RISK RETENTION GROUPS 101
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Federal Liability Risk Retention Act ("LRRA")

- Enables organizations to band together to obtain liability insurance (excluding WC)
  - Risk purchasing group
  - Risk retention group
Federal Liability Risk Retention Act ("LRRA")

- History
  - Product Liability Risk Retention Act of 1981 (Public Law 97-45)
Federal Liability Risk Retention Act ("LRRA")

- The concept of Purchasing Groups and Risk Retention Groups:
  - PURCHASING GROUPS (PGs): Groups of policyholders who purchase prescribed liability insurance from a commercial insurer or a Risk Retention Group
  - RISK RETENTION GROUPS (RRGs): Group captives licensed in one state underwriting prescribed liability insurance
Federal Liability Risk Retention Act ("LRRA")

- Both PGs and RRGs must comply with the following criteria:
  - Membership must be homogenous
  - Scope of insurance is limited to commercial liability but excluding workers’ compensation and property
  - Any business, charity or public entity is eligible
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State Regulation

- Risk Retention Groups:
  - Only subject to those state provisions specified in the Act
- Purchasing Groups:
  - Only exempt from those state provisions specified in the Act
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Risk Retention Groups
• A RRG must be chartered in a state or the District of Columbia
• Except for the chartering state:
  • A RRG is exempt from any state law, rule or regulation that would regulate or make a RRG unlawful, except that any state may require a RRG to:
    • Comply with unfair claims settlement practices
    • Pay applicable premium or surplus lines taxes
    • Participate in a proportional insurance mechanism
Federal Liability Risk Retention Act (“LRRA”)

- Register for legal service
- Submit to financial examination if the chartering state has not initiated such an exam
- Comply with lawful orders for delinquency or dissolution proceedings
- Comply with deceptive, false or fraudulent regulatory act prohibition
- Comply with an injunction for hazardous financial condition
- Comply with a prescribed notice in 10 point type advising the insured of no guaranty fund coverage and preemption of many non-domiciliary state consumer protections
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Ownership Interest in a Risk Retention Group

- All owners must be insureds and all insureds must be owners
  - An association may own a RRG but all members of the association must be insureds of the RRG
- No control or ownership restrictions in the Act, other than insured/owner; owner/insured restrictions cited above
  - NAIC action on "ownership"
- Transfer of stock or membership rights typically restricted/governed by RRG Bylaws and Subscription Agreements
Federal Liability Risk Retention Act ("LRRA")

- RRGs require insured members to surrender their stock/ownership interest upon cancellation or non-renewal

- Payment for shares/ownership is often delayed 5 or more years to mitigate against “capital crunch”; “churning of market” and/or to apply against member’s contribution the member’s proportionate responsibility for open claims and IBNR of the RRG
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Risk Retention Group Structuring

- Choice of Stock, Mutual or Reciprocal form often predicated on control issues and ease of administration

- Reciprocal: An unincorporated entity operating through an Attorney-In-Fact, the members of which share in the reciprocal’s profits and losses in proportion to insurance purchased by each member
Federal Liability Risk Retention Act ("LRRA")

- Advantages of Reciprocal form:
  - Tax benefits where policyholders are non-profits
  - Lower capitalization requirements
  - Ability of Attorney-In-Fact to exercise a high degree of control
  - Potentially greater insulation from state and federal securities’ laws
  - Assessment features often built into statute, if potential “cash call” of insureds is anticipated or desired
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Risk Retention Group Capitalization

- Statutory Minimum Capital and Surplus Requirements vary by state
- Actual capitalization required will generally be a function of:
  - The nature of the business to be written
  - Reinsurance/excess insurance secured
  - Actuarial projections/loss data
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- A portion of the capitalization can generally be secured by a Letter of Credit

- Typically a prospective insured of a RRG is required to purchase RRG stock or make a capital contribution (e.g., 1/3 of its first year projected insurance premium with the group)

  - NAIC action
Federal Liability Risk Retention Act ("LRRA")

Advantages of Risk Retention Groups

- Facilitates Raising of Capital
  - Except for anti-fraud provisions of federal securities’ laws, ownership in a RRG is exempt from federal securities’ or state blue sky laws

- Ease of Multi-state Operation
  - Upon licensure in its state of domicile, a RRG can do business in all other states on the basis of an information filing
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- Form and rate review by non-domiciliary states is preempted
- Preemption from state guaranty fund assessments
- Preemption from non domiciliary state cancellation/non renewal restrictions
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- A RRG can generally sell directly to its members without requiring an agent or broker or alternatively the agent/broker for the RRG can secure a non-resident agent’s license in any state in which the RRG policyholder resides.

- Long term service contracts between the RRG and Program Manager are typical, particularly in circumstances where Program Manager is advancing organizational costs.
  
