ALTERNATIVE RISK TRANSFER

INSURANCE SERVICES

RISK RETENTION GROUPS

THE POTENTIAL AND TRADE-OFFS

QUESTIONS AND ANSWERS

"THE REST OF THE STORY"

Q. What are the individual States likely to do by way of regulating Risk Retention Groups within the parameters allowed by the Act?

The National Association of Insurance Commissioners (NAIC) rushed to publish model legislation by mid-December, 1986, so that States could move quickly to allow their insurance departments to regulate Risk Retention and Purchasing Group formations and operations under the terms of the Act. Some states will need to enact at least rudimentary enabling legislation almost immediately and will probably adopt the model legislation substantially intact – at least for starters. There is fear in some quarters that subvert the spirit and intent of the Act and which may impel federal intervention in the insurance regulatory process. The NAIC in 1991 published a Model Bill for the Risk Retention Act.

Remember, although Risk Retention Groups are exempt from most state laws governing the practices of commercial insurers, they are not exempt from the insurance chartering (including capital requirements) or licensing laws, nor are they exempt from the laws governing initial authorization and conditions of operation. Therefore, in states where licensing of Insurer's is already stringent, and the capital requirements high for commercial insurers, they will be no less so for Risk Retention Groups. For this reason, it is expected that many new Risk Retention Groups, especially where initial funding is a costly consideration, will seek charters/licenses in the state with the easiest, fastest and least expensive access.

Also keep in mind that the chartering, licensing, feasibility study and business plan stages will not be an overnight process.

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The states that already have Captive Insurance Laws can be expected to pay the earliest in-depth attention to the provisions of the Act. Indeed some jurisdictions are already promoting Risk Retention Groups heavily as a logical extension of their already established captive industries. Not only are these domiciles prepared to service new groups now that offshore tax advantages have disappeared, they will actually promote the migration of existing off-shore captives – particularly in Bermuda and the Cayman Islands – to on-shore homes.

Also heading the list of states with regulatory interests are those whose existing insurance licensees are actively and strictly regulated. This interest is both to protect the existing insurance climate from threats to its stability, and to assure that its existing laws provide few, if any, incentives for shoddy, unsound or financially de-stabilizing activities by Risk Retention Groups or Purchasing Groups. Count among these; New York (where the insurance commissioner is very worried indeed); Florida; Texas; Illinois; Pennsylvania; Massachusetts, and California. States with strong and active regulatory systems and stringent financial requirements <u>DO NOT</u> lead the "hit parade" of favored Risk Retention Group domiciles.

Beyond these general projections, there are, of course, many states that have adopted model uniform legislation, watch the others, and eventually follow one or more "lead" states as to the shape of their ultimate regulation. And there are still others that will do little or nothing. Because of the broad geographic operating powers given to Risk Retention Groups, states' insurance regulators are keeping close watch on Risk Retention Groups domiciled in states that exercise loose or no controls.

At a minimum, each state's insurance department is reviewing all state regulations dealing with financial responsibility and the definition of acceptable evidence of financial responsibility. To the extent that evidence of Risk Retention Group participation will suffice to replace a policy from a licensed insurer, or if Risk Retention Groups must meet certain minimum financial standards, the state legislature must be asked to enact the enabling amendments.

Q. <u>In what ways, if any, is a Risk Retention Group, as a state licensed liability insurer, NOT subject to the comprehensive regulation which applies to conventionally licensed insurers?</u>

Depending on the State of Domicile, regulation of Risk Retention Groups by insurance authorities can be expected to vary from rigorous to lax, depending on the state's laws, attitudes, politics, budgetary considerations and insurance department staff capabilities.

But even within the framework of existing and amended state statutes, all state insurance departments are far more limited in their authority and ability to regulate Risk Retention Groups. The following are only some of the ways in which states will be unable to constrain Risk Retention Groups in the same ways as commercial insurance companies.

- The absence of licensing requirements for more than one state. Commercial insurers must be licensed in all states in which they wish to deal or they are classified as "non-admitted" insurers in the states where they are not licensed. A Risk Retention Group becomes an "admitted" insurer in any state merely by filing a copy of its home state authorization and plan of operation wherever it wishes to offer insurance. It does not need to make any security deposits nor have any assets in states other than the home state. Thus, the Risk Retention Group (except in certain instances) also sidesteps the state's Surplus Line Laws and Regulations. States other than the home state have no authority to suspend, restrict or remove a Risk Retention Group's license.

- State insurance departments have little direct administrative authority over Risk Retention Groups. A state wishing to take virtually any disciplinary action with respect to a Risk Retention Group must conduct detailed investigations and administrative hearings, and then go to a state or federal court to obtain an injunction. Besides impeding timely responsiveness by regulators, these mechanics will likely require huge amounts of staff time and cost – neither of which are abundant commodities in state insurance departments. These procedures also open insurance departments to counterclaims of harassment and similar charges.

- States, for the most part, have little or no approval authority for rates charged by the Risk Retention Group. Risk Retention Groups operating in states other than the State of Domicile could undercut prevailing approved rate levels and, in sufficient numbers, could substantially de-stabilize the entire insurance market in a given state.

All told, Risk Retention Group member-buyers will have far less – and often almost no – protection from state insurance regulators. And Risk Retention Group buyers do not have access to state insolvency guaranty funds.

Q. What will the states require in the way of a "feasibility study" or "operating plan"?

This depends on the requirements adopted by the various state legislatures and accompanying insurance department regulation. The NAIC model legislation defines these documents as "analysis which presents the expected activities and the results of a Risk Retention Group", and by and large must include at least the following:

- A description of coverage, limits, deductibles, rates and classification systems for each kind of insurance offered.

- Past and projected claims experience of the proposed members of the group and, insofar as it is available, the nationwide experience of similar type risks.

- Pro forma financial statements and projections.

- A qualified casualty actuarial opinion, including a projection of the minimum participation levels (in members or premium dollars) needed to avoid a "hazardous financial condition".

- A description of management qualifications, underwriting standards and procedures, management controls and investment policies.

These general standards, if approved, will be spelled out in detail in the regulations adopted by the various state insurance departments.

State regulators may, of course, go beyond these basic requirements provided they are not imposing any standards that other insurance offering similar coverage in the state don't have to meet. It is possible, but not likely, that states will adopt lesser parameters. It is probable that regulations in some states will make the standards easier to meet than in others.

Q. What should a feasibility study analyze, explain and evaluate?

As applied to the insurance of particular types of liability exposures, a feasibility study should examine the issue of, "Can we do it and what will it cost?"

The central focus of any feasibility study should be past losses incurred by members of the proposed Risk Retention Group. The farther back in time these loss histories go, the more complete they are and the more up-to-date they are as to current status, the better. Getting quality information of this sort from a multitude of individuals or firms is no easy task and getting it from their former insurers is often impossible. Loss data can be further validated by factoring in

nationwide insurance industry loss statistics, if you can get them. And the data will always have to be adjusted to take into account the effect of mergers, acquisitions and significant operating changes in the member businesses.

Beyond losses you will need reliable and detailed data as respects sales or other measures of business activity – information that businesses are often reluctant to part with or will be given only in very approximate round figures, especially when competitive firms are also in the group.

This is the essential information needed on which to base projections about future losses and on which to base determinations of a suitable retention or net loss the group can fund with members' capital contributions and premiums.

Past premiums for similar insurance provided to group members is a useful benchmark for several purposes, but not an essential element in judging feasibility.

When the loss data are further broken down among members' various locations and identified by operating unit, it becomes possible to evaluate the loss prevention and loss reduction potentials of safety, engineering or other risk management programs. This can be an important appraisal because if claims can be prevented or contained, they do not have to be defended or put before juries, and can be removed or downgraded in your expected loss calculations.

Detailed loss histories also provide valuable clues as to the type and extend of servicing the group's claims will require and the quality and quantity of staff needed to perform this critical work.

In summary, a feasibility study should present a fair profile of what is in store when a group undertakes to fund part or all of its losses. But in liability insurance things can go wrong and often do, and you will need a comfortable safety cushion against the unanticipated. The feasibility study should tell you that, too.

Q. <u>What is the role of casualty actuaries and how reliable are their forecasts?</u>

The essence of the casualty actuary's job I to lend predictability to abject uncertainty, or perhaps more accurately, to speculate in an organized way about the otherwise imponderable.

