RRGs: A matter of perception

The Federal Liability Risk Retention Act may have been designed with the lofty purpose of bringing affordable self-insurance to all, but access to RRGs is still a state lottery. By Gavin Bradshaw

In the 20 years since the Federal Liability Risk Retention Act (LRRA) was introduced, more than 250 risk retention groups (RRGs) have been formed, with over two-thirds of this number having been formed since 2000, according to the *Risk Retention Reporter*.

With such a formidable rate of growth it might come as a surprise that more than half the US states either do not or will not charter RRGs as captives.

As the 2005 GAO report emphasised, the majority of RRGs are still domiciled in only six jurisdictions that allow them to be chartered as captive insurance companies: Arizona, the District of Columbia, Hawaii, Nevada, South Carolina and Vermont. Licensing of RRGs may simply not be a priority for every jurisdiction, but for some there is an ongoing problem, perceived or otherwise, with governance.

Since the GAO Report, the National Association of Insurance Commissioners (NAIC) has employed a risk retention working group to assess RRG governance issues in order to recommend improvements. The group is due to report its findings shortly.

Sadly, the chair of the working group Tim Wagner, director of insurance in Nebraska, passed away unexpectedly in October. Acting director Ann Frohman hints at what may come out of the group's discussions when it refers its corporate governance work product to the NAIC 'E' Committee: "One thing was to make sure that the majority of the members of the RRG board are independent," says Frohman. "The group really defined that as not having a material relationship with the RRG itself. Another focus was that they wanted to make sure that entrepreneurial RRGs are really reined in."

Entrepreneurial focus

The notion of 'entrepreneurial focus' provokes a variety of responses, and lies at the heart of the GAO's concerns over slipping standards in the RRG industry. Robert 'Skip' Myers of Morris, Manning & Martin and general counsel for the National Risk Retention Association (NRRA) denies that the NRRA is in favour of squeezing out entrepreneurial RRGs. "I'd say that we're very much in favour of good regulation and all that implies," he says. "This phrase 'entrepreneurial RRGs' is a little bit amorphous. It's hard to define what one is, but we're in favour of RRGs that serve their members."

