CAPTIVE INSURANCE COMPANY REPORTS

RRG Trends and Current Issues

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Editor's Note: From **Derick White,** successful manager and former auditor and regulator, who has some thoughts on managing risk retention groups (RRGs) and some of the current trends and issues arising for RRGs. He is a managing director at Strategic Risk Solutions, where he heads up the recently formed governance, risk, and compliance practice operating from Burlington, Vermont, which is the leading domicile for RRGs. Contact him at derick.white@sytrategicrisks.com.

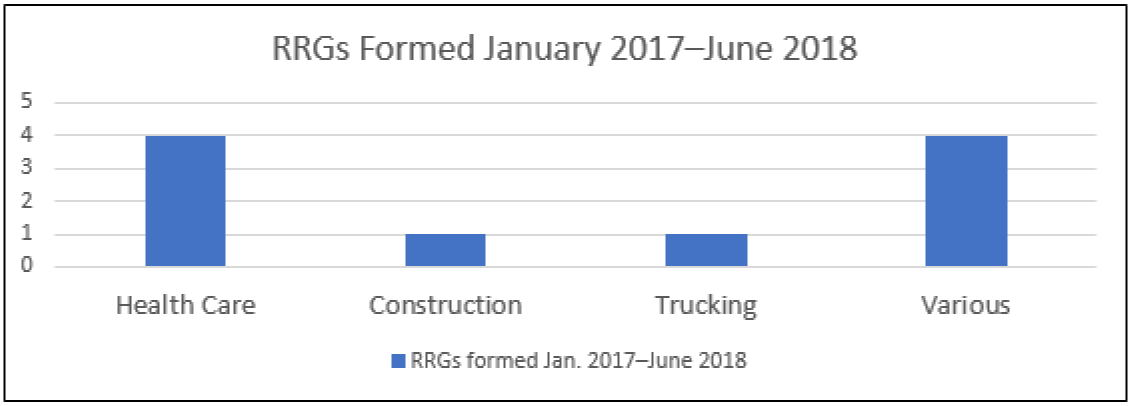
RRGs continue to be a popular form of insurer to provide coverage. While the overall number of RRGs has fallen from a year-end high of 262 in 2008 to 214 as of midyear 2018, new formations are still occurring. During the past 18 months, 9 RRGs have formed. (See charts for coverages and domiciles on page 2.) RRGs servicing the healthcare industry remain the most popular with 4 out of the 9 new formations. Over the same period, 26 RRGs closed, half related to the healthcare industry (source: *Risk Retention Reporter*).

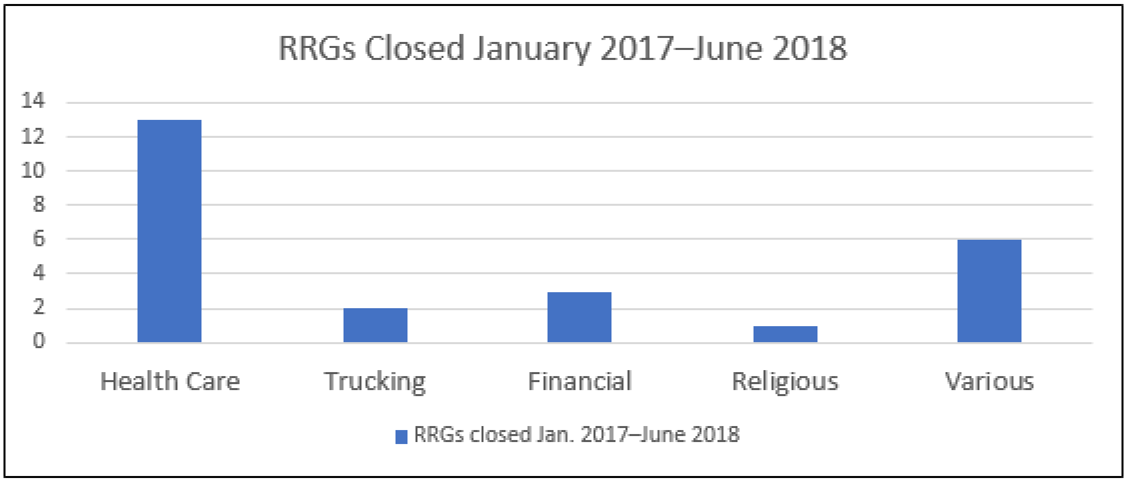
Vermont leads the way in domicile choice, forming three domiciles with both Nevada and North Carolina each forming two. Alabama licensed its first RRG during 2018 with a redomestication from Montana. Vermont also led the way for closures with eight, followed by South Carolina with four, and Nevada and DC tying with three each. Colorado, one of the first domiciles in the United States, had one risk RRG close.