The principles of actuarial science, applied to liability exposures, are perhaps more art than science. This is not due to any failings on the part of actuaries. It is due primarily to two very substantial but extraneous factors:

- <u>The lack of a large enough historical base to reach reliable conclusions about the future.</u> When it comes to forecasting death rates, incidence of certain illnesses or even incidence of congenital or occupational diseases, actuaries are in heaven because they can work with numbers in the many hundreds of millions. With automobile accidents, predictability is reasonably close to the ballpark because cars and drivers number in tens and hundreds of millions. With household fires, the predictions are les reliable, but still pretty good because there are plenty of numbers to look back on and because there are relatively few changes in the factors that cause most fires.

  By contrast, there is very little that is historically quantitative in the anatomy of legal exposures. Consider the infinite variables involved in such elements as; the legal duty owed by one person to another, behavior which can be construed as careless or negligent, shortcuts and chicanery which can lead to damages, and the imaginations of a large pool of legal talent. Consider also the uselessness of prior judgments, awards and legal costs, as indicators of what future costs will be.

- <u>The rapid adaptation of legal and social standards to technological and social change</u>. Most historical standards are unreliable indicators about the future. New products, new technologies and new tastes lead the parade as breeding grounds of new liability exposures. So do changing standards of conduct and redress. New laws and changing interpretations of old ones also contribute heavily.

These factors are apart from the imponderables which influence ever escalating legal costs and court and jury awards. It is difficult enough for actuaries to forecast future probability when the underlying causes remain fairly constant or are subject to slow change over many years' time. It is almost impossible to do so when what happened three years ago, or last month, or even last week cannot be used as an indicator of what might happen tomorrow.

Apart from low numbers and high variations in causative factors, the actuaries' job in dealing with liability exposures is further complicated by the tendency of underwriters to alter the terms of insurance coverage. Although insurance changes are usually prompted by the need to restrict coverage, it is impossible to predict what legal "loopholes" or judicial interpretations might result that were not intended or anticipated by the changed wordings. Part of the historical evaluation of liability exposures has been the application of legal precedents. In recent years many long-standing precedents have been subject to sharp revision if not reversal.

To sum up, although casualty actuarial forecasts are reasonable and necessary starting points, recent history suggests it is wise to view such predictions as "most optimistic" and to temper them with sizable multipliers of Murphy's Law and its corollaries.

Q. How long will it take to establish a Risk Retention Group and get it ready to do business?

There is no hard and fast answer to this one, but figure on a minimum of four months and probably not longer than eight months. There are a lot of variables; the state, the legal and other professional individuals and firms involved, insurance and reinsurance management abilities, the staff, abilities and budgets of the insurance departments, and the speed with which all these activities can be correlated.

A Risk Retention Group is definitely not in the category of, "Let's get the license tomorrow and start issuing policies next Thursday!" A major disadvantage to the delays is the potential loss of interest and enthusiasm among proposed participants. You have wasted a lot of time, expense and effort, if when you are finally ready to roll, the major players have either found another game or decided they don't want to play. Perhaps a significant blessing of the time required to set up shop will be to discourage ill-conceived and potentially disastrous undertakings.

Q. **<u>From the standpoint of pure insurance protection, does the Risk Retention Group mechanism present any dangers not inherent in the operations of conventional insurance companies</u>?**

Yes, definitely. And here are only some of them:

- <u>Risk Retention Groups are limited to commercial liability risks which are "similar and related"</u>. While homogeneity in an insurance portfolio is necessary and to some extent even desirable, when it is <u>only</u> one liability insurance portfolio dealing with <u>only</u> a single or a few classifications of risk, the result is to offer a <u>concentration</u> of risk. The desired "spread" has to be achieved through a multitude of re-insurers rather than by diversification of primary exposures. This has been the traditional, and thus far intractable, problem with medical malpractice insurance.

- <u>There are likely to be catastrophic loss potentials</u>. Where insurance is unavailable, limited and expensive in commercial markets, one reason is usually because there are severe exposures to <u>catastrophic</u> loss. This may take the form of a single event such as an air crash or the Union Carbide disaster at Bhopal. Or it may take the form of many businesses being exposed to a single event or a series of events such as the cumulative, retroactive claims against a number of asbestos producers. Since a Risk Retention Group is both far smaller and much more concentrated than a conventional property-casualty insurer the potential for a catastrophic loss to wipe out the company very quickly is relatively strong. As with conventional insurers, this potential will be magnified by the use of actuarially unjustified low premiums and even further magnified if the plan of insurance is unaccompanied by stringent underwriting practices and sound risk management and loss prevention controls.

- <u>Overall financial capacity</u>. As it is spelled out in the Act, "hazardous financial condition" is an ill-defined concept at best. But nobody (we hope) would argue with the premise that an insurance company must have at least a comfortable margin of liquid assets in order to meet contingencies – which is what losses are all about. Other businesses call this margin "net worth". In insurance it is called "surplus" or "policyholder surplus". Insurance premiums are (or should be) designed to pay for average (expected) claim costs;

costs of claims investigation, settlement and defense; and administrative and service overhead. Premiums contribute to surplus only as they exceed these costs over time and only very gradually considering that the final arithmetic of outgo against a year's worth of premium income may not be known until 8 or 10 years later.

So the capital for initial costs and surplus must come from somewhere in addition to the first year's premiums. This means from the member-owners (or their creditors) usually in the form of stock subscriptions, loans or irrevocable letters of credit. And all this translates into significant costs above and beyond insurance premiums in the hope of recovering some return in the form of dividends or reduced premiums years in the future.

If the surplus is dented by losses in the early years before the Risk Retention Group can reinforce and add to it with underwriting and investment earnings, the member-owners will have to ante up again to enable the Risk Retention Group to continue to write existing business, never mind consider any expanded underwriting services.

Although conventional insurers also face these problems they are generally far better established, have greater spread of risk from multiple-line volume, have somewhat more regular cash flows and have far easier access to public equity and debt markets.

All these general financial considerations do not take into account the fact that customers of most conventional insurers receive some backup in the event of insurer financial difficulty through a state's insolvency guaranty fund – to which Risk Retention Group members do not have access.

- Risk retention Group surplus will in almost all instances tend to be limited by the insurance legal requirements and by what members can afford to subscribe. When you add in the tendency for new Risk Retention Groups to accumulate members – and risk – very quickly after organization (even more so when commercial rates are high and premium savings are promised), necessarily heavy start-up expenses, and the high cost of reinsurance (which is still dictated by the commercial markets); it is easy to exceed safe surplus ratios and to overload the group's financial capacities quite rapidly. Under these conditions even a few large, non-catastrophic losses can threaten a Risk Retention Group's solvency.

- <u>Net retention's, reinsurance and reinsurance costs</u>. Any underwriter must retain for its own account at least some of the risk it assumes. It can rarely "lay off" the whole thing on re-insurers. In practical terms this means that a Risk Retention Group will probably have to pay at least 10% of all losses net.

  Beyond whatever percentage of each loss or aggregate losses in excess of those retained. This is <u>reinsurance</u> which is costly. And it means that you have to share a substantial part of the premium with the re-insurers. For the most part reinsurance companies are part and parcel of the commercial insurance market. Re-insurers look at both classes of risk <u>and</u> primary insurers. Until the primary insurer (in this case the Risk Retention Group) is tested and attains a "track record" as compared with other conventional insurers, you can expect that re-insurers will drive a hard bargain simply because the Risk Retention Group's underwriting performance is relatively unknown and imponderable and because there is relatively little regulation. This state of affairs also suggests that Risk Retention Groups will need to shop among a larger number of re-insurers than commercial insurers to meet their needs, adding still further to their costs.

- <u>Absence of unified commitment</u>. Because of its small size and concentration, without careful planning among members (all of whom also have some vote as owners) a Risk Retention Group is unlikely ever to be stronger than its initial impetus; namely, a reaction to an extreme upswing in commercial marketplace cycles. Unless there are incentives other than premium savings underpinning the Risk Retention Group, it has little ability to survive when commercial price/availability trends down, and almost no ability to survive in an out-and-out buyers' market. It is ironic to consider that any significant emergence of Risk Retention Groups as insurers will have the effect of easing price and capacity pressure in the commercial markets which, in turn, will stimulate the very competitiveness of the commercial markets.

  <u>Too few members and exposure units</u>. Insurance reduces uncertainty through the operation of the "law of large numbers" which Congress has nothing to do with. Large numbers promote greater predictability, thus greater loss and cost stability. Small numbers engender uncertainty and reduce predictability to plus or minus 100%, thereby leaving very little assurance in insurance.

Unless some sort of miracle occurs, by comparison with commercial insurers, most Risk Retention Groups will remain extremely small potatoes in the "large numbers" frying pan. This means that by contrast to commercial insurers, Risk Retention Groups will be relatively high-risk propositions.

