RISK RETENTION GROUPS 101

CICA 2009 International Conference

March 8, 2009

Robert "Skip" Myers, rhm@mmmlaw.com
Karen Cutts, cutts@rrr.com
Wendy Fisher, wfisher@2-10.com
John Svoboda, jsvoboda@2-10.com

2009 CICA INTERNATIONAL CONFERENCE

Weathering the Storm—Captive Contributions

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)

  - Liability Risk Retention Act (Public Law 99-563; 15 U.S.C. 3901-3906 (1981, As Amended 1986)

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

Federal Liability Risk Retention Act (“LRRA”)

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

Federal Liability Risk Retention Act ("LRRA")

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

Federal Liability Risk Retention Act (“LRRA”)

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

Federal Liability Risk Retention Act (“LRRA”)

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

Federal Liability Risk Retention Act (“LRRA”)

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

Federal Liability Risk Retention Act ("LRRA")

- 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

Federal Liability Risk Retention Act ("LRRA")

- 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

Federal Liability Risk Retention Act ("LRRA")

- 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

Federal Liability Risk Retention Act ("LRRA")

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

Karen Cutts, J.D., Managing Editor

Risk Retention Reporter

2009 CICA International Conference

March 8, 2009

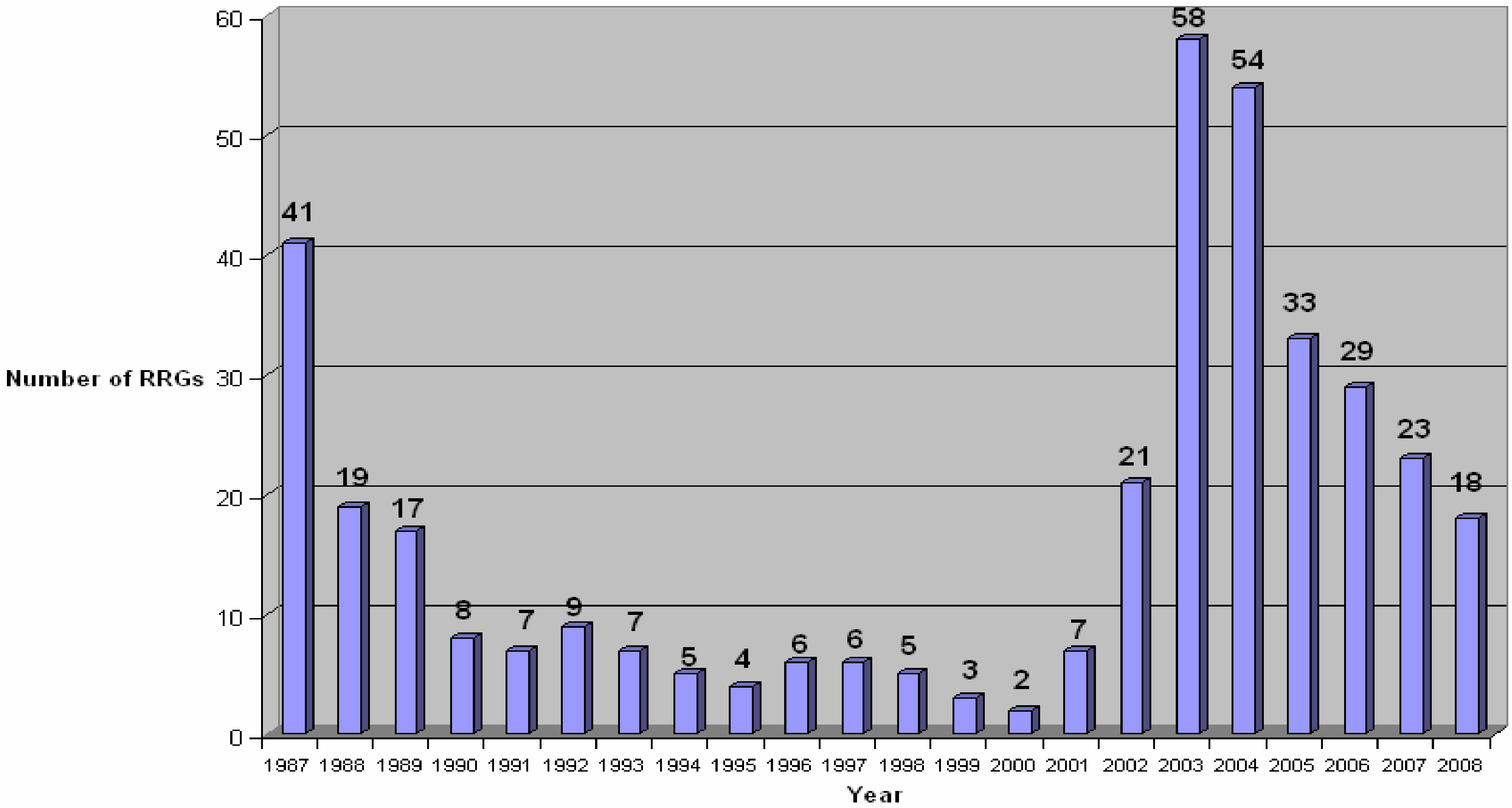
2009 CICA INTERNATIONAL CONFERENCE

Weathering the Storm—Captive Contributions

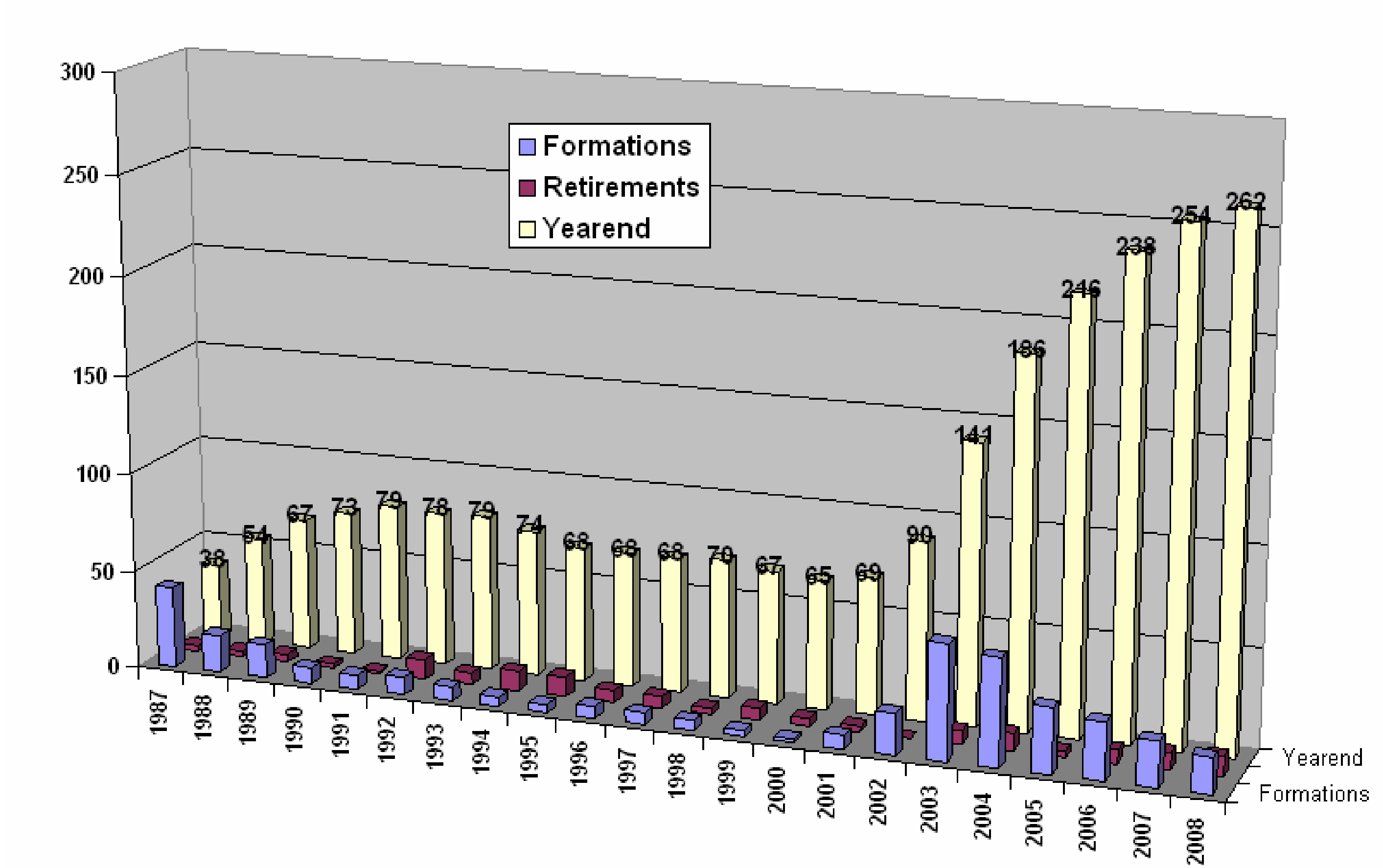
Outline

- 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

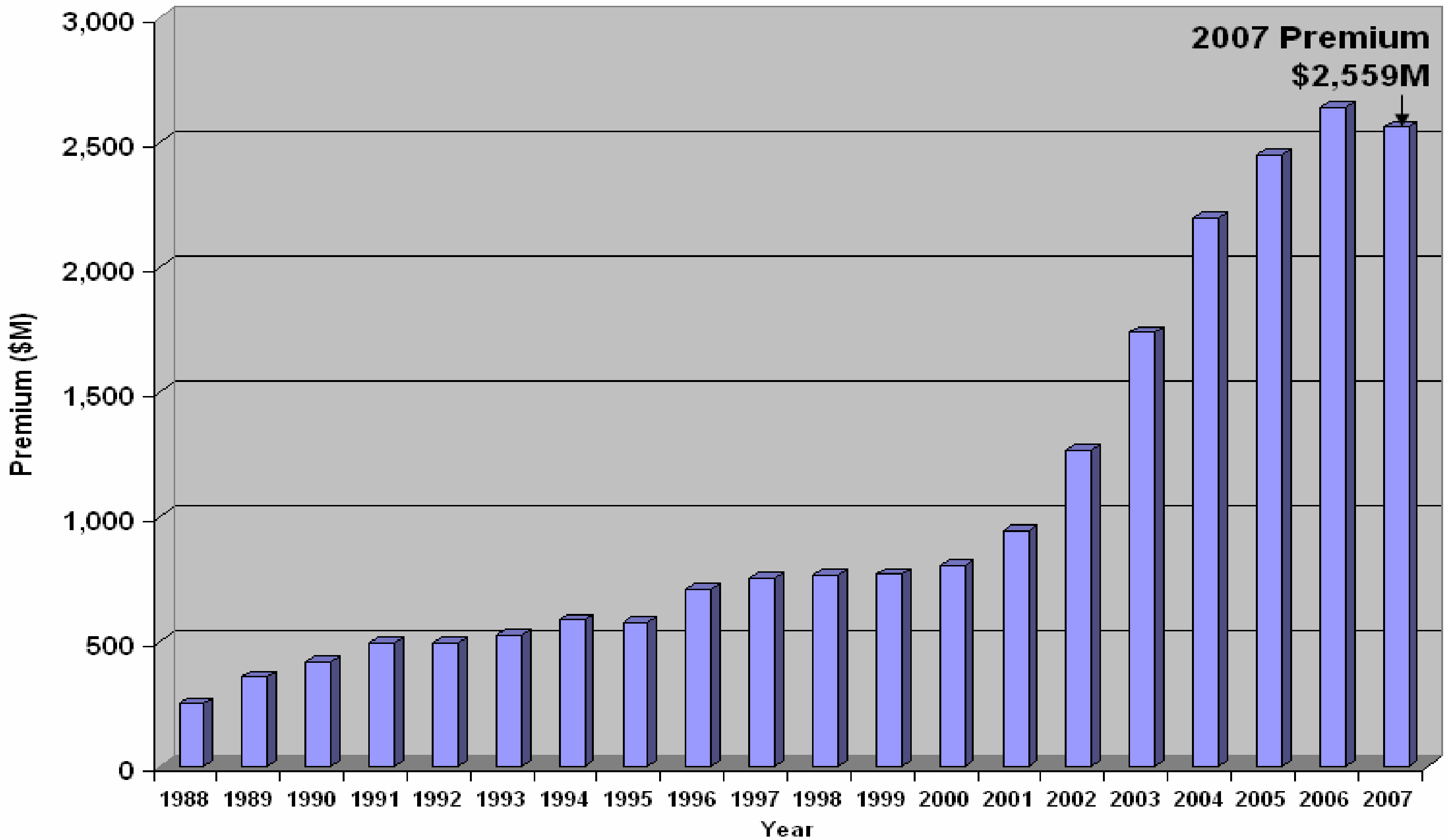
RRG Formations -- 1987 to 2008



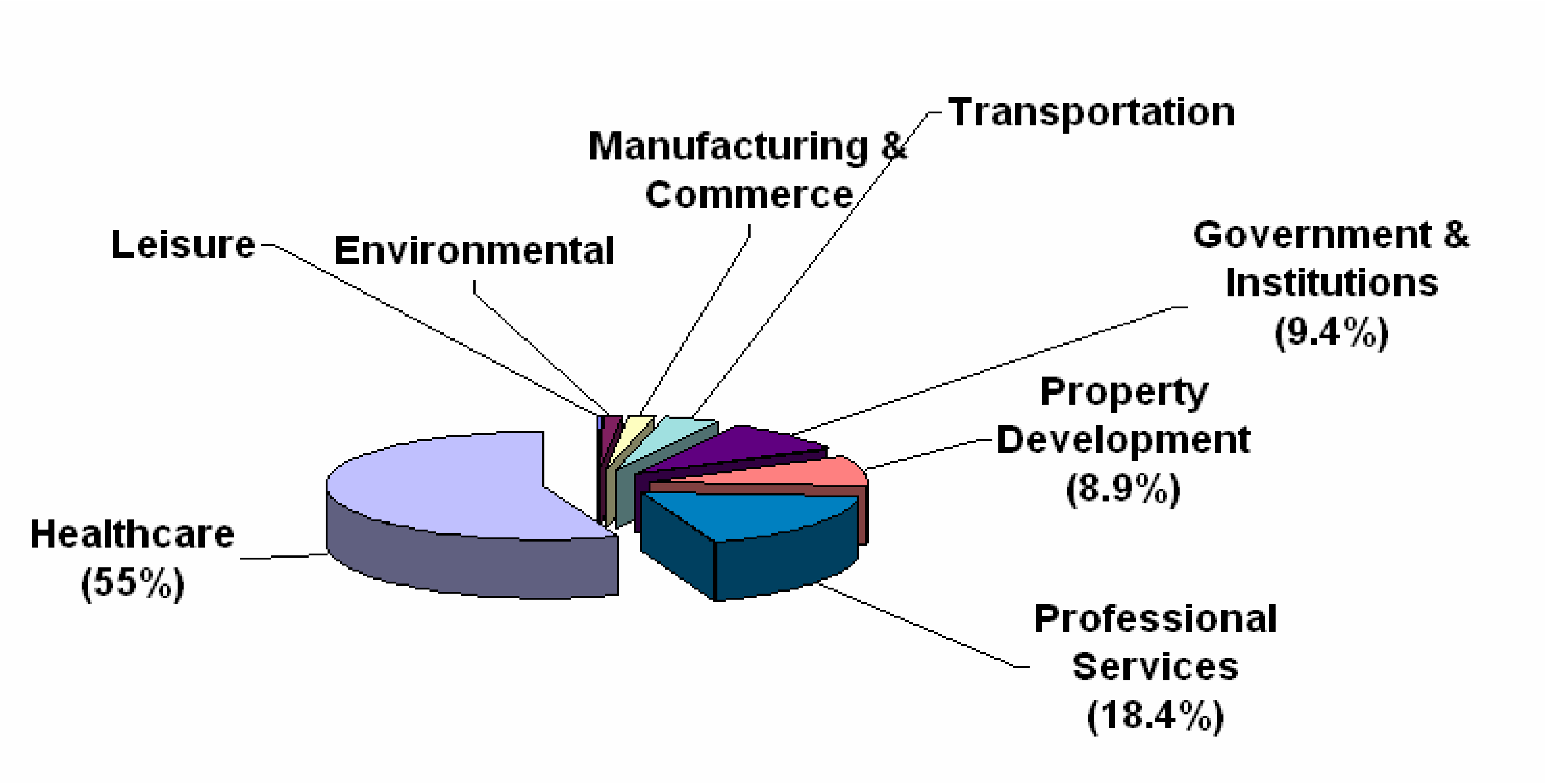
RRG Formations & Retirements -- 1999 to 2008