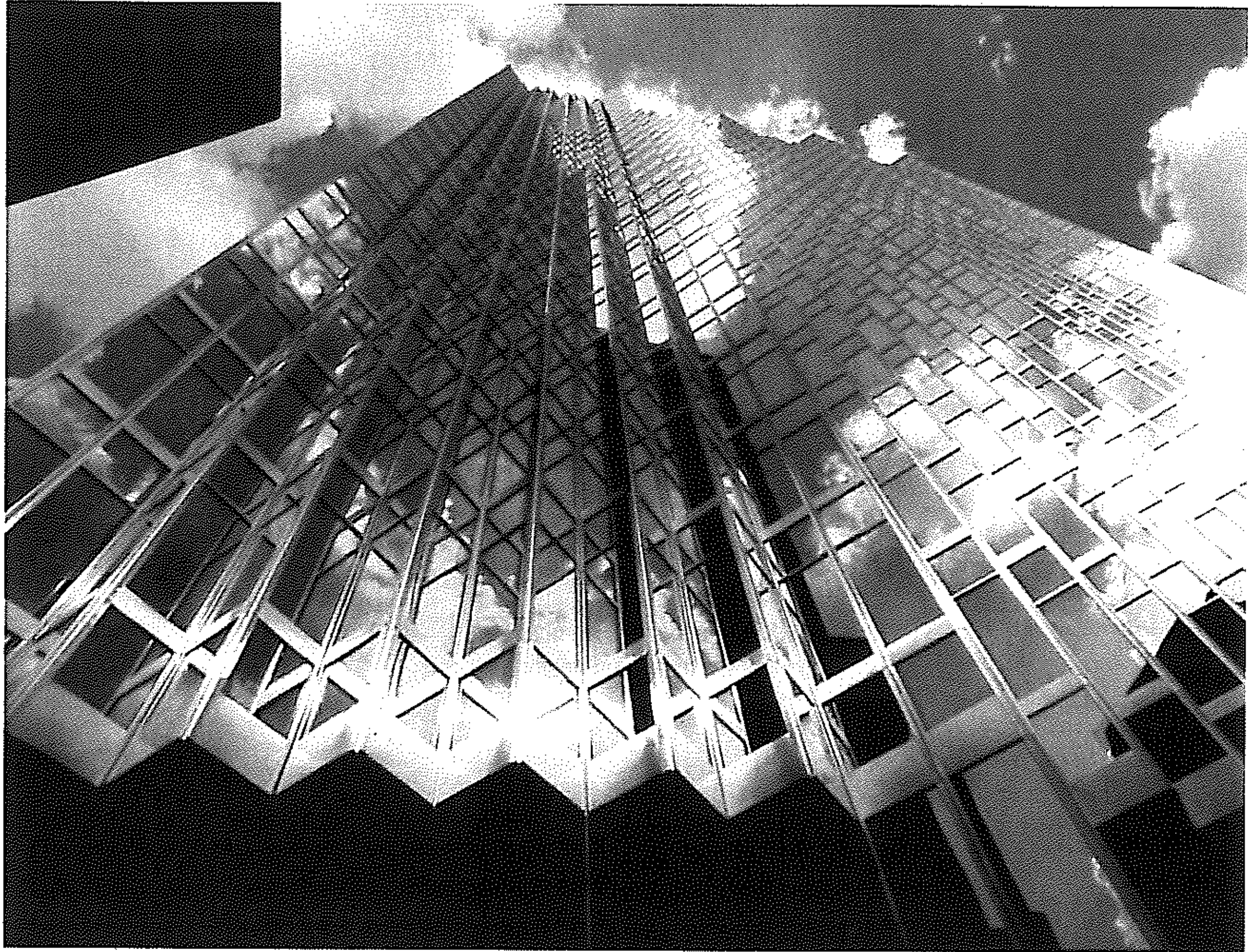
Dick Goff, principal of Taft Companies, and a steering committee member of RRG lobby group the American Risk Retention Coalition (ARRC), says there are two distinct types of basic RRG. First there is the hospital or hospital group that puts up the capital and surplus to form an RRG

UNRESOLVED ISSUES

The GAO report went further than to just criticise the governance and regulation of RRGs. Another contentious issue is the question of accounting reporting standards. Currently, the majority of RRGs use Generally Accepted Accounting Principles (GAAP). The GAO report suggested a move towards Statutory Accounting Principles (SAP). Dick Goff is incredulous about this prospect. "It's kind of ridiculous. The LRRA has been around since 1981, it was expanded in 1986 - why, all of a sudden, is there a problem with the financial reporting?" he says.

Leslie Jones says part of the problem is the nature of individual RRGs themselves. "Some look very much like traditional insurance companies, and they should be regulated that way. Then there are others that look very much like a captive and they should be regulated that way," she says. "In South Carolina we have required SAP reporting for some of our RRGs and we've permitted GAAP for others."

The GAO report caused further inflammation with its implication of that RRGs have a high failure rate. All parties seem to be in agreement that this issue is a non sequitur. "A standard licensed company has a failure rate, certainly in the early years, that's just about the same as RRGs - not statistically significant," says Skip Myers. "It's a misconception that RRGs are any more likely to fail than a P&C company, given the relative size and the fact that many RRGs are startups and need time to mature."



because it cannot buy affordable and appropriate medmal insurance. Then there is the group of contractors or doctors who, tiring of the limitations of the traditional insurance market decide to form an RRG, each putting up a capital contribution. The latter type, Goff says, could be defined as an entrepreneurial RRG, but in Goff's view the true entrepreneurial RRG is a retailer, group of retailers or wholesaler perhaps who decides to take advantage of this market niche to profit by forming an RRG.

"Unless the insureds of that entrepreneurial initiative contribute surplus and capital to the group then I'm all for not allowing them to come out of the ground," says Goff. He is staunch in his defence of the contractors/doctor's group, however. "How dare the NAIC call that an entrepreneurial initiative and make it a negative," he fumes.