While Risk Retention Groups can be established with as few as two member-entities, it would be a very unsound insurance proposition indeed if units of loss exposure did not reach at least into the hundreds, i.e., stores, cars, trucks, clients, patients, etc.. Hopefully an aspiring or emergent Risk Retention Group will attract hundreds of members whose exposure units will total into the tens of thousands. Conceivably, some Risk Retention Groups will involve thousands of members with aggregate exposure units in the millions. You don't have to guess which of these categories approaches the ideal from a pure insurance viewpoint.

Q. <u>Could there be any significant differences in administration and service between a Risk Retention Group and a conventional insurer</u>?

Yes, several. Beyond the differences underscored by the basic mathematics of any insurance mechanism, there are many ways in which dealing through a Risk Retention Group can – and probably will – turn out to be more expensive, and perhaps less thorough and reliable, than dealing with a commercial insurer.

But, as with any purchase, you have to look very carefully when you compare. Perhaps, in the future, independent review organizations, such as Best's, will examine and appraise Risk Retention Groups and rate them, as they do commercial insurers, for quality and safety. For now and the foreseeable future you will have to satisfy yourself in such areas as the following:

- <u>Operating costs and overhead</u>. Start-up costs alone can be substantial. Incorporation, chartering and licensing fees, security deposits, bonds, and letters of credit are expensive – not to mention the cost of feasibility studies, personnel, servicing contracts, actuarial projections, office start-ups, policy and forms design and printing and mailing. Most start-up budgets are the day-to-day operating costs involved in the creation and maintaining of all the services a commercial insurer has to provide in all the locations where services are needed, only on a generally far smaller scale.

The majority of commercial insurers have the advantage of already being established, of having some sort of recognized financial rating, and of having a service network in place and handling a substantially larger pool of exposure units than a Risk Retention Group is ever likely to see.

- Claims investigation, settlement and legal defense. Conventional insurers have staff and counsel in place in key locations to respond promptly to claims. Where they do not have staff or counsel, they generally have pre-arranged to contract out this work to independent professionals and law firms. Insurance companies also have the advantage of a large claims volume over which to spread the cost of these services. By contrast, a Risk Retention Group will either have to create a service staff from scratch or contract out such services (and police their delivery and quality) to independent firms, probably without the benefit of any high-volume pricing considerations.

- Actuarial, investment, accounting and banking services. Commercial insurers already have either experienced staff or independent facilities in place to oversee these critical areas.

  It is essentially the actuary's job to see that the Risk Retention Group is charging premiums to cover expected losses plus costs plus a small margin for contingencies. That actuaries rarely bat 1000 is evidenced by long-standing industry wide combined ratios well in excess of 100% (not counting the margin for catastrophe). Because there is a lot of room for actuarial error in liability insurance forecasting, not all insurers follow the advice of their numerical soothsayers very closely – especially not in a competitive market. Such departures, naturally, will be very tempting for a Risk Retention Group.

  All this means that the pressure to achieve maximum gains from investment activity will be enormous – which in itself involves greater than average investment risk. Insurers have established on-going mechanisms to keep every loose dollar of premium and loss reserves working overtime to achieve this.

  Insurance accounting is a world unto itself as evidenced by the initial fact of life in insurance that premiums paid in are actually earned day-by-day and that, technically, the premium is a liability of the insurer until it is earned. Beyond that there must be accounting for claims – those that have been paid, those in process of payment from early stages to final settlements, and even the sophisticated estimates involved in accounting for claims incurred but at any given time as yet unreported. These aggregate “guesstimates” are critical in determining funds available for investment and in assuring that the insurer or Risk Retention Group is fully invested at all times. For an insurer, money in the mattress or even in most banks is a losing proposition.

All these activities require skilled and experienced talent and judgment and are not to be entrusted to amateurs. Predictably, this expertise will be expensive for a Risk Retention Group, but to take the short cuts is to court disaster.

Q. Can a Risk Retention Group underwrite types or amounts of liability insurance not generally available from commercial insurers?

Yes, as long as it represents a formal plan of risk sharing among the members.

Consider first the broad definition of “liability” in the Risk Retention Act. “Liability for damages” can include legal judgments, settlements in lieu of judgments, statutory liabilities, contractual penalties, voluntary payments to forestall legal actions, costs of deductibles or self-insured retentions, legal costs, fees and other claims related expenses.

“Injuries to persons” is by no means limited to physical or bodily harm. Except for Employers’ Liability and Personal Risk Liability, these definitions are broad enough to take in all the traditional “compartments” of liability typically insured by commercial insurers. These include, among others: general liability, including medical payments; automobile liability; bailee, warehouseman and other custodial risks; products and completed operations; owners’ and contractors’ protective liability; contractual liability, including service contracts and warranties; fire legal liability; liquor liability; personal injury; professional liability; errors and omissions liability; fiduciary liability; malpractice liability; statutory liabilities, such as OSHA, consumer products safety, environmental impairment, nuclear, etc..

Thus, provided the state does not prohibit insurance (such as for fines, penalties and punitive damages), Risk Retention Groups are permitted to insure about any category of business liability that a state insurance department will approve as actuarially within reason and not contrary to public policy.

Now look at the kinds of insurance traditionally written by commercial insurance companies. Ask yourself why it is difficult or impossible to buy certain kinds of coverage. Directors and officers liability and medical malpractice insurance offer two good examples. With average combined ratios in the industry exceeding 120% in recent years, if a commercial insurer could come close to break-even (or 100%) on these types of insurance, it would be a good deal. But they cannot even come close to the average combined loss and expense ratio, which is a classic door-closer in the insurance business.

Within traditional lines of insurance, there is much that a Risk Retention Group may be able to do to alleviate the problem of adequate limits. Creating an insurance mechanism to fund large member deductibles is one way to avoid expensive dollar trading with an insurer, and at the same time, use available premium dollars to purchase higher per claim or aggregate limits. Another way, obviously, is for a Risk Retention Group to confine itself to offering only excess limits to those provided by the commercial market. There are endless variations.

Next, consider the many types of liability risks which commercial insurers either do not deal with at all, or definitively exclude from their policies, or cover only under very limited conditions. One such area is property damage liability with respect to property owned or in the care, custody and control of the insured. Although in many cases a “Broad Form Property Damage” extension can alleviate some coverage problems, this has generally been a far from satisfactory solution for businesses with custodial, repair or service operations. Another example is the existence of a sweeping “Pollution Exclusion” in most commercial liability policies. Thus, the need to finance these potentially heavy liabilities is almost un-met. In still another area, many businesses offer warranties, service contracts and various extensions of these protection’s, and these are kinds of risks that commercial insurers have long shunned.

The Act enables Risk Retention Groups to undertake the insuring of such risks provided there is sufficient statistical predictability and adequate funding.

For a Risk Retention Group to do what even the professional insurers cannot, means that the group has to be a better money manager and a better underwriter and as good a claims payer as the commercial insurer it is proposing to supplant.

But the insurance industry has no monopoly on creative thought or imagination. In recent years there has been a severe scarcity of new ideas (or new wrinkles on old ones) for improving the performance of the insurance mechanism. Successful concepts often have their roots in disciplines other than the one in which they are eventually applied. It is to be hoped that the insurance community will embrace new thinking that is consistent with insurance experience – as opposed to insurance traditions, habits and politics. (Wouldn’t it be ironic if a coffee merchant named Floyd came up with a whole new system?)

Q. **<u>Other than the offering of direct, traditional primary insurance, what risk spreadsheet techniques might be used by a Risk Retention Group</u>?**

The list is limited only by the imagination, but here are a few possibilities:

- <u>Direct full or partial insurance of risks not covered or only marginally covered by insurers.</u> There have always been classes of risk – usually with catastrophic potential – that the majority of commercial markets have refused to tackle or have entered only tentatively. At present, exposures involving pollution-environmental impairment, liability and products recall are examples of such risks. Directors and Officers Liability and risks involving asbestos handling are only two kinds of exposures where conventional insurance capacity has dried up.

  While it is unlikely that Risk Retention Groups can do much more than bring minimal capacity to these needs, they do have the opportunity to form underwriting consortia that can act as leads to attract capacity from other national and international insurers. Besides these areas there are numerous risks <u>excluded</u> in conventional insurance policies, and a Risk Retention Group might undertake to insure some or several of these.

- <u>Quota share reinsurance of primary insurers plus one or more layers of excess insurance</u>. The effect of this for the Risk Retention Group is to create a nominal capacity and put its own dollars on the line in participation with conventional insurers. Viewed another way, such techniques might be viewed as a large, group, multi-faceted deductible.