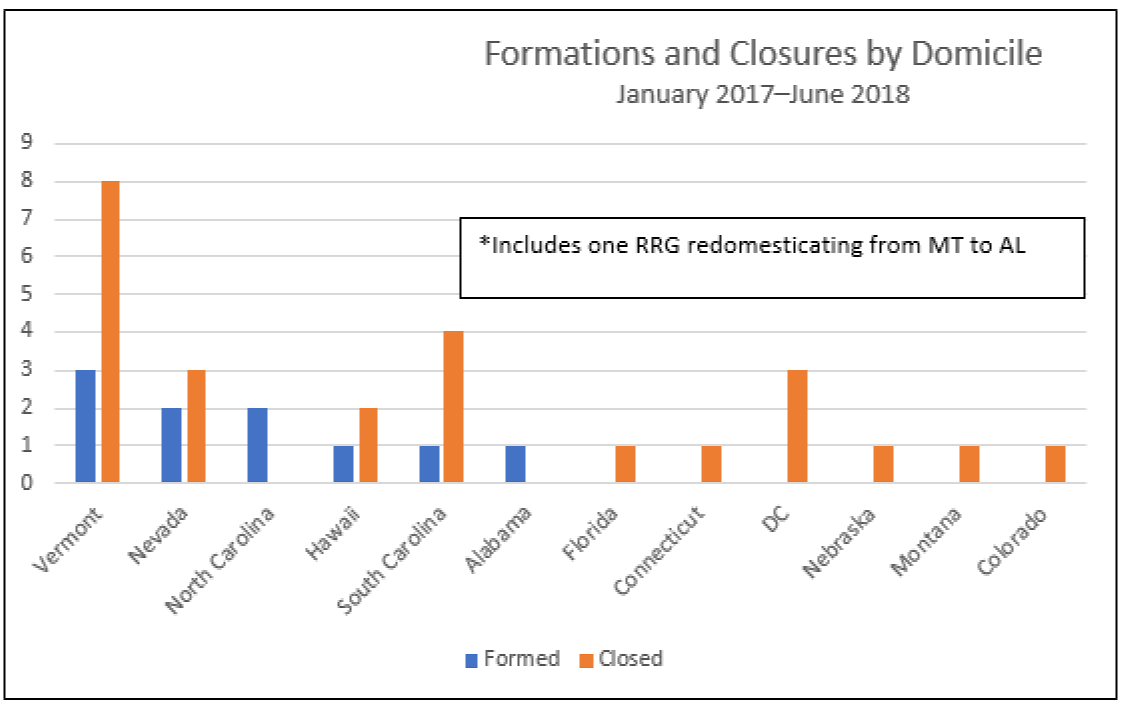
Despite all of this activity and the freedom that the Liability Risk Retention Act (LRRA) intended to provide RRGs, they continue to be caught between the broad-based style of traditional regulation and the more proportional regulation applied to captive insurers. While the domestic regulator may recognize the need for requirements suited specifically to RRGs, foreign regulators often do not understand nor seem to care to understand the uniqueness of these insurers, along with the purpose they serve for many residents from their states.

Cyber Security

After several high-profile computer hacks of large financial institutions, the federal government along with various states began considering cyber-security regulations. New York was first with New York Cyber Security Regulation (23 NYCRR 500).







Source: *"Special Report: Risk Retention Groups by State of Domicile,"* Risk Retention Report, July 2018.

This regulation had an effective date of March 1, 2017, and a 180-day compliance period. Originally encompassing all financial services companies doing business in New York, it would have included RRGs. After concern was expressed throughout the RRG community, including a response from the National Risk Retention Association pointing out that the regulation was preempted by the LRRA, 15 U.S.C. 3901(a), clarification followed eliminating foreign RRGs from the regulation (500.19(f)). Although not applicable to RRGs registered in New York, all subsequent cyber regulations issued by the government are based on this NY regulation.

In addition to foreign RRGs, the regulation exempts organizations that have the following attributes.

- Fewer than 10 employees
- Less than $5 million in gross annual revenue for 3 years
- Less than $10 million in year-end total assets

To be compliant, covered entities must do the following.

- Establish an effective cyber-security program.
- Create and maintain a written cyber-security policy.
- Designate a chief information security officer.
- Hire qualified cyber-security personnel, or utilize third-party providers.
- Establish an incident response plan.

The covered entity must submit a certification of compliance on the 1-year mark and then regularly conduct penetration testing and vulnerability management, as well as biannual risk assessments. At the 1.5 year mark, the covered entities must also prove that they have maintained an audit trail and implemented application security protocols.