Growth of RRG Premium -- 1988 to 2007

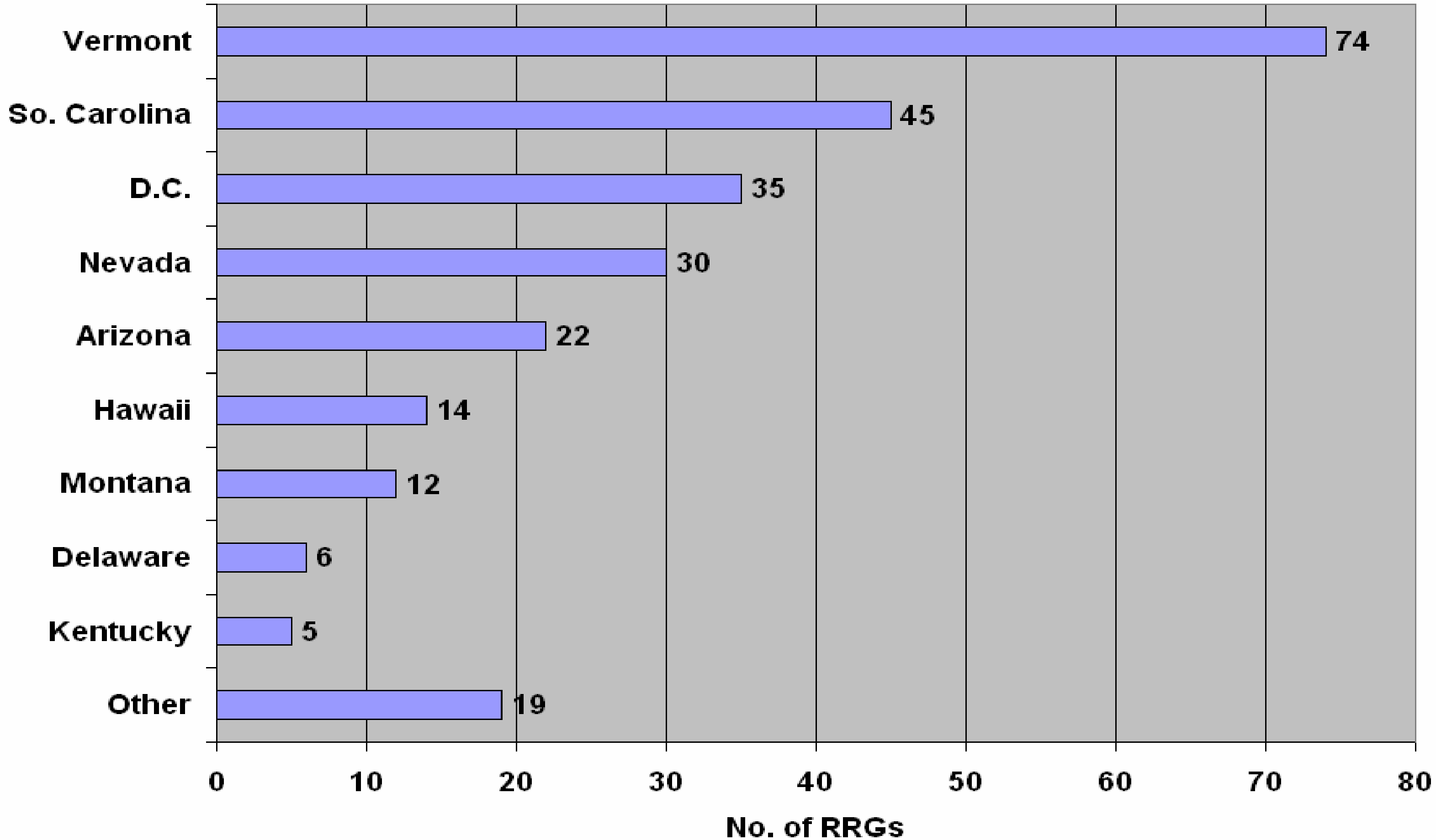


RRG Premium by Business Areas for 2007



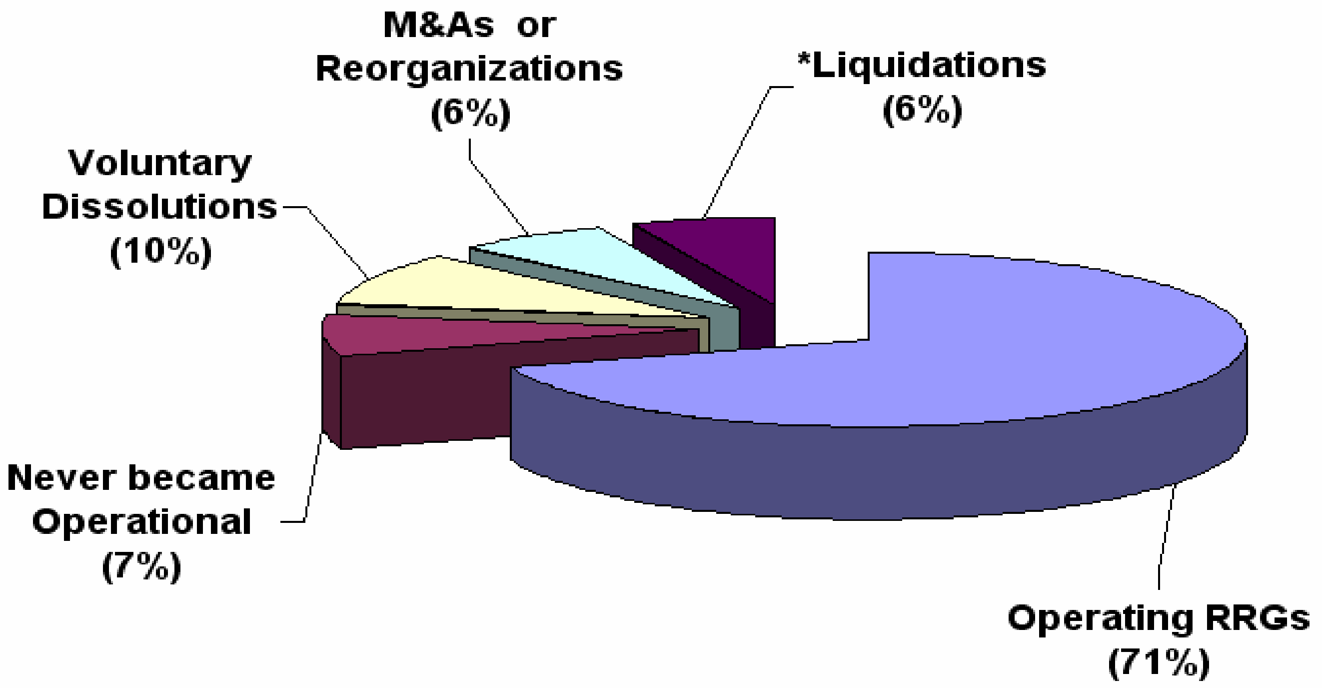
Leading RRG Domiciles

(as of December 2008)