- <u>Reinsurance of admitted "fronting" insurers or reinsurance of other Risk Retention Groups with similar exposures</u>. Because of state motor vehicle statutes, "fronting insurers" (admitted companies) may still be required for most automobile liability insurance, and perhaps for other lines as well.

- <u>Group purchase of claims investigation and adjustment services or legal defense services</u>, eliminating these services from those provided by the insurer. While unheard of in the past, this is increasingly likely as insiders limit coverage and responsibility for defense and place more of these requirements on policyholders.

Q. **<u>What does the Act say about conventional insurers becoming involved with Risk Retention Groups</u>?**

Very little by way of outright prohibition. But since the Act, in part, grew out of failures by conventional insurers to respond to liability insurance needs, there is little evidence of any intent to directly benefit the insurance community.

Specifically, the Act refers to insurance company ownership of Risk Retention Groups in Section 3 (h), which permits states to regulate or prohibit insurers from ownership interest in Risk Retention Groups, except for such groups comprised of insurance company members for their own collective benefit.

Beyond this, the Act erects several barriers to conventional insurers playing anything but a subordinate or peripheral role in the control of Risk Retention Groups. Notably the Act:

- Requires the owner of risk Retention Group to be members and the members also to be owners. (This rules out most insurers by ownership structure).

- Requires that no other insurance be provided other than liability insurance within the meaning of the Act. (This rules out most insurers by type of activity).

- Limits the provision of reinsurance to Risk Retention Groups with similar exposures. (This also rules out most insurers by type of activity).

- Prohibits participation in insurance insolvency guaranty funds to which state licensed insurers must belong.

- Does not exempt insurance companies from any securities laws.

Any or all of these provisions would have the effect of keeping conventional insurers on the sidelines of any risk Retention movement.

But these strictures apply only to insurance companies, NOT to insurance agents or brokers, third party administrators, structures settlement firms, public adjusters, insurance or risk management consultants and any number of other players who are a regular part of the insurance industry. All these can be and are expected to be jockeying for position in the Risk Retention Group "sweepstakes". In fact, as of this writing, a number of Risk Retention Groups have already been formed with the sponsorship of large insurance brokerage firms.

Still, it is important to realize that while ownership or control of Risk Retention Groups may be circumscribed by the act, commercial insurers and re-insurers will, of necessity, play a central role in the functioning of such groups. The primary purpose of a Risk Retention Group is, "assuming and spreading all or any portion, of the liability exposures…." This means that Risk Retention Groups will have to buy insurance and reinsurance beyond the amounts that its financial capacity will allow it to retain or underwrite for its own account (just as commercial insurers have to do).

Remember, a Risk Retention Group is restricted to exchanging reinsurance only with groups having similar exposures. This makes it unlikely that any group will be able either to depend on the capacity of others to add to its own, or to extend much of its own capacity to insure members of other groups. Thus, commercial insurers and re-insurers are likely to become major suppliers to Risk Retention Groups.

Q. Can insurance companies set themselves up as Risk Retention Groups?

Yes and no. You may safely expect that insurers will rightly seek to join and benefit from any significant legitimate movement to Risk Retention Groups rather than to oppose it. After all, who is better positioned to provide most of the services that Risk Retention Groups will need to offer its members, i.e., risk pooling, engineering, reserving, claims settlement, policy service, marketing, investment pooling tailored to maturing liabilities, and so on?

Much depends on what the states decide to do – if anything – by way of prohibiting or regulating insurers in this field. If history is any guide, some states will forbid such ownership, some will set bounds on insurer involvement and many states will do nothing at all – at least until a specific problem arises or until they see what other states are doing.

But there are several ways for an insurer to get around these apparent constraints or otherwise "join the Risk Retention Group party". Among them:

- Provide direct reinsurance – on a share or on an excess basis – of Risk Retention Group portfolios of business.

- Form "shell" Risk Retention Group corporations for sale to interested groups along with a contract for a package of support services in return for management fees and collateral insurance or reinsurance business on an exclusive basis in defined areas. This would allow bypassing the agency-brokerage system to some degree, and a general reduction of conventional acquisition costs which could be passed along in part as a saving to the group members. Besides giving the insurer an "exclusive" on certain kinds of Risk Retention Group business, it provides a superb entrée to compete for members' other business. Such an arrangement could be highly appealing to a Risk Retention Group that wants to get in on the "action" but is shy on expertise and capacity to do the support work.

- Form Risk Retention Groups to underwrite "surplus lines". (MBIA is an excellent example of this). Joining with one or more insurers, poll certain classes of liability business to which each are exposed, i.e., medical or other professional malpractice, ERISA, trust liability, etc.. The group could file in a state with few prohibitions and write everywhere at their own rates.

- Join a Risk Retention Group as a member with other insurers, purchasing some of its own insurance or reinsurance through the facility and participating otherwise as an investor.

- Join (as a separate corporation) with non-insurance groups to provide insurance for similar risks, i.e., fiduciary liability, automobile liability, office premises and operations, etc..

Q. <u>What about an insurance company that has affiliated loss control, claims, risk management and other service corporations as separate entities</u>?

Strictly speaking, it would seem to depend on how separated the other companies actually are from the insurer itself. If the insurer is the sole or principal owner-parent, the subsidiaries are part of the insurer legally and for regulatory purposes. If they are owned by a holding company, which also owns or is owned by the insurer, these affiliates may not be construed as part of the insurer for purposes of the Act. Put another way, it depends on the nominal relationship and how the paper is hung.

Q. <u>In what ways may a Risk Retention Group be owned and organized</u>?

Although ownership has an influence on organization and vice-versa, this is actually a two-part question – at least for now, and until some clarifications are handed down by Congress or the courts.

- **<u>Ownership</u>** of a Risk Retention Group is referred to only in Section 2.(a) (4) (E) of the Act as part of the definition of a Risk Retention Group. Subsection (i) seems reasonably clear as to <u>multiple ownership</u>: the group can be owned <u>only</u> by persons who are Risk Retention Group <u>members</u> AND such members must be <u>insured</u>. Thus, owners must be members and insureds. It is technically possible to be an insured-member without being an owner of the Risk Retention Group (although it is difficult to see why investor-insured would agree to a pooling with non-investor-insureds in the absence of some form of participation or underwriting commitment, such as assess-ability. There may be profits far down the line, but meantime this would be tantamount to offering a free lunch). It is <u>not</u> possible to be an investor-member without also being an insured member.

Subsection (ii) is somewhat more complex in setting the criteria for sole-ownership. The sole-owner of a Risk Retention Group, a trade association corporate subsidiary for instance, must be an organization whose members “comprise the membership of the Risk Retention Group” AND whose owners are members who are insured by the Risk Retention Group. While the owner as insured-member criteria seems to express the same intent, as for multiple ownership, there are a lot of open questions. Among them:

- What would be the pint of being a Risk Retention Group member or an investor if not to be insured? (It’s easier to go to the track).
- In the absence of an IRS ruling and a direct pass-through of benefits to members, why would largely non-profit associations consider setting up a for-profit insurance subsidiary?
- What happens to the ownership interest of an insured-member who fails to qualify for insurance at renewal time, or who eventually decides to leave the group?
- What happens if the owner-member goes bankrupt or into receivership, or is merged with or acquired by a non-member?
- What happens if the number of owner-members falls below the state’s minimum requirements?
- To whom is ownership transferable if no other members are available as investors?
- Would the “stock” or other “ownership interests” have to be restricted on account of the member-insured eligibility requirement for ownership?

The intent of Congress appears to be to keep the control of the Risk Retention Group among the members, especially among insured-members and to keep out disinterested speculators–such as bookies and commercial insurance companies. Still, there is a considerable distance between the intent, the expression and how these and other key questions will eventually sort themselves out.

- **Organization** of a Risk Retention Group is referred to in Section 2. (a) (4) of the Act, also as part of the definition. The only requirement is that the group be a "corporation or other limited liability association". Within those confines, therefore, the type of organization will be governed primarily by the laws of the State of Domicile – which vary quite a good deal.

  Of all the traditional forms of property and casualty insurance organizations, the "limited liability" requirements of the Act rule out only two otherwise permitted structures: The unlimited assessment mutual and a London Lloyd's type organization. Because member liability is unlimited, these forms are ineligible by definition. This still leaves the most common organizational forms, which in descending order of popularity are:

- **Stock corporations**. Stockholders own, vote and share in the profits, but not the losses. So-called "participating stock" companies also may pay dividend to policyholders who are not owners.

- **Advance premium (or "legal reserve") mutual companies**. Policyholders are owners, but not necessarily capital subscribers. Policyholders vote and share in profits, but not losses.

