPFC will be permitted to fail, ultimately harming unknowing consumers and innocent third parties.

The Solution

Requiring a connection between the SPFC and its ceding insurer and strengthening the SPFC's financial foundation will result in a better regulatory environment that will work for captives, their sponsors, and innocent consumers and third parties.

Unaffiliated Transactions Should Not Be Permitted

Section 431:19-D of the Bill states that a Special Purpose Financial Captive insurance company may only insure or reinsure the risks of its counterparty. Section 431:19-C defines "Counterparty" as "the insurer that cedes risk to a special purpose financial captive insurance company which, unless otherwise approved by the commissioner, shall be the parent or an affiliated company of the special purpose financial captive insurance company."

An SPFC should be permitted only to insure or reinsure the risks of its affiliates, parents or other insurance company that sponsored the SPFC. Otherwise, an SPFC essentially becomes a general purpose reinsurer rather than a captive, but is allowed to operate under a different, weaker set of solvency requirements. Moreover, there are no parameters or standards that a commissioner must follow in exercising his discretion under this provision.

Action

The RAA recommends that Section 431:19-C be amended as follows:

"'Counterparty' means the insurer that cedes risk to a special purpose financial captive insurance company which~~, unless otherwise approved by the commissioner,~~ shall be the parent, ~~or~~ an affiliated company **or the insurance company sponsor** of the special purpose financial captive insurance company."

Minimum Capital and Surplus Requirement Should Be In Cash

Section 431:19G provides that a SPFC must maintain "unimpaired capital and surplus of not less than $250,000 in the form of cash or other assets approved by the commissioner."

This minimum capital and surplus should be maintained in cash or in a cash equivalent. As with other insurers, it is important to ensure that the SPFC maintains a degree of liquidity in the event the SPFC finds itself in financial difficulties. Discretion should not be given to the commissioner to waive this important requirement. Moreover, "assets" is not defined and therefore may not be limited to a cash equivalent.

Action

The RAA recommends that Section 431:19-G be amended as follows:

"Minimum capital and surplus. A special purpose financial captive insurance company shall not be issued a license unless it possesses and thereafter maintains unimpaired capital and surplus of not less than $250,000 in the form of cash or **<u>a cash equivalent</u>** ~~other assets~~ approved by the commissioner."

<u>Debt Securities Should Be Accounted For As Debt and Not Surplus</u>

Section 431:19H of the Bill provides that the SPFC may, "[s]ubject to the approval of the Commissioner, account for the proceeds of surplus notes as surplus."

Debt securities should be accounted for as debt, not as surplus. If this language were adopted, it could allow double counting of and artificially inflate surplus.

Action

We recommend that Section 431:19H of the Bill be deleted in its entirety, as follows:

"~~Subject to the approval of the Commissioner, account for the proceeds of surplus notes as surplus.~~"

<u>SPFCs Should Be Required To Comply With the Captive Laws of Hawaii</u>

Section 431:19-B(c) provides that the commissioner may exempt a SPFC from any provision of this article or from any rule adopted pursuant to Section 431:19-114.

While we understand the desire to create a cutting edge financial services domicile, this section is overly broad and gives the commissioner unfettered discretion without regard for Hawaii's captive laws. Merely a few bad decisions rendered under this extremely open-ended discretion could wreak havoc on the captive market and the Hawaii insurance industry as a whole. The RAA would suggest deleting this section in its entirety. In the alternative, this section at a minimum should list which provisions the commissioner has discretion to waive.

Action

The RAA recommends that Section 431:19-B(c) be deleted in its entirety, as follows:

"~~The commissioner may, by order, exempt a special purpose financial captive insurance company from any provision of this article or from any rule adopted pursuant to section 431:19-114 if the commissioner determines the provision to be inappropriate, given the nature of risks to be insured by the special purpose financial captive insurance company or its approved plan of operation.~~"

Conclusion

Thank you for the opportunity to present the views of the RAA. Please feel free to contact us or Linda Chu Takayama at (808) 384-9030 if you have questions or need further information.

Sincerely,

Dennis C. Burke
Vice President and Director of State Relations

Kimberly M. Welsh
Assistant Vice President and Assistant General Counsel

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