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Seeking Business, States Loosen Insurance Rules

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Companies looking to do business in secret once had to travel to places like the Cayman Islands or Bermuda.

Today, all it takes is a trip to Vermont.

Vermont, and a handful of other states including Utah, South Carolina, Delaware and Hawaii, are aggressively remaking themselves as destinations of choice for the kind of complex private insurance transactions once done almost exclusively offshore. Roughly 30 states have passed some type of law to allow companies to set up special insurance subsidiaries called captives, which can conduct Bermuda-style financial wizardry right in a policyholder's own backyard.

Captives provide insurance to their parent companies, and the term originally referred to subsidiaries set up by any large company to insure the company's own risks. Oil companies, for example, used them for years to gird for environmental claims related to infrequent but potentially high-cost events. They did so in overseas locations that offered light regulation amid little concern since the parent company was the only one at risk.

Now some states make it just as easy. And they have broadened the definition of captives so that even insurance companies can create them. This has given rise to concern that a shadow insurance industry is emerging, with less regulation and more potential debt than policyholders know, raising the possibility that some companies will find themselves without enough money to pay future claims. Critics say this is much like the shadow banking system that contributed to the financial crisis.

Aetna recently used a subsidiary in Vermont to refinance a block of health insurance policies, reaping $150 million in savings, according to its chief financial officer, Joseph M. Zubretsky. The main reason is that the insurer did not need to maintain conventional reserves at the same level as would have been required by insurance regulators in Aetna's home state of Connecticut.

In other big transactions, companies including MetLife, the Hartford Financial Services Group, Swiss Reinsurance, Genworth Financial and the American International Group, among others, have refinanced life, disability and long-term-care insurance policies, as well as annuities.

For the states, attracting these insurance deals promotes business travel and creates jobs for lawyers, actuaries and other white-collar workers, who pay taxes. States have also found that they can impose modest taxes on the premiums collected by captives.

For insurers, these subsidiaries offer ways to unlock some of the money tied up in reserves, making millions available for dividends, acquisitions, bonuses and other projects. Three weeks after Aetna's deal closed, the company announced it was increasing its dividend fifteenfold.

And as changes to the nation's health systems are phased in, such innovations might even help hold down the cost of insurance for consumers, much as selling pooled mortgages to investors has made buying a home less expensive.

The downside, though, is that the states are offering a refuge from other states' insurance rules, especially the all-important ones requiring companies to have sufficient reserves. California, for one, has already chosen not to try to lure such businesses. "We are concerned about systems that usher in less robust financial security and oversight," said Dave Jones, the California insurance commissioner.

While saying that he wanted to remain open to innovation, Mr. Jones added, "We need to ensure that innovative transactions are not a strategy to drain value away from policyholders only to provide short-term enrichment to shareholders and investment bankers."

The cost of some of the deals has been considerable. In 2008, MetLife used a subsidiary in Vermont to handle a crucial $3.5 billion letter of credit, with help from Deutsche Bank, because the subsidiary was not subject to the same collateral requirements as in New York. The trade immediately bolstered MetLife's balance sheet, helping the company to endure that year's market turmoil without government assistance. But MetLife agreed to pay Deutsche Bank $3.5 million a year for 15 years, according to internal documents obtained by The New York Times — locking itself into high costs for years.

MetLife said its transaction was in keeping with industry rules and norms, and Deutsche Bank declined to comment.

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Another issue is public oversight. State regulators normally require insurance companies to make available reams of detailed information. A policyholder can find every asset in an insurer's investment portfolio, for instance, or the company the carrier turns to for reinsurance. But not if the insurer relies on a captive. The new state laws make the audited financial statements of the captives confidential.

A.I.G. illustrates the kind of secrets companies can keep. One of its many lines of business involves a mortgage insurance unit, based in North Carolina but with affiliates as far away as Australia. The unit promised to keep making payments when homeowners defaulted, but nearly failed when the housing bubble burst in 2008 and claims poured in.

Normally, state regulators shut down insolvent insurers, but Vermont saved the day. It allowed A.I.G. to create a subsidiary, called MG Reinsurance, that took on $7 billion worth of insurance claims. Getting the claims off the books of the North Carolina unit made it solvent again, so it could keep selling more policies.

A.I.G.'s mortgage insurance affiliates in Europe and Australia sent the Vermont captive even more obligations, making the transfers retroactive to Jan. 1, 2009, even though MG Reinsurance was not licensed until May. That turned what would have been big losses into a modest profit for A.I.G.'s offshore mortgage insurers.

Vermont's confidentiality rules make it impossible to find out how MG Re is juggling all that debt. A.I.G. is liable, but for now the problem is hidden away.

A.I.G. confirmed it was responsible for the pending claims but declined to comment further.

David F. Provost, the deputy commissioner of captive insurance in Vermont, said he believed confidential treatment was appropriate because these entities were, in essence, insurance companies with only one policyholder — their parent. He said Vermont's large and experienced staff of regulators vetted all transactions carefully to make sure they were sound.

Furthermore, he said, his staff worked with less experienced states to help them avoid undue risks. "We try to make sure that everybody does a good job," Mr. Provost said.

Vermont sought the business in a big way back in 2001, when Governor Howard Dean announced the state would take on Bermuda. Before long, the taxes it levied on the insurance premiums collected by captives, as well as from additional fees, were enough to cover 2 percent of state spending. Vermont also credits these insurance subsidiaries for the creation of 1,400 full- and part-time jobs, and for roughly $1 billion deposited with banks and other financial institutions.

Perhaps more important, Vermont redefined the term "captive" to include subsidiaries of insurance companies.

"It is no longer 'captive' insurance," said Thomas D. Gober, a financial fraud examiner who specializes in complex reinsurance transactions. "It's now billions of dollars from all over the country, yet it's still being regulated lightly, as if it's captive."

Other states took note of Vermont's success. Hawaii charged lower taxes than Vermont on the revenue that captives took in on premiums, leading Vermont to reconsider its rates. Delaware gave its insurance commissioner the power to exempt a captive from provisions of state insurance law; the number of captives in the state doubled last year.

New Jersey, the latest entrant, offered to cap its tax on such subsidiaries at $200,000 a year. Michigan decided not to tax them at all, but charged a modest fee. Nevada passed a law allowing captives to be formed with as little as $200,000 in capital.

And now Aetna may not have to look outside its home state at all, as Connecticut has adopted a law allowing onshore captives.