- **Reciprocal exchange organizations**. These are cooperatives. Each policyholder is insured by all the others. Member liability is individual, not joint, and assessment is usually limited to multiples of the annual insurance premium. Members must contribute to capital, usually also in multiples of premiums paid.

- **Limited assessment mutual companies**. Premium is paid in advance, but each member is assessable to a maximum of contingent liability. Policyholders are liable to the corporation jointly for assessments, not individually to other policyholders.

- **American Lloyd's organizations**. These are rare, except in Texas. The organization is similar to a reciprocal except that investor-underwriters need not be policyholders – a feature that may disqualify this structure for Risk Retention Groups. Otherwise an American Lloyd's is similar to a London Lloyd's organization except that members' liabilities are limited.

You would be quite safe if you bet that most Risk Retention Groups will opt either for one of the eligible stocks or one of the eligible mutual formats. Because some provision will have to be made for dividends to policyholders in almost every case, you could focus particularly on the participating stock or mutual company formats. Beyond that a lot of issues have to be resolved as to how to define the rights to ownership participation (as opposed to participating in better or worse than average insurance claim experience). Should ownership interests be redeemable:

- By shares or some other measure relative to contributions to capital and surplus?
- By retention relative to limit insured?
- By assess-ability ratio or amount?
- By number of exposure units relative to the total insured?
- By ratio of investor premiums to total premiums?
- As dividends based on a percentage of the premium or based on overall results?
- Or by some other measure or combination of measures?

In sum, the successful Risk Retention Group will require a lot of planning to attract and retain dedicated and loyal members.

Q. What are some of the avenues that may be used to provide insurance to Risk Retention Group members?

There are many ways in which a Risk Retention Group can provide insurance. Here are just a few samples to give you the general idea. The names we have used are strictly to promote understanding and do not reflect any "inside" insurance jargon.

- The Front Door Approach. The group issues ordinary liability insurance policies to members following a fairly standard form and for full limits, retaining for the group account an amount that is both prudent and in compliance with home state regulations regarding allowable total premium written relative to surplus. The rest is reinsured. Thus it is possible for the group to issue a policy for a $1 million limit, retain for its own account only $50,000 or $75,000, and buy insurance to cover the remaining $900,000-plus from other insurers. The buyer knows only that he has a single policy issued by the group and it is to the group that he will look in the event of a claim. If claims or legal costs are incurred, it is up to the group to see that each of various reinsuring companies pays its appropriate share.

- The Back Door Approach. The most obvious version of this would be to have the group arrange for one or more conventional insurers to issue standard or "tailored" specific liability or even "package" policies to members. The Risk Retention Group would then have a reinsurance agreement with the conventional insurer(s) agreeing that the group would provide reinsurance for specific liability coverage. This could range from a minimal share to up to 100%. Thus, member's policies are issued by conventional, rated insurers, but the Risk Retention Group has agreed to reimburse the insurers for part or all of the liability claims and costs. Of course, if the reinsurance agreement called for the Risk Retention Group to be responsible for more than a prudent net retention in the event of any single claim or annual aggregate of claims, then the group would seek to reinsure its own commitment in other reinsurance markets, possibly including other Risk Retention Groups with "similar or related" exposures.

This technique could be called "partial fronting". The member gets the benefit of having a policy from a rated insurer (which may be necessary in certain cases), and the member may also get the benefit of access to the state's insolvency guaranty fund – at least for coverage(s), which are not ultimately the responsibility of the Risk Retention Group itself.

- The Side Door Approach. Many kinds of liability insurance are written with the requirement that the insured bear a "self-insured retention", which in essence, is a large deductible. Typically these retentions range from \$1,000 to \$10,000 per claim although in certain instances they can go much higher. Also as a rule, insurance contracts typically require that such deductibles must be borne "out of pocket" and may not be insured under another policy.

  In recent years, there has been extreme upward pressure on these self-insured retentions. Many businesses and professionals who had in the past been prepared to take a "hit" of from \$1,000 to \$5,000 per claim, are typically asked nowadays to pay out of their own pocket anywhere from \$5,000 to \$15,000 or more per claim. This of itself creates tremendous financial uncertainty to the individual business or professional practice. Risk Retention Groups could well be used to create what we could call a "jumbo retention". This could have the effect of reducing, or at least putting a cap on, this financial pressure on individual businesses; and, at the same time, it could expand the overall participation of group members in payment of the first dollars of all claims before the primary insurer is called upon to pay. The effect of this approach would be to put a financial cushion between the insured members and the commercial insurer. Such a "wedge" could be designed to apply over a basic dollar threshold of say, \$10,000, or if member retentions were reduced to palatable levels, the Risk Retention Group could undertake to pay shares based on multiples of the self-insured retention.

No matter what variation is adopted, the effect is to level out the payment of deductible amounts by the individuals, yet to increase the threshold, which must be reached before the commercial insurer is called upon to pay.

- The Next Door Approach. Arrangements to provide standard primary liability insurance may be made with a conventional insurer. But, the Risk Retention Group may wish to go beyond the scope of standard coverage and design broader more responsive insurance conditions. Thus, this could be called a "difference in conditions" approach.

  For example, general liability insurance policies typically exclude property damage claims with respect to property in the care, custody and control of the insured. Directors and Officers liability forms typically exclude claims arising out of errors in insurance placement, statutory liability such as ERISA, SEC, EEOC, etc., allegations of libel or slander and discrimination.

  Depending upon what is important to its members, the Risk Retention Group may elect to provide insurance for some of those otherwise uninsured exposures. This is not an easy as it sounds. Besides having to design very carefully worded policies to cover such hazards, one additional problem in obtaining approval to provide such insurance is the difficulty in establishing a reliable actuarial basis.

- The Over-the-Roof Approach. In the insurance business this is known as excess coverage. One such arrangement would be to require members to buy standardized primary coverage on a common policy form for a uniform minimum insurer of their choice. The Risk Retention Group in turn would provide excess coverage which begins when claims exceed $1 million and continues to a pre-determined maximum, say $2 million or $5 million.

  Arrangements to provide an excess layer of insurance may be made along pretty much the same lines as providing primary insurance. One approach would be for the Risk Retention Group to negotiate a standard excess coverage form with an excess and surplus lines insurer for specific issuance to Risk Retention Group members. Members then would deal directly with the commercial insurer, with the Risk Retention Group acting as an agent or broker. The Risk Retention Group in turn, would reinsure all or part of the pre-determined excess level. Another way would let the Risk Retention Group issue its own excess insurance contracts to members. The group would retain an appropriate percentage and then reinsure the rest in the commercial insurance and reinsurance markets.

- The Basement Window Approach. A Risk Retention Group may not have the financial capacity to do much more than attempt to put some kind of a cap on the number of dollars of maximum annual out-of-pocket to members in deductible-retentions under conventional insurance policies. In this case, the subject of the insurance would be the “aggregate-insured retention”. The group could arrange to insure that the maximum amount to which any member is exposed in any single year is capped either at a specific dollar amount or at a multiple of the retention under an existing conventional policy.

- The Roof Approach. This is nothing more than a variation on retrospective rating. The Risk Retention Group could deal with a primary conventional insurer to establish a threshold experience ratio for acceptable combined losses and expenses. If desirable, the Risk Retention Group could participate in some way in either providing some services ordinarily provided by the insurer or in otherwise exerting some expense control. If the combined loss and expense ratio exceeds the established range, the Risk Retention Group reinsures the commercial insurers for the excess up to a pre-determined limit. This is just another form of insuring the insurer otherwise known as “reinsurance”.

The possibilities and the variations are endless. It is indeed possible to transfer risk in virtually any fashion which is equitable among the parties to the agreement and which provides “insurance” in exchange for the prospect of a fair return.

Q. Will Risk Retention Groups write liability insurance on an “occurrence” basis? Or will they lean towards providing insurance on a “claims made” basis?

At lease at the outset it seems sensible that a Risk Retention Group would tend to offer insurance on the same (or more favorable basis as the members presently have or previously enjoyed. For some specialty lines such as Directors and Officers Liability, Errors and Omissions coverage(s) and various Malpractice lines, “claims made” will be merely a continuation of the basis of coverage traditionally available in the commercial markets. But for most forms of general or automobile liability insurance the existing “occurrence” or “occurrence/accident” forms will probably apply.

This is not the place to debate the wisdom of either course. But remember the essential distinction between these two approaches. In essence, an “occurrence” policy attaches at the point of injury or first exposure to injury, no matter when an eventual claim is made. That policy you bought in 1971 should still be “alive” if a claim is brought next year.

