FSM CAPTIVE INSURANCE REGULATIONS

I. **Purpose and Authority.** The purpose of these regulations is to set forth the financial, reporting, record-keeping, and other requirements which the Commissioner deems necessary for the regulation of captive insurance companies, as authorized by 37 F.S.M.C. 1016.

II. **Definitions.** For purposes of these Regulations:

"Adverse financial condition" means one or more of the following conditions:

A. The impairment of capital resulting from an imbalance of liabilities and assets;
B. Financial ratios exceeding levels established by the Commissioner, or
C. The material degradation of financial results envisioned by the designated captive insurance manager or certified public accountant through predictive forecasting.

"Captive" means a captive insurance company or companies, as applicable, licensed by the FSM.

"Commissioner" means the Banking and Insurance Commissioner of the FSM or his duly authorized representative.

III. **Force and Effect.** These regulations and any amendments hereto shall have the force and effect of law.

IV. **Severability.** If any parts of these Regulations are held ineffective, void or otherwise inactive, the remaining regulations shall continue unaffected.

V. **Application Forms.** Forms for licensing of Captives shall be those set found under the Captive Insurance Company application package.

VI. **Annual Reporting Requirements.** All Captives shall have an annual audit, which shall be part of the Captive's annual report of financial condition, prepared by an Independent Certified Public Accountant, approved by the Commissioner, and shall file such audited financial report with the Commissioner within ninety (90) calendar days following the fiscal year-end of the Captive. The annual audit shall consist of the following:

A. Opinion of Independent Certified Public Accountant
   1. Financial statements shall be examined by the independent certified public accountant in accordance with generally accepted auditing standards as determined by the Institutes of Chartered Accountants, American Institute of Certified Public Accountants, or Japanese Institute of Certified Public Accountants.
   2. The opinion of the independent certified public accountant shall cover all years presented.

3. The opinion shall be addressed to the board of directors of the Captive on stationery of the accountant showing the address of issuance shall bear the original manual signatures and shall be dated.
4. The opinion shall contain an evaluation of management (including the members of the board of directors, officers and/or insurance manager of the Captive) experience, ability and control.

B. Report of Evaluation of Internal Controls
1. This report shall include an evaluation of the internal controls of the Captive relating to the methods and procedures used in the securing of assets and the reliability of the financial records, including but not limited to such controls as the system of authorization and approval and the separation of duties.
2. The review shall be conducted in accordance with generally accepted auditing standards and the report filed with the Commissioner.

C. Accountant's Letter
1. The independent certified public accountant shall furnish the Board of Directors of the Captive, for inclusion in the filing of the audited annual report, a letter stating:
   a) That he is independent with respect to the Captive, its parent and subsidiaries and conforms to the standards of his profession as contained in the Code of Professional Ethics and pronouncements of the American Institute of Certified Public Accountants, Japan Institute of Certified Public Accountants, Institute of Chartered Accountants or other such professional accountancy body as approved by the Commissioner.
   b) The general background and experience of the staff engaged in audit including the experience in auditing captives and other insurance companies.
   c) That the accountant understands that the audited annual report and his opinions thereon will be submitted to the Insurance Board of the Federates States of Micronesia.
   d) That the accountant consents to the requirements of Section 10 of this regulation and that the accountant consents and agrees to make available for review by the Commissioner, his designee or his appointed agent, the work papers as defined in Section 10.
   e) That the accountant is properly licensed and/or authorized by and in good standing with Institutes of Chartered Accountants, American Institute of Certified Public Accountants or the Japanese Institute of Certified Public Accountants, or other qualified accountant as recognized by the Commissioner and Insurance Board.

D. Financial Statements, which shall include:
1. Balance sheet;
2. Statement of gains or losses from operations;
3. Statement of changes in financial position;

4. Statement of changes in capital paid up, gross paid in and contributed surplus and unassigned funds (surplus)
5. Notes to financial statements as required by generally accepted accounting principles, international accounting standards or other basis of accounting as approved by the Commissioner, including:
   a) A summary of ownership and relationship of the company and all affiliated corporations or companies insured by the captive.
   b) A narrative explanation of all material transactions and balances with the company.

E. Certification of Loss Reserves and Loss Expense Reserves
1. The annual audit shall include an opinion as to the adequacy of the Captive's loss reserves and loss expense reserves, such opinion shall be supported by appropriate data and analysis.
2. The individual who certifies as to the adequacy of reserves shall be approved by the Commissioner and shall be a member in good standing of the Institute of Actuaries, Institute of Actuaries of Japan, American Academy of Actuaries, or an individual who has satisfactorily demonstrated his competence in loss reserve evaluation to the Commissioner.
3. Certification shall be in such form as the Commissioner deems appropriate.

