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A guide to what's hot in the world of captives and ART

Strategic Risk Solutions

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With the proposed LRRA modernization bill (HR 5792) pending before the House Financial Services Committee, we are focusing our third quarter newsletter on Risk Retention Groups (RRGs). We take a look at the current size of the RRG market, review some of the regulatory challenges that RRGs have faced and discuss on-going opportunities for the use of RRGs.

The Market for Risk Retention Groups

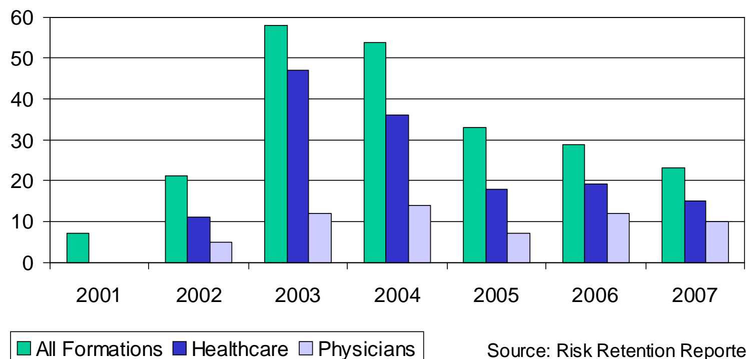
The amended Federal Risk Retention Liability Act was passed in 1986 at a time when liability insurance was difficult to obtain. The Act is Federal legislation which provides a mechanism for a RRG to operate in multiple states under one license. Its goal was to make it easier for like risks to form insurance companies and do business throughout the United States. Since its passage, RRGs have become an accepted and expanding part of the alternative market.

RRG Numbers - A number of RRGs were formed after the passage of the Act reaching a high of 79 active companies in 1991. This trend reversed during the soft insurance market of the 1990s, with numbers falling to a low of 65 active RRGs in 2000. Since then we have seen rapid growth, particularly in the hard market period of 2002-2005. Numbers have continued to increase in the soft market. There were a total of 257 active RRGs last year. (Exhibit 1).

Premiums - Premiums written by RRGs have also increased significantly in the past few years from less than $1 billion in 2001 to more than $2.7 billion in 2007 (Exhibit 1). Premiums have tracked the number of active RRGs. Premiums continue to increase in the soft market, although at a slower rate.

Domiciles - RRGs must be formed in the US. Vermont, the leading US captive domicile, is also the leading domicile for RRGs with 30% of the total. Vermont is home to most of the larger more mature RRGs with a disproportionate share of RRG premiums. Vermont has seen its fair share of new RRG formations over the past six years, although several of the emerging domiciles have been very active in this area.

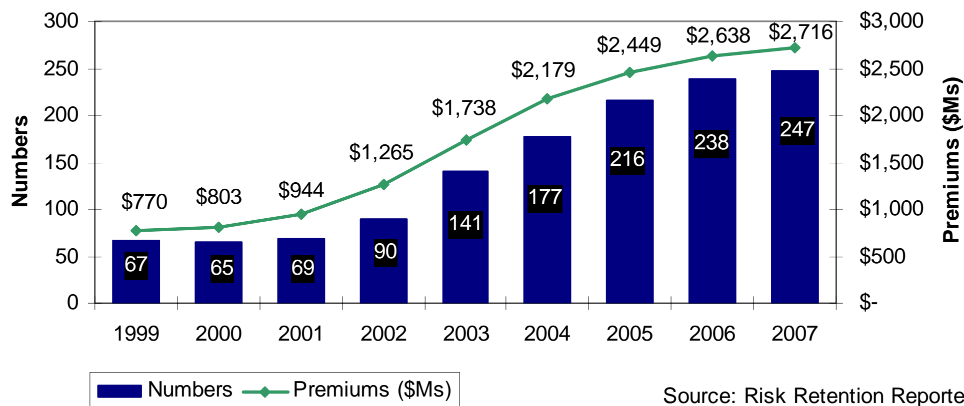
Exhibit 2: Recent RRG Formations



Source: Risk Retention Reporter

- South Carolina was a favored domicile for RRGs from 2002-2004. Its share of new formations has decreased since then as the domicile has looked to diversify its captive population. It was the leading domicile for RRG formation in 2003 & 2004.
- The District of Columbia was very active in RRG formations from 2003-2005, although formations have dropped since then. DC was the leading domicile for RRG formations in 2005.
- Nevada has been attracting an increasing share of RRG formations since 2005. It was the leading domicile for RRG formations last year.