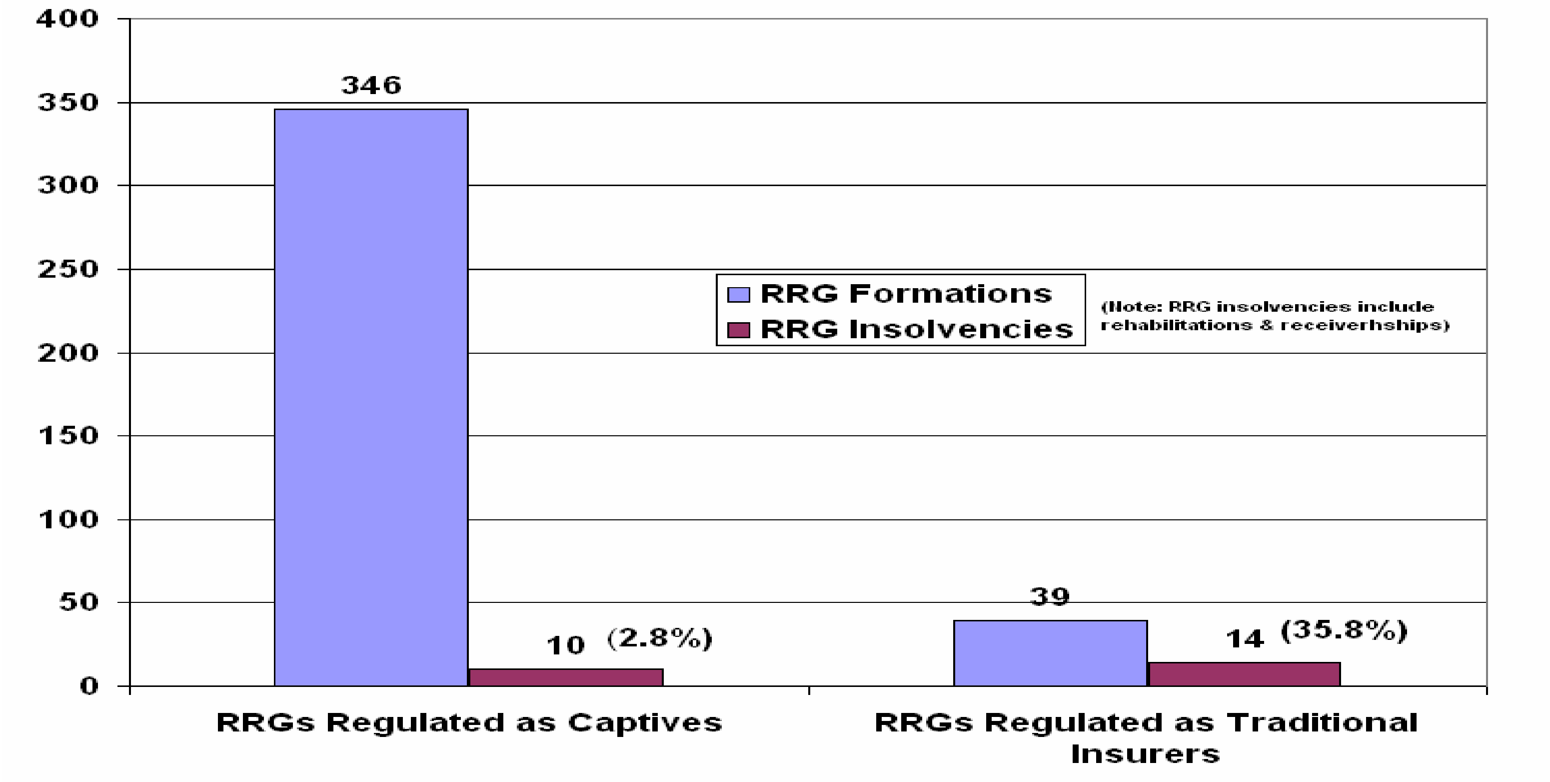
All RRGs - Operating History -- 1987 to 2009

(as of January 2009)



*Includes RRG Rehabilitations and Receiverships

Comparison of RRG insolvencies (1987-2008) based on type of regulation (captive vs. traditional insurer)