The NAIC's Risk Retention Task Force is shortly due to deliver a white paper of its findings. Leslie Jones, deputy director of actuarial services in the South Carolina Department of Insurance (SCDoI), spoke on behalf of Scott Richardson, Director of the SCDoI and chair of the task force.

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She said the overall charge of the task force was to look at accreditation standards for RRG regulation.

Adhering to tight standards

Accredited states must adhere to so-called Part A, Part B and Part C standards; domestic RRGs are typically subject to the part B and C standards. To date they have not been subject to the Part A standards, which refer to the laws and regulations states must have on their books to regulate insurance companies. However, the task force has been reviewing the Part A standards to assess which of them should reasonably be applied to RRGs. Currently it is deciding on whether a standard can be developed for states that license RRGs to give commissioners discretionary powers to grant exceptions to the Credit for Reinsurance statute.

"I believe if we get those standards tight enough then we will feel comfortable permitting discretion, within very tight limits, to the commissioner," says Jones. "I think the argument in favour of granting an exception is that RRGs are different by their very nature to traditional companies – they're owned by their insureds."

Rebecca Smart of Lenders Protection Assurance Company (LPCA) and current chair of the NRRA says the NRRA is very much in favour of some form of standardisation. "So far nothing has come out of the accreditation standards that we think is going to lead to the demise of RRGs or make it so difficult that they will no longer be formed," she says. "What we are really hoping for, having gone through that exercise, is that we see more acceptance in non-domiciliary states." According to Smart, the first test of non-domiciliary states' attitude will be when a new RRG bids to write business in California.

However, the ARRC is strongly opposed to accreditation standards. "I think it's criminal where it's going," says Goff. "Everything the NAIC is asking for in preparation for their audit, or whatever they call it, is at least 60% focused on how domiciles run their alternative risk transfer divisions and maintain their files, application process and review process. Well guess what? The NAIC's got no business looking there. That's just absurd!"

Collaboration

The NRRA, however, appears to take pride in having an amicable relationship with the commissioners. "I think we work very hard to achieve that," says Smart. "That's not to say that if there is not an issue that we don't go to bat for it. But certainly, working with the NAIC groups, we find it much more beneficial to be working on a collaborative basis.

"There's no federal regulator to turn to and so, working at the state level, I think getting some uniformity and some baselines standards for states that are going to be the domiciles is what bodes best for us," she says.

Skip Myers is of the opinion that there is only one body equipped to implement changes to the LRRA and deliver these baselines standards for RRGs: the NAIC. "If the NAIC isn't equipped to do it, who is?" he says. "I would just point out how difficult it is to get a bill through Congress. Working with the states and through the NAIC is the sole practical way to operate."

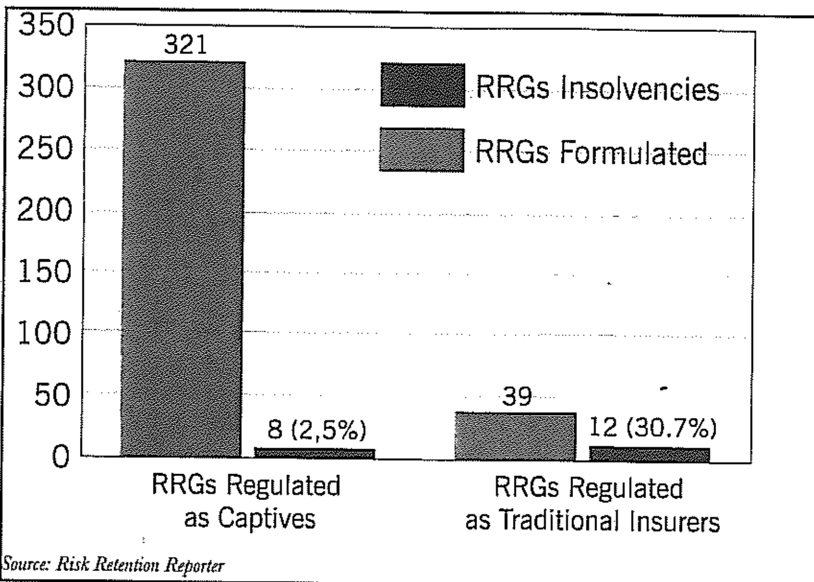
Does this mean, then, that the NAIC should drive the formation of an intermediary body between the federal and state level, deciding on and delivering amendments to the LRRA and overseeing a programme of corporate governance?