  - NAIC: not greater than five years
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Risk Retention Group Formation and Operation Issues

- Defining “liability insurance” under the Act
- Defining “similar or related” risks under the Act
- Federal securities’ and state blue sky exemptions do not apply until the RRG is licensed in its state of domicile
- Qualification of non-domiciliary RRGs as “authorized” or “admitted” insurers under state financial responsibility requirements
Federal Liability Risk Retention Act ("LRRA")

- Ability of a RRG to operate as a front
- Adding additional named insureds to the policy
- Frequent over-reaching by non-domiciliary states on:
  - Registration filing requirements
  - Imposition of registration and other fees
  - Required use of agent or broker
  - Definition of "Liability"
Risk Retention Groups 101

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Risk Retention Reporter

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Outline

• Introduction
• RRG Formations and Retirements - 1987 - 2008
• Growth of RRG Premium -- 1988 - 2007
• RRG Premium by Business Area of as year-end 2008
• Leading RRG domiciles
• RRGs’ - Operating History
• RRGs Regulated as Captives vs. Traditional Insurers
• Challenges and Opportunities
• Conclusion
RRG Formations -- 1987 to 2008

Number of RRGs

Year


1987 41 19 8 7 9 7 5 4 6 6 5 3 3 2 7 58 54 33 29 23 18
Growth of RRG Premium -- 1988 to 2007

2007 Premium
$2,559M

Year

Premium ($M)
0 500 1,000 1,500 2,000 2,500 3,000
RRG Premium by Business Areas for 2007

- Healthcare (55%)
- Professional Services (18.4%)
- Property Development (8.9%)
- Government & Institutions (9.4%)
- Transportation
- Manufacturing & Commerce
- Environmental
- Leisure
Leading RRG Domiciles
(as of December 2008)

- Vermont: 74
- So. Carolina: 45
- D.C.: 35
- Nevada: 30
- Arizona: 22
- Hawaii: 14
- Montana: 12
- Delaware: 6
- Kentucky: 5
- Other: 19

No. of RRGs
All RRGs - Operating History -- 1987 to 2009
(as of January 2009)

- Operating RRGs (71%)
- Never became Operational (7%)
- Voluntary Dissolutions (10%)
- M&As or Reorganizations (6%)
- *Liquidations (6%)

*Includes RRG Rehabilitations and Receiverships
Comparison of RRG insolvencies (1987-2008) based on type of regulation (captive vs. traditional insurer)

Note: RRG insolvencies include rehabilitations & receiverships.
Conclusion

• Will RRGs Will Continue to Serve as Viable ARTs Mechanisms?
  – From a market perspective?
  – From a regulatory perspective?
Federal Liability Risk Retention Act ("LRRA")
Feasibility Process

- Define Business and Financial Objectives
- Forecast Ultimate Retained Loss Costs
- Develop Program Structure and Business Plan
- Identify Capitalization Requirements and Sources
  - Cash/LOC
- Develop Financial Forecasts – expected and adverse
- Compare and Contrast Domiciles
- Visit Domicile Regulators

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Weathering the Storm—Captive Contributions
Federal Liability Risk Retention Act ("LRRA") Application Process

The application must include the following documentation:

- Explanation of insureds/owners and their purpose for forming the RRG
- Actuarial feasibility study including description of information used, loss history of insureds is preferable but not required, methodology and conclusions on pricing
- Business plan incorporating the actuarial feasibility study
- Proforma financial statements – expected and adverse
- Draft agreements with business partners, i.e. reinsurers, managers, claims administrator, actuary, auditors, etc.
Federal Liability Risk Retention Act ("LRRA") Application Process (cont’d)

- Identification of Directors and Officers
- Biographical affidavits for each officer and director
- Bylaws and Articles of Incorporation
- Disclosure documents including a draft offering memorandum and subscription agreements
- Underwriting guidelines and procedures
- Draft policy to be issued
- Explanation and/or sample procedure manuals for loss control and safety programs
- Identification of committees and participants, i.e. underwriting, claims, finance, investment
- Draft investment policy if available
RRG Structure

- Paid-In Capital
- Premium
- Ceded Premium
- Program Assets
- Approved Reinsurer assumes 750 x 250
- Bank Holds premiums net of ceded premium

RRG issues a 1m/3m policy to members
Keys to Successful RRG’s

• Sense of urgency – problem to solve
• Good spread of risk
• Understanding of loss volatility and the need for prudent funding
• Members trust and risk sharing approaches
• Long-term commitment - discipline to “stay the course” through markets cycles
• Strong business partners – manager, claims service, actuary, banking and investment
• Understanding the benefit being provided by the RRG
RRG: Pro

• Adds stability
  • Availability of coverages
  • Premium pricing fluctuations
• Enables customization of coverages
• Delivery mechanism for loss control programs
• Ability to write directly, *i.e.*, no “Front” needed
RRG: Con

- Capital
- Commitment
- Regulatory challenges by states
- Liability insurance only
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Purchasing Groups