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

Federal Liability Risk Retention Act ("LRRA") Application Process

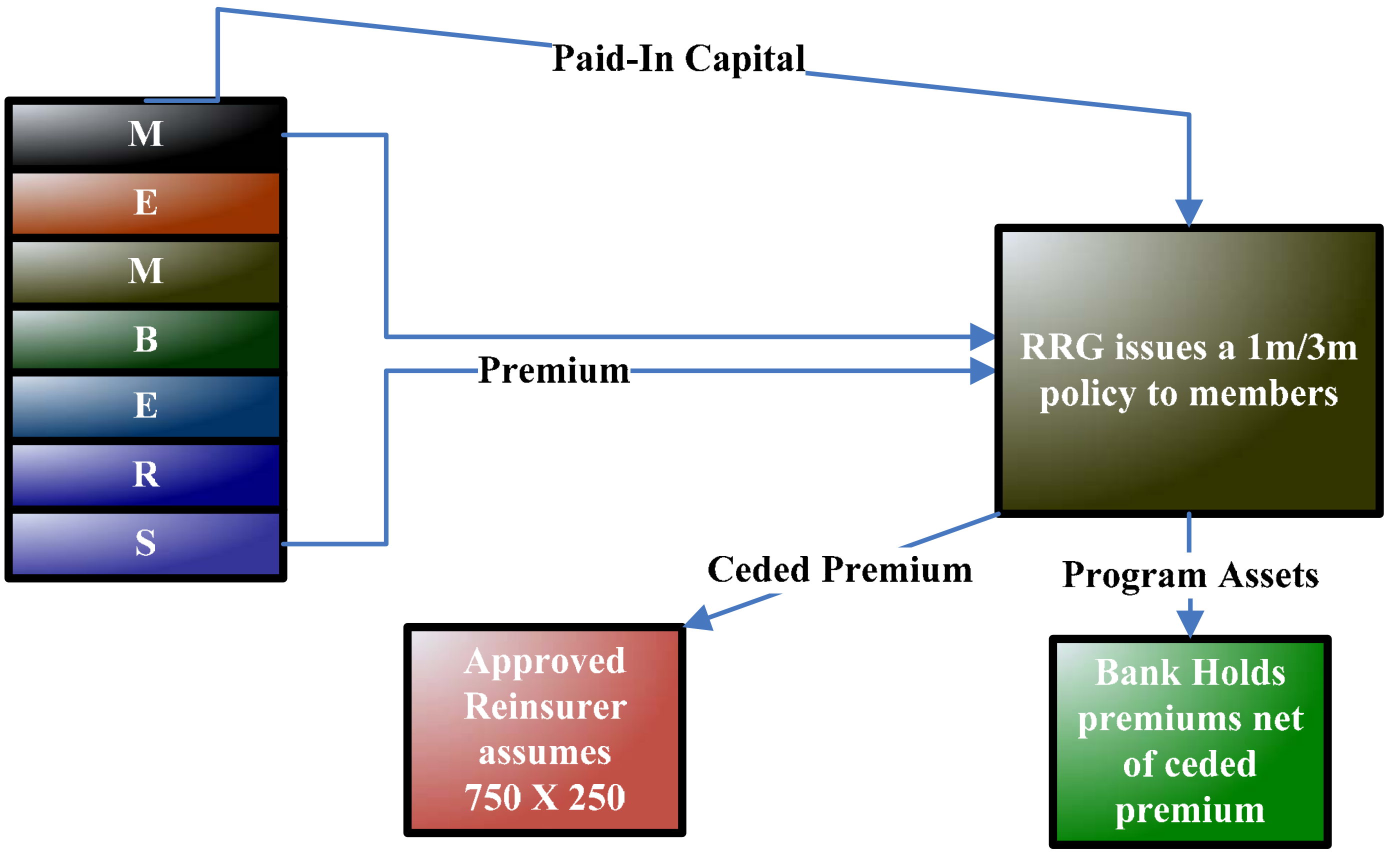
The application must include the following documentation:

- 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



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

Federal Liability Risk Retention Act ("LRRA")

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

Federal Liability Risk Retention Act (“LRRA”)

- 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

Federal Liability Risk Retention Act ("LRRA")

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

Federal Liability Risk Retention Act ("LRRA")

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

Federal Liability Risk Retention Act (“LRRA”)