"Well that sounds like a platonic ideal" says Karen Cutts, editor of the *Risk Retention Reporter*. "First of all, the NAIC is a private trade organisation – it is not a government body. If you look at its corporate structure it has the same standing as any other kind of trade association. The question is really whether the NAIC is usurping the legislative authority of elected representatives."

The ARRC's Dick Goff is dismissive of the NAIC's involvement in any amendment of the LRRA. "I have no problem with full continuity of regulation whatsoever, but it's not the NAIC's position to bring that forward."

The NRRA's Smart agrees. "Speaking on my own account, but it would also be the sentiment of most of our members, it should be kept at the federal level," she says. "The NAIC has taken it upon themselves to take a look at either the regulation of RRGs or the requirements within states that are the domiciles."

However, Smart notes that the NAIC has been valuable in educating non-domiciliary states about the regulation of RRGs.



Source: Risk Retention Reporter

'The ARRC has reached out to the NRRA on numerous occasions and it has had the door slammed in its face.'

This view is certainly not to Dick Goff's taste. "I think the NRRA is biased in trying to compromise with the NAIC and I think that is going down absolutely the wrong path," he says. "The ARRC is diametrically opposed to any type of compromise – why in the world should anybody be negotiating with the NAIC?"

But despite their differing views on collaboration with the NAIC, it does appear that the NRRA and ARRC have some aims in common. In particular, both organisations have been lobbying in favour of extending the LRRA to include property and other risks.

"We've always supported that and we've always lobbied for it," says Myers. "I can't say that we would go line by line and make a differentiation, but we would like to work with anyone that's willing to work towards our mutual objectives."

Naturally, Dick Goff sees things differently. "The ARRC has reached out to the NRRA on numerous occasions and has had the door slammed in its face. The NRRA's approach is 'let's find common ground and compromise with the NAIC'. The ARRC will not support that approach."

Bad rep

Meanwhile, states' perceptions of RRGs remains a problem. Of the 25 states that have captive laws, 19 allow RRGs to be formed under that law. The usual suspects, states that consistently demonstrate an unwillingness to license RRGs (even if they have a captive law) are generally agreed to be California, Florida, New York and, to a lesser extent, Wisconsin and Washington State.

According to Leslie Jones, part of the perception problem may be to do with the drive to extend the LRRA. "There's huge opposition from the states because they feel the Federal Act preempts state laws, which of course it does to a large degree," she says.

Addressing the perception issue

Rebecca Smart thinks the problem may be more fundamental than that. "It just stems from their natural tendency to not trust other states," she says. "The NAIC has put out model application processes for what you need to submit for certificates of authority and the vast majority of states followed those guidelines – California does not. They have all their own and New York has all their own."

Karen Cutts says the NAIC accreditation will go some way to addressing the perception issue, but only so far. "I think there's a kind of acceptance that every state wishes to be accredited – except for New York because New York doesn't care," she says. "But truly, what would happen if states suddenly started to say 'we don't care if we're accredited'. If enough do that then it undermines the accreditation process."

Dick Goff is characteristically blunt on the issue. "Where the problem lies is that a number of the states feel that they are giving up their control of what happens with regard to insurance transactions within their state," he says. "Their egos are having a hard time with that."

Anne Frohman strikes a conciliatory note, however. "I think what the states are really interested in is being assured that the domiciliary regulator can do its work with confidence. And an accreditation programme might be the way to get there."

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