VII. **Designation of Independent Certified Public Accountant.** A Captive shall submit a written application (see attached Schedule H-1) to the Commissioner for his approval the name and address of the independent certified public accountant which it proposes to retain to conduct the annual audit.

VIII. **Notification of Adverse Financial Condition.** A Captive shall require the certified public accountant to immediately notify an officer or the insurance manager and all members of the Board of Directors of the Captive in writing if it determines through the conduct of its audit that the Captive has materially misstated its financial condition or that, since its last financial report to the Commissioner the Captive has experienced results which lead the certified public accountant to the determination that the Captive is in adverse financial condition. The Captive shall forward such written notification by the certificated public accountant to the Commissioner within five (5) working days of receipt thereof.

IX. **Minimum Capital.** The minimum capital required for Captive Insurance Company is:

A. For a Class 1 Captive - $100,000.
B. For a Class 2 Captive - the greater of:
1. $100,000;
2. twenty percent (20%) of net premium income; or
3. five percent (5%) of the value of loss reserves.

X. **Solvency Margin.**

The minimum margin of solvency for a captive insurer is the amount by which the total value of the insurer's assets must exceed the total amount of its liabilities.

A. The solvency margin of a captive insurer in any year is an amount equal to the greater of:
   1. Twenty percent (20%) of the net premium income; or
   2. Five percent (5%) of the value of loss reserves.

B. In calculating the value of assets of a Captive, for the purpose of meeting the minimum capital requirement the following assets are allowable:
   1. Those investments specified under Section 1013 of the captive law.
   2. Cash in hand or on deposit in a financial institution approved by the Commissioner;
   3. Irrevocable letters of credit issued by financial institutions approved by the Commissioner. A letter of credit must be in the form and content as provided in Schedule J-1 to be acceptable for purposes of meeting the minimum capital and surplus requirements of 37 F.S.M.C 1007.
   4. Securities quoted on a stock exchanged approved by the Commissioner, but not exceeding seventy percent (70%) of the quoted market value;
   5. Premiums receivable;
   6. Reinsurance balances receivable;
   7. Accounts receivables net of provisions for bad debts;
   8. Any other assets specifically approved by the Commissioner.

C. If the total allowable assets of a captive insurer fall below the value required to maintain the insurer's minimum margin of solvency, the insurer must , as soon as reasonably practicable rectify the deficiency and notify the Commissioner.

XI. **Loss Reserves.**

The reserves for unexpired risks, outstanding claims and contingencies to be maintained by captive insurance companies under the Act shall be;

1. For unexpired risks
   a) On all business, using the 365th method on net premiums; and
   b) Any other actuary approved method.
2. For outstanding claims, the total estimated amount of all outstanding claims plus 20% of the estimated amount of outstanding claims at the end of the last preceding year to cover claims incurred but not reported (IBNR).
3. For contingency, not less than 3% of the total premiums, if required by the Insurance Board.

XII. **Availability and Maintenance of Work Papers of the Independent Certified Public Accountant.**

A. Each Captive shall require its independent certified public accountant to make available for review by the Commissioner or his appointed agent the work papers prepared in the conduct of the annual statement and the audit of the Captive. The

Captive shall require that the accountant retain the audit work papers for a period of not less than five (5) years after conclusion of transactions to which they relate.

B. The review conducted in (a) above shall be considered to be an investigation and all work papers obtained during the course of that investigation shall be confidential in accordance with 37 F.S.M.C. Section 1004. The Captive shall require that the certified public accountant provide photocopies of any and all work papers that the Commissioner deems relevant. These copies may be retained by the Commissioner.

C. "Work papers" as referred to in this section include, but are not limited to, schedules, analyses, reconciliations, abstracts, memoranda, narratives, flow charts, copies of company records, or other documents prepared or obtained by the accountant in the conduct of the investigation of the Captive.

XIII. Documentation Required to be Held in FSM.

A. All Captives licensed by the FSM shall maintain and have available for inspection and examination by the independent certified public accountant, the Commissioner, or the Commissioner's agent, any and all documents pertaining to the formation, operation, management, finances, insurance, and reinsurance of each Captive.