- Unlike RRGs, PGs are groups of insurance buyers who:
  - Retain no risk
  - Purchase liability insurance from admitted or surplus lines insurers
- State preemptions are limited to prohibitions against:
  - Establishment of a PG
  - Limitations imposed by state fictitious group laws
  - Requirements imposed by state countersignature laws
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- Discrimination against a PG or any of its members
- Discrimination against nonresident agents
- PGs need not be incorporated, but generally are, often under state not-for-profit corporation status
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State Regulation of Purchasing Groups

- States have wider latitude under the Act as to information required for PG registration
- A state may require that the PG insurer be admitted or an eligible surplus lines insurer in the state
- A state may impose its surplus lines laws on a PG transaction involving an eligible surplus lines insurer
- The premium tax rate applicable to PG depends upon the status of its insurer as either an admitted or surplus lines carrier in the state of the policyholder
- A state may require form and rate review of coverage offered by a PG insurer
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Purchasing Group Advantages

- Ease of formation
- Lower cost of formation and operation
- Preemption of state “fictitious groups” underwriting prohibitions
- Preemption of state countersignature requirements
- Availability of nonresident surplus lines licenses for PG producers
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Purchasing Group Disadvantages

- Unlike a RRG, a PG is largely subject to regulation in each state, including form and rate review (although some states defer to regulation of the domiciliary state)

- The PG’s ability to provide coverage is dependent upon its insurer’s status on a multi-state basis

- Need for multi-state agent/broker licenses
Risk Purchasing Group (Liability Only)

Association [Optional]

Insurance Co.

Members

Risk Purchasing Group

Ins. Certs.

Master Policy

$ Purchase insurance for members

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Weathering the Storm—Captive Contributions
Risk Purchasing Groups: Pro

- Same as Association-endorsed programs
  - Benefits of group buying power
- Regulatory advantages over Association-endorsed plan
  - Policy can be specifically tailored to group needs
  - Avoid anti-group laws
- Opportunity to ease transition to a RRG in future
- Requirement to register in each state and related rules
- Liability insurance only
Risk Purchasing Groups: Con

• Requirement to register in each state and related rules
• Liability insurance only
Regulatory Perspectives

• Who “regulates” RRGs?
• Why are regulators “interested” in RRGs?
• What is the difference between regulating a RRG captive and other captives?
• How are RRGs regulated?
Who Regulates RRGs?

• “Home” versus “Host” Regulator
  • “Home” Regulator:
    – Is the insurance supervisory authority of the chartering jurisdiction of the RRG
  • “Host” Regulator:
    – Is the insurance supervisory authority of the jurisdiction where the RRG member/insured or its risk is located
Why are Regulators interested in RRGs?

• “Home” Regulator:
  – Has primary/exclusive responsibility for overseeing formation, multi-state operations and financial solvency

• “Host” Regulator
  – May implement “limited” requirements
  – Is oftentimes the first to receive inquiries and complaints from local consumers, competitors, claimants, and other constituents
Why are Regulators interested in RRGs?

• Notable failures of several large RRGs in recent years
• LRRA preemption of state insurance laws resulted in widely varying state standards and limited host regulator confidence in the system
• Captive RRGs are not subject to uniform, baseline standards like those set forth in the NAIC’s financial accreditation program for traditional multi-state insurers
GAO Report

• Conducted between November 2003 through July 2005
• Final report issued in August 15, 2005
• GAO-05-536
What is the difference between regulating a RRG captive and other captives?

• Frequency and volume of transactions
• Unaffiliated members/insureds in multiple states
• Multiple service providers and vendors
• Potential conflicts of interest
• Cooperation between Home and Host Insurance Supervisors
• Compliance with NAIC “Accreditation” standards
NAIC Financial Regulation Standards and Accreditation Program

• Provide a process whereby solvency regulation of multi-state insurers can be enhanced and adequately monitored

• Three primary areas of focus:
  – Laws and Regulations (Part A)
  – Regulatory Practices and Procedures (Part B)
  – Organizational and Personnel Practices (Part C)
How are RRGs regulated?

• Formation
  – Application review and evaluation

• Implementation
  – Organization, capitalization, licensure, registration

• Ongoing requirements
  – Interim and annual filings
  – Financial and operational surveillance and monitoring
Risk Retention Group Operations: Management

- Self-managed vs. management by captive manager; other service providers
  - Accounting/financial reporting
  - Premium taxes/other regulatory
  - Underwriting
  - Risk management; claims
- Actuarial
- Reinsurance
- Investments
- Legal
Risk Retention Group Operations: Regulatory Compliance

- Business plan changes; other filings
- Rate/form filings
- Non-domiciliary state filings/regulatory issues
- Maintaining good communication and relationships with regulators
Risk Retention Group Operations: Governance

- NAIC Governance Standards for Risk Retention Groups
- Audit committee
- Board and shareholder meetings
Risk Retention Group Operations: Control

• Control by members/insureds/owners
• Internal controls
• Conflict of interest/code of ethics policy
For Further Information,
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