“Claims made” policies, on the other hand, apply only to legal claims actually made in writing during the period the policy is in force, regardless of when or under what circumstances the injury or damage took place.

The major drawback to old "occurrence" policies is inadequacy. That jumbo limit of $250,000 or so in 1971 does not look very reassuring these days when the opening numbers in lawsuits are in the millions – unless one or more of the interpretations of "occurrence" allow policies for years subsequent to 1971 to be "stacked". The big zinger in "claims made" is that underwriters have invented a companion concept called a "retroactive date". This means that the insurer will respond only to claims where the injury or damage "occurred" after the "retroactive date" which in most cases is the date of your first claims made policy – although some insurers will let you buy "retroactive coverage" going back maybe three or five years if you can afford it.

In theory, short or non-existent retroactive periods eliminate the "long tail" exposure for the insurer. But it does not eliminate it for the insurance buyer. In practice, if your "claims made" policy – let's say as of now – and if that insurer keeps renewing that "claims made" policy every year, then after five years the insurer has a brand new "long tail". After 10 years, the tail is not new, but it is even longer.

So with the "retroactive date" we are right back to the issue of determining the 'what and when' of "occurrence" and that problem is not solved. And with "retroactive dates" receding farther and farther into the past as renewals distance the date of the "first claims made" policy, we will have come full circle and be right back in the middle of the very "occurrence" and "long tail" problems that are supposedly creating all of the difficulties that "claims made" is supposed to solve. Needless to say, the longer the retroactive periods grow under "claims made", the more the "claims made" policy is going to cost, simply because there may be more and more old, covered injuries out there that are just waiting to emerge and to find their way into a lawyer's office and thence to court. The more things change, the more they remain the same, etc…

Another factor to keep in mind is that in the great majority of instances the Risk Retention Group will only be funding a share of either first-dollar or excess layers of each insured risk. As a participant, in reality, Risk Retention Groups will be constrained to offering insurance using the policy terms and conditions either dictated by or agreeable to the other participating insurers and re-insurers. The group will not be able either to call all the shots or "give away the keys to the vault".

Despite publicity which has surrounded the insurance industry's planned changeover to "claims made" – based coverage for all forms of liability insurance, a wholesale adoption of this approach and abandonment of the "occurrence basis has yet to come about. The net effect as of now is that "claims made" complicates rather than simplifies things. And one thing most people agree on is that insurance is complicated enough without adding to it.

Q. Will liability insurance premiums paid to Risk Retention Groups be tax deductible?

Again, it depends. While there is no hard and fast rule for Risk Retention Groups, there have been a number of private letter rulings issued concerning individual captive insurers. You will have to consult your accountant and tax counsel for more definitive opinion but, in general, you can expect that the fewer the number of members of the Risk Retention Group, the more likely it is that the tax deductibility of premiums paid to it will be called into question.

This issue has been kicking around for years and has been a thorn in the side of captive insurers with only a single parent. At one point, insurance premiums paid to captive insurer subsidiaries were not allowed as tax deductions on the grounds that the insurance was merely an internal bookkeeping operation and that no actual transfer of risk had taken place (as would be the case if premiums were paid to a commercial insurer). This finding also jeopardized the deductibility of loss reserves for the same reason and on the additional grounds that to allow the deduction of the captive's loss reserves would discriminate against businesses who could not deduct losses until they were incurred.

This stance has changed to some extent. Essentially now the owner of a captive insurance subsidiary can deduct premiums paid to it if the subsidiary is actually writing insurance for other risks as well as the parent. In practical terms, this has been defined to mean that the captive must provide at least as much insurance to outside businesses as it does to the parent. This requirement has the effect of somewhat distancing the business of the insurer from the business of the owner.

Q. How much reinsurance will a Risk Retention Group need to buy?

In most instances quite a lot. (As you may have guessed, this subject does not lend itself to explanation in succinct or compelling terms, and you will need to do a fair amount of homework on the financial underpinnings of liability insurance to grasp these issues fully).

Reinsurance is almost always desirable for all insurers. Besides helping to insulate against shock loss, its risk-spreading capabilities aid substantially in stabilizing underwriting results over time. But in the beginning especially a Risk Retention Group will need a lot of reinsurance basically because it will have only limited direct capacity. At the risk of oversimplification, here is why.

- <u>Reinsurance Provides Large Capacity</u>. You do not have to be an insurance maven to realize that if a Risk Retention Group-insurance company has surplus (net worth) of $1 million, it would be exceedingly imprudent to issue any insurance policies with limits of $1 million. Unless there are hundreds of policyholders with diverse exposures (not a likely scenario for a Risk Retention Group), the group would be putting itself in extreme jeopardy if it issued policies with limits as high as even $100,000. Indeed in many states $100,000 or 10% of surplus will be the maximum legally allowed to be underwritten against any single claim. So if two or more members were subject to being sued over a single event, the maximum limits written for each member would have to be way less than $100,000.

  Of course, you will find almost no buyers for liability policies with limits less than $1 million. So if your Risk Retention Group with its surplus of $1 million can prudently be responsible for a maximum net amount of only $75,000 per member, there are only two ways you are going to be able to issue policies with limits of $1 million or more:

  - Increase your surplus to $12 or $15 million; and/or,
  - "Rent" part of the surplus of other insurance companies.

  If group members could easily whistle up $12 or $15 million – in cash or credit – and sent it in, there would be no problem. Maybe members can put together enough pledges (secured, of course) to get a bank to issue a letter of credit for perhaps a contingent $500,000 or so. But an $11 to $14 million cushion? Forget it! This leaves the second option.

  The only practical answer to this dilemma is reinsurance, which practically speaking, means expanding your own capacity by borrowing the capacity (surplus) of other insurers. To be able to issue that $1 million policy you have to go into the commercial insurance markets and say, in effect, "Here is a $1 million loss potential. We'll take a 7½% share of any loss up to a total of $75,000. Who will sign on for (underwrite) the rest of the $1 million?"

  Professional reinsurance intermediaries (for a fee, of course) will go out and assemble a group of 20 to 30 or more other insurers who together will subscribe the 92½% of the risk that your group can't afford. And you will obviously have to pay them the lion's share of the premium since they are taking the lion's share of the risk.

In practice, you won't have to do this for every $1 million policy separately. Your intermediaries will get you a "treaty" that applies to all your risks. They can also get you treaties that insulate you against various other forms of financial surprise and perhaps even to put a cap on the maximum amount the Risk Retention Group will have to pay out in any one year regardless of what happens.

- <u>Reinsurance Preserves Limited Capacity</u>. Reinsurance also helps to conserve the Risk Retention Group's surplus in another way. Put simply, premiums start out as <u>liabilities</u>. As soon as they are written they are booked in the <u>Unearned Premium Reserve</u> account. Over the life of the policy the earned share is gradually taken into income. This is complicated by the fact that up-front sales costs and premium taxes must be expensed immediately. The purchase of reinsurance generates commission income from the re-insurer which helps offset these up-front expenses, and your transfer of premium to the re-insurer allows an immediate reduction in your own Unearned Premium Reserve. Both these transactions avoid charges which would otherwise reduce surplus sharply and rapidly.

  Look at it this way: If the group starts out with a surplus of $1 million and during the first month of operation signs up premiums of $500,000 while at the same time incurring $200,000 in other operating expenses, its surplus is reduced to ZERO almost immediately. Without surplus the group has <u>no capacity</u> either to pay its share of losses or to underwrite any new business. Tack up the CLOSED sign! In this sense reinsurance stems direct surplus outflow.

  Depending to some extent on the State of Domicile, this will be a problem for any new insurer or any insurer that is writing new premium much faster than it is earning premiums already on the books. Indeed many states have rules of thumb – if not actual statutes – that expose an insurer to direct regulatory intervention in its operations if its premium writing exceeds a certain ratio to its surplus. This threshold varies by kind of insurance, but for most liability lines for <u>established</u> insurers, written premium liabilities cannot exceed surplus by more than 2 or 2½ to 1. For newly germinating insurers – that means most insurers less than 5 years old – these guidelines will be a good deal more conservative.

Taking these issues into account, it is no exaggeration to suggest that most Risk Retention Groups will be very heavily dependent upon sound reinsurance arrangements for many years into the future. It goes without saying that the solvency, financial capacity and integrity of your re-insurers is a critical factor since if they cannot or will not pay, your group is in the soup so to speak.

Q. Can one Risk Retention Group buy reinsurance from another Risk Retention Group?

Yes and no. Since the Act defines insurance to include reinsurance, a preliminary conclusion would suggest that a Risk Retention Group could provide reinsurance to other groups provided the reinsurance is of the same kind and classification as the liability insurance the group is licensed to write and actually does provide for its own members directly.