While New York was first out with cyber-security regulations, the National Association of Insurance Commissioners (NAIC) was not far behind. It had previously formed a task force in 2014 to monitor cyber-security issues. The task force moved quickly after New York issued its own draft with a lengthy draft model act that was later blended with attributes of the NY regulation. This ultimately became the Insurance Data Security Law issued in October 2017, which was intended to be available to states during their 2018 legislative sessions. Elements of the model law are the following.

- Written information security program and a designated responsible person
- Risk assessment of policies and procedures
- Evidence of "due diligence" exercised in selecting third-party service providers
- Submission of annual certification of compliance to the domestic commissioner
- Prompt investigation of any cyber-security events
- Notification to the commissioner if a cyber-security event has occurred

The model law is not part of the accreditation requirements, so there are no direct penalties should states not pass the act; however, the federal Treasury Department has endorsed the model and recommended prompt adoption by the states. It further recommended that if adoption and implementation of the model law by the states does not result in uniform data security regulations within 5 years, Congress should pass a law setting forth requirements for insurer data security but leaving supervision and enforcement with state insurance regulators (Report on Asset Management and Insurance by the Treasury Department). Some states have expressed concern with the difficulty of passing a cyber bill that does not encompass all financial institutions, rather than just insurance entities. Only Rhode Island and South Carolina have introduced the model law into the legislative process to date. Vermont is considering it for the 2019 fiscal year but only for commercial insurers. RRGs need to monitor this as quick adoption may be necessary once final regulations are adopted by states in the coming years.

Corporate Governance

The Government Accountability Office released a report following an 18-month study of RRGs on August 15, 2005. Its concluding report was titled Common Regulatory Standards and Greater Member Protections Are Needed and included observations on RRGs that failed. As indicated by the title, it posited that provisions for ownership and control might not be sufficient to protect the best interests of the insureds. It noted that many failed RRGs shared the commonality of lack of participation by insureds. It recommended that the states, through the NAIC, be given a chance to implement a platform to ensure RRGs are controlled by their insured members.

This issue was addressed by the NAIC Risk Retention Working Group that was charged with drafting governance standards. The Working Group considered existing standards for similar entities along with the definitions of "control" and "ownership." It passed "Corporate Governance Standards for Risk Retention Groups" in 2007. The draft standards moved up to the parent committee and sat for almost a decade. The standards were finally adopted and made part of the accreditation standards beginning in 2017. The standards addressed the lack of control by the insured members by requiring the following.

- A majority of the board be independent
- Board approval of all material service providers

It also required certain actions by the board including the following.

- Adopting bylaws or a plan of operation that includes certain requirements
- Formation of an audit committee along with a written charter that includes specific wording
- Board governance standards detailing how members are elected, director qualifications, and other items
- A written code of business and ethics policy

RRGs will have adopted these policies by now, but it is a good idea to dust off the documents, reread if they have been sitting on a shelf since first considered to ensure continued compliance, and reevaluated. One requirement requiring annual affirmation is that the board considers the independence of its directors. The model law states: "Each risk retention group shall disclose these determinations to its domestic regulator at least annually." Vermont was one of the first states to adopt the model law but included that the determinations be filed "upon request" rather than "annually." The NAIC did not feel that this language was substantially similar to the model law, so Vermont changed its law in 2018 to require the annual filing. Other states that followed Vermont's original language will have to update their statute soon.

Other Issues

The LRRA was written to provide a mechanism whereby entities could band together across state lines to easily form their own insurance company. The domiciliary regulator was the primary regulator, and other jurisdictions could only ask for certain information. Unfortunately, many states still confuse RRGs with commercial insurers and include RRGs in any rules promulgated without considering whether they would not be allowed under the LRRA or simply not make sense for any RRG.

For example, New Mexico issued its annual fraud assessment on all insurers including RRGs. It is still unclear as to whether this assessment is a fee or a tax and if RRGs must pay. Texas has issued its medical joint underwriting association (JUA) fee to RRGs newly registered in Texas. RRGs cannot belong to a guarantee fund, and many RRGs are not licensed to provide medical liability coverage, so it is still unclear whether RRGs would legally be allowed to participate in the JUA or pay future assessments. Meanwhile, some states continue to delay registrations requesting additional information and ask multiple rounds of questions long after the initial filing.

RRGs are an excellent option to consider when the commercial market is not meeting the needs of insureds within an area or industry. Obtaining coverage specific to a business need can be crucial in keeping that business afloat and its employees working and successful, as well as addressing the needs of consumers. The majority of RRGs continue to pay attention to and comply with all the legal regulatory requirements. Nondomiciliary states must consider RRGs when promulgating rules and regulations and whether these should and legally could apply to RRGs. Maintaining insurance for their residents, as well as access to vital services and products they need, depends on this.