B. Original documents may be kept in the offices of the Captive manager, the Captive's parent, or the Captive itself. Accurate and complete copies shall be held in a FSM office designated by the Captive and approved by the Commissioner. The documents shall include but are not limited to the following:

1. Regulatory records:
   - a) Certificate of authority;
   - b) Certificate of public good;
   - c) Articles of incorporation and by-laws;
   - d) Corporate resolutions and minutes;
   - e) Full application for admission and related documents, and all changes and amendments to application;
   - f) All filings and correspondence with other jurisdictions;
   - g) Annual reports filed with the FSM Insurance Board since the Captive insurance company's commencement of business; and
   - h) Correspondence with the Commissioner, the FSM Insurance Board and its advisors.
2. Loss and expense records:
   - a) Reports certifying loss reserves, allocated loss adjustment expense reserves and rates by an actuary in accordance with 37 F.S.M.C. Section 1010(c);
   - b) Incurred loss reports (loss runs) including:
     - (1) Claim numbers;
     - (2) Occurrence dates
     - (3) Report dates;
     - (4) Lines of coverage;

(5) Payments to date;
(6) Reserve amounts;
(7) Date closed;
(8) Policy periods; and
(9) Loss valuation dates;

c) Schedule of subrogation, salvage, reinsurance, or recoverables;
d) Claim file summaries and correspondence; and
e) Summary narrative review of each large loss (exceeding ten percent of retention).

3. Accounting files:
   a) Audited annual financial statements since start-up;
   b) Auditors' opinion letters and reports;
   c) Charts of general ledger accounts;
   d) Ledgers (general, payable, receivable)
   e) Journals (general, cash receipts, disbursements)
   f) Documentation supporting accounting records;
      (1) Bank statements and reconcilements;
      (2) Checks and deposit slips;
      (3) Signature authorization cards and board resolutions of approval;
      (4) Letters of credit and other approved securities of guarantees, with board approvals;
      (5) Investment statements, documentation, including brokerage receipts, with board approvals;
      (6) Premium invoices, deferrals, and payment plans;
      (7) Deferred start-up/acquisition cost statements, with board approval; and
      (8) Schedule of premium taxes and fees paid and payable.
4. Fronting arrangements:
   a) Signed, approved fronting agreements, with board approval;
   b) Reports and correspondence with front or underwriters; and
   c) Audit reports and board acceptances.
5. Reinsurance reports:
   a) Reinsurance agreements and amendments, with board approvals;
   b) Binders, covered notes, slips;
   c) Correspondence with brokers and underwriters;
   d) Evidence of reinsurance premium payments with board approvals;
   e) Reinsurance audit reports or letters with board approvals; and
   f) Letters of credit with notice to the Commissioner if "call" is made.
6. Insurance policy records:
   a) Policy registers – numeric control;
   b) Application summaries;
   c) Declaration pages, forms, and endorsements;

d) Binders, cover notes, certificates of insurance;
e) Schedules of exceptions to normal underwriting/implementation process;
f) Risk control reports and policyholder response/implementation plans; and
g) Underwriting and rating plans, with board approvals.

7. Professional services providers:
   a) Contracts or agreements with providers of services, with board approvals, including but not limited to:
      (1) Actuaries;
      (2) Banker/trust departments;
      (3) Insurance and reinsurance brokers;
      (4) Claim managers;
      (5) Investment managers/advisors/custodians;
      (6) Lawyers (non-privileged reports and correspondence);
      (7) Program/underwriting managers;
      (8) Risk control advisors; and
      (9) Risk management advisors.
8. Other information which the Commissioner deems pertinent.

XIV. Reinsurance.

A. All reinsurance companies shall be subject to approval by the Commissioner and shall, at the Commissioner's discretion, be required prior to assuming the risk of any Captive licensed by the FSM to submit for review the following:
   1. A copy of its most recent interim or annual report;
   2. A current actuarial reserve opinion;
   3. A current audited financial report; and
   4. A copy of its license as issued by its home country supervisory authority.

B. A Captive may take credit for reserves on risks ceded to a reinsurer subject to the following limitations:
   1. No credit shall be allowed for reinsurance where the reinsurance contract does not result in the complete transfer of the risk or liability to the reinsurer.
   2. No credit shall be allowed, as an asset or a deduction from liability, to any ceding insurer for reinsurance unless the reinsurance is payable by the assuming insurer on the basis of the liability of the ceding insurer under the contract reinsured without diminution because of the insolvency of the ceding insurer.
   3. No credit shall be allowed for reinsurance ceded unless the reinsurer and amount of reinsurance has been approved by the Commissioner annually.
   4. Reinsurance shall be effected through a written agreement of reinsurance setting forth the terms, provisions and conditions governing such reinsurance.
   5. The Commissioner in his discretion shall require that complete copies of all reinsurance treaties and contracts be filed and/or approved by him.