But the criteria of "similar or related activity" for purposes of offering reinsurance cannot be applied as generously as in interpreting similarity or relationship among members of the group itself. At the primary membership qualification level, as we have seen, members need not be either in the same business or a related business. They need only face legal claims arising from similar liability exposures – such as owning cars or sponsoring a pension or benefit plan or running restaurants or being medical doctors. So it is possible for a multitude of diverse businesses or professions to share a similar exposure to particular kinds of liability, and participate in a Risk Retention Group for the purpose of sharing the risks and funding their own losses.

At first blush it might seem that Risk Retention Groups could become a breeding ground of hybrid, loosely controlled securities which could be traded over or under the counter or on the telephone much like the "secondary market" in football betting slips.

But it is not so for a number of other reasons:

- Risk Retention Group stock or ownership interests can only be held by members who are also insurance purchasers in the group. The underwriter must be an insured, and the insured must be an underwriter. There is almost no room for outsiders as owners.

  Issuers (sellers) of Risk Retention Group "stock" are fully subject to the Fraudulent Interstate Transactions prohibitions of Section 17. of the Securities Act of 1933.

- Issuers (sellers) of Risk Retention Group "stock" are subject to the "Manipulative and Deceptive Devices" regulations of Section 10. of the Securities Exchange Act of 1934 – although it is unlikely that many Risk Retention Group issues will ever be traded on national securities exchanges or by exchange members.

- Regulations aside, it is also highly unlikely that outsiders or the public at large would even be interested in speculating on a "stock" whose underlying organization exists only to "profit" members and that only in relation to their insurance claims experience as opposed to the size of their ownership interest.

By excluding Risk Retention Groups from the provisions of state blue-sky laws, there is a distinct technical gap in the application of any securities regulation to groups organized and operating within the confines of a single state. That the insurance provided may of itself be deemed to be "interstate commerce" would seem to have little bearing. So while there may be some room for securities "operators" to play games within the confines of one state, it still does not appear that the speculative opportunities would appeal to anyone but a masochist.

Q. <u>Are Risk Retention Groups exempted from any other major federal laws</u>?

Yes, to a limited degree. As a licensed insurance company, a Risk Retention Group is subject to the McCarran Act (Public Law 15). This law makes the business of insurance subject to the Sherman Act, the Clayton Act, and the Federal Trade Commission Act, BUT only "to the extent such business is not regulated by state law".

This means that the states are the primary regulators as far as conduct addressed by those statutes is concerned, but that the Federal government <u>may</u> regulate if state laws are deemed to be inadequate. It must be kept in mind, however, that the Risk Retention Group <u>exempts</u> Risk Retention Groups from almost all state insurance regulations except those governing chartering, licensing and plan of operation. Therefore, if abuses in these areas arise, the Federal government has the power to impose remedial legislation fairly quickly.

Q. May a Risk Retention Group also be a Purchasing Group?

Provided the Risk Retention Group conforms to the definitions in the Act, there appears nothing to prevent it from also acting as a Purchasing Group. Even without designating itself as a Purchasing Group, the activities involved in "assuming and spreading all, or any portion, of the liability exposure of its group members" imply the power to purchase both insurance and reinsurance on behalf of the group. Also, the authority to provide "insurance related services" also implies the purchase of insurance and reinsurance by a Risk Retention Group.

Still, a lot of questions remain unanswered. For instance, would "provision of insurance' enable a Risk Retention Group to buy from a commercial insurance company a "package plan" of some sort covering multiple property-liability risks and then assume from the insurer all or part of the reinsurance and service of the liability exposures only? If so, would such an approach enable Risk Retention Group members to benefit directly or indirectly from a state's insolvency guaranty fund? The intent of the Act says, "No". But a lot will depend on what the individual states promulgate in the way of regulations governing Risk Retention Groups. A lot more can be expected to hinge on eventual court rulings.

Q. Can a business, professional group or governmental entity belong to more than one Risk Retention Group?

Yes. In theory, membership is limited only to such affiliations as meet the test of "similar or related" activities that give rise to legal claims. And you may well belong to several groups whose members share "similar or related" activities involving common legal exposures.

In practice there is nothing to stop you from joining any Risk Retention Group formed by any association you belong to – as long as you buy the insurance they sell and as long as you don't mind the expense and the added investment risk of a participating insurance underwriter.

Besides belonging to multiple Risk Retention Groups, you can also join one or more Purchasing Groups at the same time – as long as you meet the qualifications for membership.

Risk Retention Groups need large number of members – the more the merrier and the more the safer. While most will likely start out with membership confined to the basic "club", a majority will commence an early search for cousins in "similar or related" fields who face the same kinds of claims and who will add to the stability – and to the funding – of the group.

If you've a mind (is that right?), you can become a real insurance "junkie".

Q. **<u>What are some of the practical issues involved in forming a Risk Retention Group</u>?**

Some may think of these as "obstacles" rather than "issues". But they are not. If the Risk Retention Group is truly to "insure" its members and relieve them to some extent from the uncertainty of claims, the first "insurance" is a sound and adequately financed method for doing it. Here are some of the major specific considerations:

- <u>Membership Commitment</u> is the sine qua non of any Risk Retention Group or group active insurer wherever it may be located. No matter that all the hurdles are crossed, if the members themselves are not actively interested in long-term insurance and financial stability and actively willing to adopt and enforce and abide by programs and policies to contain or reduce losses as well as to pay claims, then you have not got a workable – or long solvent - Risk Retention Group regardless of the feasibility studies, operational plans, charters, licenses and actuarial projections. Without energetic commitment by the majority of members DO NOT PASS GO.

- <u>Lots of Members/Lots of Premium</u>. This is one way in which risk is spread. Although the Act is silent as to the minimum number of members (meaning there must be at least two), state laws governing insurer licensing may require a minimum number of incorporators (translate members).

  But none of these elements change the fact that for <u>any</u> insurance mechanism to <u>work</u>, you need large numbers of exposure units and large numbers of premium dollars to be able to pay expenses, expected losses and generate investment income.
  Opinions will vary on minimum numbers depending on the type and disaster potential of the insurance involved, but in our view you are on thin ice with about 25 members generating $500,000 or so in annual premiums. Essentially below these absolute minimums, you are "walking on water". Your feasibility study should provide specific projections in this area. Another very good reason to have lots of <u>members</u> is to avoid any IRS challenge to the deductibility of premiums on the grounds of insufficient risk transfer.

- Premium Adequacy #1. There's no such thing as a free lunch anywhere and insurance is no exception. It is unlikely in the early stages that most Risk Retention Groups will be efficient, smooth-running operations. This takes time, and large numbers will make opportunities for efficiency even greater. Yet, efficiency or not, the Risk Retention Group must collect sufficient premium to pay for expected claims, settlement expenses and legal fees plus a small margin for contingencies. As with any other business, if you cannot cover costs, you don't survive very long.

  Insurance is significantly different from other businesses in that you must set the price before costs are known. Most conventional insurers have a sufficient cushion of cash to lose the underwriting game occasionally (some even consistently) and come up on the plus side with investment income and capital gains. Most Risk Retention Groups will have neither the necessary cushion nor the necessary cash to play this game successfully for very long. It is axiomatic, therefore, that you must charge adequate premiums. Any immediate savings to members over conventional insurer premium levels can reflect only perhaps a slight savings in selling costs. Over time, of course, significant savings are possible once surplus is built and once risk management and loss control efforts come into full effect.

- Premium Adequacy #2. As if all the forces mentioned above weren't enough, and despite your relative "independence" as a Risk Retention Group, the adequacy of your premium structure will also be determined by the very commercial insurance markets that have contributed to the need for your Risk Retention Group to begin with.

  Very few Risk Retention Groups will be either large enough or sufficiently capitalized to handle more than a conservative percentage of the aggregate insurance needs of the whole group and still offer maximum coverage to all who want it. This means that the group itself will be a risk sharer and will need to obtain capacity through reinsurance probably in substantial amounts. Risk sharing means premium sharing. If rates are adequate, the re-insurer's share will be inadequate and he, she or they will say, "thanks, but no thanks!" In a very real sense, for the foreseeable future, the market will tend to stifle premium inadequacy long before state regulators and judges can do anything.

- Coverage Adequacy #1. To some degree a Risk Retention Group can tailor-make its insurance product to the needs of the members. This means you may not have to buy all the extras that come as part and parcel of many insurance company “packages”. But you will have to look long and hard at this issue for at least two reasons. The first is that if the scope of the coverage offered is materially or substantially less than what the members are used to or what they can get in the commercial markets, the group-offered insurance will not be attractive to many members for very long. The second reason is that if the coverage differs substantially from the terms of typical insurance covering similar exposures, you will have great difficulty in spreading risk through reinsurance because it will be dissimilar from the other insurance that is being reinsured.