Exhibit 1: RRG Numbers & Premiums



Source: Risk Retention Reporter

Size - The vast majority of RRGs are small. 64% have surplus of less than $5 million based on 2006 numbers. Only 12 RRGs (5%) have surplus greater than $30 million, although surplus levels have been increasing in recent years.

Risks - The passage of the Federal Risk Retention Act was in response to liability problems in a variety of industries. This included products liability for manufacturing companies, E&O and D&O liability for professional services firms, transportation liability, general liability for education and non-profit organizations and medical malpractice for healthcare organizations. The early years of RRG

formations saw a balance in industries reflecting the overall liability concerns at the time (Exhibit 2). That balance has changed with the healthcare industry dominating recent RRG formations. The healthcare industry has accounted for the majority of RRG formations in each of the past six years.

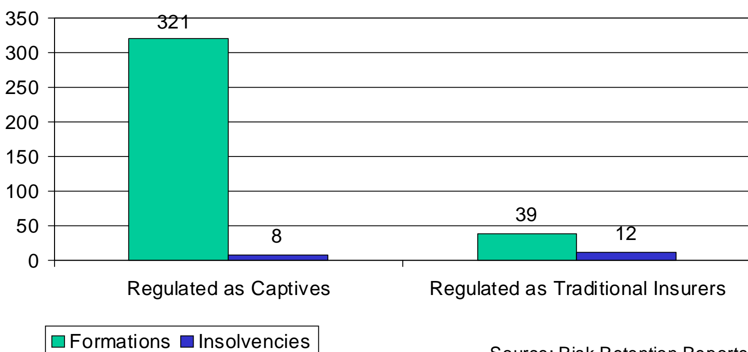
RRG Challenges

The objective of the Federal Risk Retention Act was for a RRG to be regulated in its domiciliary state, with the right to operate in any state in which it registers. Over the years this has caused concerns among local state regulators, as non domiciliary states had very little control over RRGs operating in their states. Some put up roadblocks in requesting information. Others ignored registration requests, leaving the RRG unsure if it was licensed to write insurance in that state. The non domiciliary states' concerns have focused on inconsistent regulation of RRGs by the domiciliary state, including:

- Inconsistent reporting: RRGs are required to produce the standard yellow blank filing, although some states allow RRGs to use a modified version.
- Captive vs commercial statutes: Some RRGs were licensed under traditional insurance laws with minimum capital of $2 million - $5 million. Others were licensed under captive laws with much lower minimum capital requirements.
- GAAP vs Statutory accounting: statutory accounting is used by traditional insurers and focuses on the claims paying ability of the insurer. Captives use GAAP, which looks at the business from the investor's perspective as a going concern.
- Other differences in accepted practices, for example Letters of Credit, Surplus Notes, Reserve Discounting, etc. None of these practices are normally accepted by regulators for traditional insurers, but they often are for RRGs licensed as captives.

The growth in RRGs in the past 6-7 years combined with the emergence of new US captive domiciles have added to the concerns. A large percentage of RRGs have been formed in the new domiciles, where the regulatory environment for captives is relatively immature. RRG failures have added to the concerns, although the failure rate has been no greater than that of commercial insurers. 21 RRGs became insolvent between 1990 and 2003. This represents 6% of the total number of RRGs formed. RRGs licensed under captive laws have had a much lower failure rate than those licensed under captive laws (Exhibit 3).

Exhibit 3: RRG Insolvencies



Source: Risk Retention Reporter

GAO Report - In 2003 The House Finance Committee on Financial Services asked the GAO to determine the impact RRGs have had and whether they are working as intended. This was a comprehensive report with the findings issued in August 2005 in the report 2005 titled "Common Regulatory Standards and Greater Member Protections are Needed". The key findings from the report were:

- Although they represent a small part of the overall insurance market, RRGs have increased the availability and affordability of insurance for their members as was intended by the Act.
- There is a lack of common regulatory standards for RRGs across domiciliary states.
- The Act's provision for ownership control and governance may not be sufficient to protect the interests of the policyholders.

The problems of ownership control and governance were highlighted by the GAO in some of the more notable RRG failures. In each of these cases, the common theme was the lack of control over the RRG by the policyholders.

- Charter RRG Insurance Company (1987-1992): The managers of this group undercharged premiums to sell more policies and increase their own compensation. Individual Board members also had ownership interests in the manager and reinsurer.
- Professional Mutual Insurance Co (1987-1994): The president was the sole owner of the marketing company and agency that had sole rights to sell to the RRG. Exorbitant commissions were paid for services which were never performed.
- Nonprofits Mutual RRG, Inc. (1991-2000): It was alleged that the manager charged excessive fees. The manager was also in a position to exert influence as the principals loaned the RRG the start-up capital. The management contract was for 5 years with a one-year notice period.