XV. **Changes of Business.** A Captive shall request approval from the Commissioner prior to implementing any changes in its business plan or operations from that which was approved by the Insurance Board as part of its licensing. Any such request for changes in the business plan may be approved subject to an appropriate board resolution authorizing such changes being received.

XVI. **Acquisition of Control of or Merger with Domestic Company.** No person shall, without the prior written approval of the Commissioner, acquire an ownership interest in a Captive, either directly or indirectly, which would result in the person owning or controlling twenty percent (20%) or more of the outstanding shares of the Captive.

XVII. **Directors, Officers and Insurance Managers.**

A. A Captive shall report to the Commissioner in writing prior to any change in director, officer, insurance manager and shall provide the completed Form G-1.

B. A Captive shall submit a written application (see attached Schedule I-1) to the Commissioner for his approval the name and address of any person proposed as or any change in Insurance Manager for a Captive.

C. No director, officer, insurance manager, or employee of a Captive shall, except on behalf of the company, accept, or be the beneficiary of, any fee, brokerage, gift, or other emolument because of any investment, loan, deposit, purchase, sale, payment or exchange made by or for the Captive but such person may receive reasonable compensation for necessary services rendered to the Captive in his or her usual private, professional or business capacity.

D. Any profit or gain received by or on behalf of any person in violation of this section shall inure to and be recoverable by the Captive.

XVIII. **Appointment for Agent for Service of Process.** Before commencing business, a Captive shall file with the Insurance Board an appointment of the Commissioner as its agent (see attached Schedule K-1) upon whom all process in any action or proceeding against it arising out of the operations or activities of its office or offices may be served, which appointment shall be by its terms perpetual and irrevocable.

XIX. **Conflict of Interest.**

A. Each Captive licensed by the FSM shall adopt a written conflict of interest statement for officers, the insurance manager, directors and key employees. Such statement shall disclose that the individual has no outside commitments, personal or otherwise, that would divert him from his duty to further the interests of the company he represents but this shall not preclude such person from being a director, officer or insurance manager in more than one insurance company.

B. Each officer, insurance manager, director, and key employee of a Captive shall annually in writing file such disclosure with the Board of Directors.

XX. Suspension or Revocation of License.

A. The Commissioner may by order suspend or revoke the license of a Captive:
   1. if the Captive has not commenced business according to its plan of operation within six (6) months of being licensed; or
   2. if the Captive ceases to carry on insurance business in or from within the FSM; or
   3. at the request of the Captive; or
   4. for any reason provided in 37 F.S.M.C. 1012 or pursuant to the Captive's request

B. Before the Commissioner suspends or revokes the license of a Captive, the Commissioner shall give the Captive notice in writing of the grounds on which he proposes to suspend or revoke the license, and shall afford the Captive an opportunity to make objection in writing within the period of fifteen (15) calendar days after receipt of notice. The Commissioner shall take into consideration any objection received by him within that period and, if he decides to cancel the license, cause the order of suspension or revocation to be served on the company.

C. In case of suspension or revocation, the Commissioner will advise the Captive of procedures and requirements for ongoing operations and winding up of the Captive's business.

XXI. Money Laundering and Proceeds of Crime. Captives shall comply with the provisions of 11 F.S.M.C. 9, as amended.

Insurance Board Adoption Page

Pursuant to existing laws, including Section 1016 of Title 17 of the Code of the Federated States of Micronesia, the Insurance Board adopted and approved these Regulations on December 2, 2008.

Date: 12-18-08

Wilson F. Waguk
Insurance Commissioner

Date: Dec. 18, 2008

Alexander Narruhn
Chairman, Insurance Board

ADOPTION

These regulations have been reviewed by the Department of Justice and are in the proper legal form.

Date 12/30/08

Maketo Robert
Secretary, Department of Justice

Pursuant to the authority vested in me by the Captive Insurance Act of 2006, 37 FSMC 1016 and having complied with the Administrative Act, 17 FSMC 102, I hereby adopt these regulations.

Date 01-05-09

His Excellency Emanuel Mori
President, Federated States of Micronesia