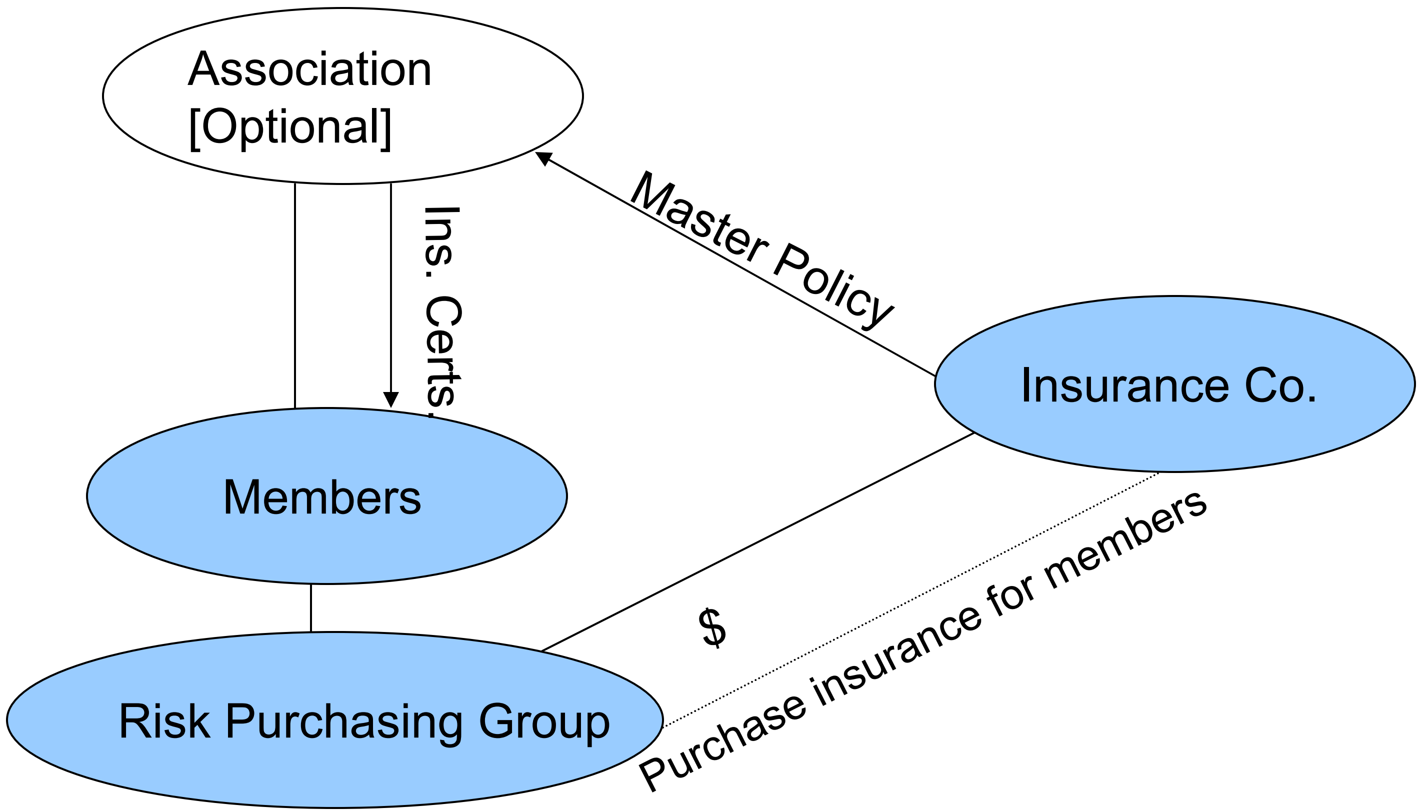
Purchasing Group Disadvantages

- 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)



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?

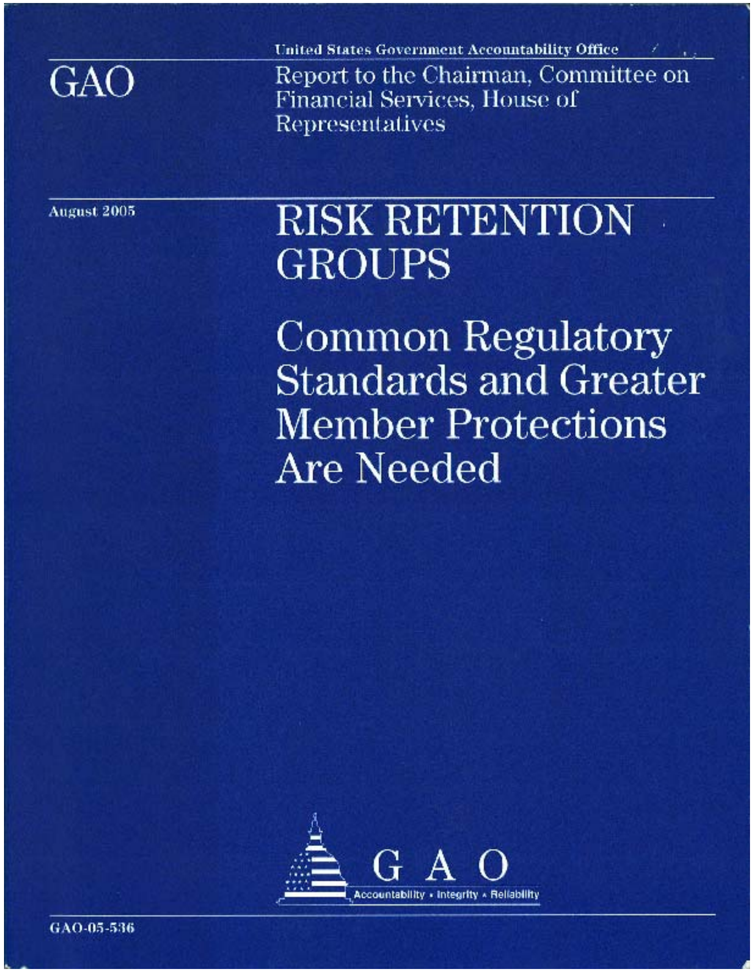
- “Home” Regulator:
  - Has primary/exclusive responsibility for overseeing formation, multi-state operations and financial solvency
- “Host” Regulator
  - May implement “limited” requirements
  - Is oftentimes the first to receive inquiries and complaints from local consumers, competitors, claimants, 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
- http://www.gao.gov/new.items/d05536.pdf


United States Government Accountability Office

GAO

Report to the Chairman, Committee on Financial Services, House of Representatives

August 2005

RISK RETENTION GROUPS

Common Regulatory Standards and Greater Member Protections Are Needed

G A O

Accountability * Integrity * Reliability

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, Please Contact:

Robert "Skip" Myers, rhm@mmmlaw.com

Karen Cutts, cutts@rrr.com

Wendy Fisher, wfisher@2-10.com

John Svoboda, jsvoboda@2-10.com