The GAO concluded that the problems of ownership control and common regulatory standards should be addressed by the states through the NAIC before Federal intervention.

NAIC Involvement – The NAIC responded by creating two committees: the RRG (C) Working Group under the property and casualty insurance committee and the RRG (E) Task Force under the financial condition committee.

The RRG (C) Working Group focused on the ownership and governance issue. Its recommendations included:

- Boards should have a majority of independent directors. A policyholder is considered an independent director.
- The term of any material service provider contract can not exceed 5 years.
- The regulator has 30 days to disapprove a service provider contract if it feels it is not in the best interests of the policyholders.
- The RRG must set up an audit committee. The regulator can waive, for example if there are only a couple of members.
- The Board must adopt a code of business conduct and ethics.

These recommendations were adopted by the parent committee but have never been implemented.

The RRG (E) Task Force is focused on consistent regulatory standards and is using the NAIC accreditation process as the platform. This process, which is voluntary, was set up in the early 1990s to establish a common set of regulatory standards across the states. They were created in response to a series of failures of commercial insurers in the 1980s and early 1990s. There are three parts to the accreditation process:

A. Model Laws: 18 model laws were identified, including items such as audits, the need for actuarial opinions, minimum capital requirements, the right to examination, etc.
B. The standard of the examinations and analysis conducted by the state regulators
C. Staffing: whether the state has the appropriate regulatory staff.

Parts B & C were adopted for both traditional insurers and RRGs. Part A was not adopted for RRGs and the task force is re-examining the applicability of the Model Laws to RRGs. The task force is also looking at other regulatory standards beyond the 18, including items such as the use of risk based capital and the acceptance of reinsurance. The task force is about to issue a white paper for comment.

Through the Committee and Task Force the NAIC is addressing both the ownership and control issue and providing common regulatory standards. Non domiciliary states, including the larger states sit on the NAIC committees and task forces and are having a say. This provides a mechanism to raise concerns and have them addressed. Problems can still occur and there have been a few recent cases in which non domiciliary states, particularly California, have challenged an RRG's registration. Notwithstanding these cases, the work of the NAIC should make it easier for well run RRGs to register in non domiciliary states.

Opportunities for RRGs

This article summarizes information presented by Scott Spencer of Stevens and Lee in our Webinar, "RRGs: Opportunities and Challenges" held in May 2008.

Traditional RRG Uses

There continue to be areas of the traditional market which are under-served or distressed. These areas include healthcare liability particularly among physician groups, where the traditional market varies considerably from state to state. The influences are both in the liability awards in the state and the funding of state insurance programs such as the individual JUAs or equivalent. They are often independent of insurance market cycles providing ongoing opportunities for the creation of RRGs among physician groups. There is widespread acceptance of RRGs among hospitals and physician groups and we expect to see continued growth in the use of RRGs in this industry. More widespread opportunities for the traditional use of RRGs will emerge once the insurance market hardens.

Fronting: one of the major benefits of RRGs is the ability to write direct. This can help mature captives reduce their cost structure and expand their underwriting. Onshore group captives are converting to RRGs to reduce fronting costs and gain more control. Offshore captives are creating onshore RRGs to front for them. This has been most prevalent among healthcare organizations who are providing coverage for physicians from an offshore captive. This structure provides the regulatory authority for the captive to write in the state using the RRG as the front.

Non-Traditional Uses

There are a couple of novel uses of RRGs currently being discussed in the industry. These uses are new and largely untested with only a limited number of examples of actual use.

Employee Benefits — Under this structure the RRG provides a contractual liability policy to a policyholder to reimburse the policyholder for payments under its employee benefit plan. The RRG is formed by a number of similar companies who are usually linked by some group such as a trade association. The RRG pools the risk of each members' employee benefit program. Each policyholder buys a stop loss policy above the limit of contractual liability provided by the RRG. The RRG is not responsible for benefit payments to employees. It sits behind the policyholders' individual plans (similar to a reinsurer) allowing for the spreading of risk and the sharing of infrastructure costs.

There are two examples of funding employee benefits in a RRG:

- American Construction Benefits, which is operating
- AD Comp, a Montana RRG, which has recently ceased operations following litigation brought by the California Department of Insurance over the validity of this structure for a RRG.

Cell Captive RRGs — Can a US-domiciled "Sponsored Captive" with "protected cells" qualify as a risk retention group? This structure may be attractive as it could provide efficiencies to the participants in the cells.

The premise behind this use of RRGs is that groups of insureds can organize into separate cells with the sponsored captive itself qualifying as a RRG. The groups in the separate cells may be similar but not identical, for example a group of orthopedic surgeons and a group of OB/GYNs. Issues to address in this structure include:

- Insureds must be owners: the sponsor owns the captive, the insureds do not. To satisfy the requirement of insureds as owners the cell participants need to have some ownership in the cell captive. This may be difficult as most domiciles limit sponsors to existing insurance companies.

- The spreading of risk among homogenous exposures: the wording of the Act requires risk spreading but not spreading across all members of the RRG. This opens the door for the structure to work for groups insuring together in cells. Some level of risk sharing between cells will help the structure.

There have been no approvals for this structure yet. It will need more discussion before regulators get comfortable with this structure. If that occurs and there are economic benefits to the structure, it could become more prevalent among RRGs and cells.

Expanding the Act— HR Bill 5792 Increasing Insurance Coverage Options for Consumers Act, 2008 would allow RRGs to write property insurance. There are some additional provisions to the Act:

- Property RRGs would be subject to special requirements typically applied to commercial insurers.
- The governance standards proposed by the NAIC RRG (C) Working Group would be imposed on all RRGs.
- A new Federal fiduciary duty would be introduced for RRGs.

The Bill still has a long way to go before it would be introduced into law. It has received support from the alternative risk and risk management community, but not insurance regulators. The NAIC recently stated that it cannot support the expansion of RRGs into commercial property as currently proposed by the Bill.

SRS News

SRS Launches Healthcare Practice, Appoints Industry Leaders

In July SRS launched a healthcare industry practice. The industry practice will co-ordinate services provided to clients in the Healthcare industry regardless of domicile and captive structure. Seamus Tivnan and Wayne Cowan will jointly head the Healthcare industry practice. Both are Directors of Strategic Risk Solutions (Cayman) Limited.

“The Healthcare industry represents an important and growing sector of our business and it is not limited to Cayman. We are working with captives from different areas of the healthcare industry across all domiciles”, said Brady Young, President and CEO of SRS. “The creation of the industry practice recognizes a need to bring consistency of service and the cross-fertilization of ideas within SRS to better serve our clients in this industry”.

SRS currently manages healthcare captives in Cayman, Bermuda, Vermont and South Carolina. Our clients include healthcare institutions, both for profit and not-for-profit, physicians groups, long-term care companies, and service providers to the healthcare industry. Collectively healthcare captives represent approximately 30% of the company’s clients.

Staff News — Michelle McTaggart has joined SRS (Cayman) as an account executive. Michelle has 11 years experience in the captive management industry. She was formerly a Client Service Team Leader and Vice President at Marsh Management Services in the Cayman Islands. We are pleased to welcome Michelle to SRS.

Events

SRS will be participating in the following upcoming industry events:

- **Aug 12 – 14, VCIA:** SRS will be exhibiting at the annual conference at the Sheraton in Burlington, VT. Brady Young and Michael O’Malley will be speaking. Visit us at Booth #9.
- **Sept 16-19, CAJPA/AGRIP:** Derick White will be speaking at the annual fall conference in Lake Tahoe.
- **Sept 19**, **Utah Captive Association:** Ann Wick will be speaking at the annual conference to be held in Midway, Utah.
- **Sept 22-24**, **NRRA**: Derick White and Brady Young will be speaking at the annual conference in Washington, DC
- **Oct 2-5**, **ASHRM:** Seamus Tivnan, Wayne Cowan and Ron Sulisz will be attending the annual conference in Boston. MA.
- **Oct 3, The Friendly Society Restored**: Derick White will be speaking at the monthly breakfast in Charleston, SC.
- **Oct 5-8, Self-Insurance Institute of America**, Brady Young will be speaking at the national conference to be held in Phoenix, AZ.

Please contact us at info@strategicrisks.com to arrange meetings with our team at any of these industry events.

SRS Webinar Series

SRS hosts periodic webinars on topical issues affecting the captive insurance industry. Our provisional schedule of upcoming webinars includes:

- **Sept 3**: To grow or not to grow – captive strategy questions
- **Sept 24**: Rating your captive

To ensure you are included on the distribution list for webinar announcements, contact us at info@strategicrisks.com.

Recordings

Recordings of prior webinars are available at our website (www.strategicrisks.com). Recent recordings include:

- What’s new in Vermont?
- Metrics that Matter – A Guide for Captive Owners
- RRGs – Opportunities and Challenges
- The State of the Market for Healthcare Captives

Strategic Risk Solutions (SRS) is an independently owned captive management and consulting firm. The company is an approved manager of captive insurance companies in most leading onshore and offshore domiciles. SRS is committed to being the premier provider of captive management and advisory services in the territories in which we operate.

For more information on SRS, visit us at www.strategicrisks.com.

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