- Coverage Adequacy #2. You must have (or be able to obtain through reinsurance) the capacity to offer substantial limits of liability. If your capitalization limits you to a net retention of say $100,000, you are not going to be able to satisfy member needs for $1 million, $5 million or $20 million limits. You need to be able to offer limits equal to or better than the commercial markets are offering.

- Management/Administration/Service. You will have, perhaps in miniature, the same needs as any other liability insurer. In some states you may be able to get away with a couple of visits to the racetrack to recruit your top management, but you should not count on it. You know what lawyers cost these days. The other kinds of specialists don’t come cheap either. While perhaps some of these can serve part-time, you will need reliable and responsive accountants, actuaries, underwriters, risk managers, safety engineers, auditors, marketers, managers, raters, policy service people and a host of other necessary support personnel.

  Not only must you be prepared to hire such people and provide facilities for them to do their job, you must also provide them with competitive benefits and employee perquisites. A quality operating staff is no small task to get together, and it is not cheap.

  There is, of course, an alternative. You can hire a captive manager. There are many such firms – most of them owned and run by established commercial insurers, agents, brokers and reinsurance intermediaries, as if you couldn’t guess. As you might also imagine, they are not cheap either. But this route is probably far less costly than building a large staff on your own.

- Capitalization. A cardinal rule of Risk Retention Groups is that members must buy and members must belong. There can be no strictly passive investors; however, some will be required (allowed) to invest more or less than others – usually dependent upon total number of exposure units or total premiums involved. The point here is that members have to subscribe capital – over and above whatever the annual premium costs are. This means that potential members have to have money to invest, and it means that they must invest without expectation of an early tangible return. It also means that if losses cut into statutory capital, members have to be on call to respond to assessments to cover the shortfall in order to avoid insolvency. For starters, assume that the initial sum to be raided from members will be at least $1 million over and above other start-up expenses. For some groups this will be chicken feed. For others it will make the idea of a Purchasing Group sound highly appealing.

Q. In general, what will be the financial implications of Risk Retention Group membership for a business or institution?

On the surface it would appear that membership in a Risk Retention Group is simply an alternative to paying premiums to a commercial insurer. And as far as it goes this is true. But there are several important differences. Among them:

- The Risk Retention Group may be offering fuller and more comprehensive services than the conventional insurer. The increased costs of such services must be justified to auditors (and to stockholders in a public company). When the expected benefits and their quality can be measured against current outlays of either insurance premiums or direct expenses, this may not be difficult to do. When, as is likely in many cases, the expected benefits are anticipated future reductions in claims incidence or claims cost, there may be a problem.

- The Risk Retention Group may be offering service comparable to commercial insurers, but the actual scope of insurance coverage or the limits of liability per claim or in the aggregate may be less than was carried previously or less than is available currently in the commercial market. Either of these instances translate into less insurance protection for (and therefore greater risk assumed by) the business. Accountants, auditors (and probably stockholders if you have them) will want to see these decisions justified by at least two standards:

   - *How does the assumption of this greater risk comport with other business risks assumed by the company?*
   - *How does this practice measure up against what other companies in the same business have done or are doing?*

- The Risk Retention Group member must subscribe to the group's capital and be a financial investor of funds in addition to annual premiums paid. This adds an entirely new dimension to the traditional arm's length insurance transaction, and the member-business must consider not only how this activity "tracks" with its other investment activity (if any), but also how the membership will be valued as an asset. Compared to many other investment assets, ownership interest in a Risk Retention Group has to be considered as not only highly illiquid but as having perhaps somewhat less opportunity of recovery than most. As an asset, most accountants and auditors will incline to treat it as little more than an unsecured loan. Yet the purpose and expected benefits will have to be explained and justified.

- The Risk Retention Group will need to be supported by many reinsuring participants. These are the people, who together will be responsible to pay for the bulk of the group's losses and upon whom the Risk Retention Group's solvency depends to a large degree.

  The quality and financial ability of the re-insurers must be evaluated by comparison to the primary and reinsurance guarantees of commercial insurers. The fact that an appraisal of reinsurance programs is included in the financial evaluation of most conventional insurance companies is to their advantage. The fact that most, if not all, Risk Retention Groups will not be subjected to financial review for a rating of quality and capacity puts this problem squarely in the lap of each member and its accountants and auditors. If the Risk Retention Group is dealing with a number of non-professional, investor-type re-insurers or with marginal re-insurers, the results will be unpleasant in the extreme, and member-company managements will wind up with both a lot of un-financed losses and a lot of questions to answer.

- Especially in liability insurance, the potential for large claims to impair minimum statutory surplus is high. Beyond the initial capital investment in a Risk Retention Group, there is also the prospect that the group may have to assess members if there is a shortfall in order to avoid being declared insolvent and placed in receivership or liquidation. This is a contingent liability that, while difficult to measure, must be evaluated.

Q. **<u>In summary, what are the principal advantages of a Risk Retention Group</u>?**

Although the powers of Risk Retention Groups are confined to liability insurance and services related to it, the Act offers significant business opportunities in many way:

- <u>Capacity Relief, Leadership and Problem-Solving</u>. Soundly organized and implemented, Risk Retention Groups can add needed financial capacity and stability to cyclical insurance markets. This, of course, is a primary objective of the legislation. Regardless of how much or how little actual risk financing capacity a Risk Retention Group can muster, it has the potential to become a leader which commercial markets will favorably <u>follow</u> as primary and reinsurance subscribers.
  In addition, the group has the inherent ability to lead its business or professional community into new concepts of risk and insurance management, loss prevention and control and to bring fresh viewpoints to many long-standing insurance market and technical difficulties.

- <u>Ease of Formation and Entry</u>. The charter, licensing, capitalization and actuarial requirements of only <u>one</u> state need to be met in order to do business in <u>all</u> states. This is a considerable financial and organizational advantage over commercial insurers who must qualify separately and meet the individual requirements in each state where they seek to be admitted to do business.

- <u>Relative Lack of Regulatory Control</u>. Depending on the State of Domicile, Risk Retention Groups are subject to some supervision at the charter, licensing and plan approval states of their organization. Beyond that, states can exercise relatively little control.

  No state insurance department has the administrative power to suspend licenses, or even to issue cease-and-desist orders to Risk Retention Groups, and such actions could be delayed indefinitely by the need for investigations, hearings and court procedures which may (or may not) lead to injunctive relief.

  These provisions of the Act effectively make the <u>courts</u> the regulator, not the insurance departments. Such oversight as may be exercised by the states is likely to be passive, advisory and reactive only if serious problems or abuses come to its attention. Thus, Risk Retention Groups have considerable latitude to be innovative and responsive to member needs without regulatory constraints or obstructions.

- Convenience of Policy Issue and Countersignature. Freedom from the inconvenience (and expenses) of using state-licensed resident agents or brokers to countersign policies is a definite plus. Countersignature laws are essentially protectionist legislation which exists in all states to assure that resident agents and brokers are not cut out of participation in local business.

- Tailor-Made Coverage's and Services. The ability to "unbundle" traditional insurance coverage(s) and services is a distinct possibility for Risk Retention Groups. Coverage can, to some extent, be "tailored" to the specific needs of the group as opposed to having to buy inclusive, standard "packages" sold by commercial insurers. Services such as claims investigation, legal defense, risk management and engineering can also be tailored and provided apart from the actual claim payment function if desired.

- Lower Selling Costs. The group has the ability to achieve reductions – often substantial – in selling costs. The cost of commissions to independent agents and brokers is a significant percentage (usually from 7½% to 15%) of the average insurance premium. The costs of direct marketing to group members should be considerably less, as should the costs of advertising and promotion to prospective members considering that current members can be used to assist in selling relatively narrow-targeted business or professional segments in a majority of instances.

Q. In summary, what are the principal disadvantages of a Risk Retention Group?

Depending on its size, financial capacity and the risk assumed, there could be several, including:

- Size #1. Compared to almost any commercial insurer a Risk Retention Group is likely to have a lot less of an asset called safety-in-numbers. With substantially fewer insureds (members), exposure units at risk, and dollars of premium and surplus, a Risk Retention Group is relatively vulnerable to both a rash of unexpected ordinary-sized losses as well as to a single catastrophic loss.

- Size #2. The relative smallness of a Risk Retention Group leaves it without the economics of scale in providing member services – either through group staff or independent supplies. While economies of scale are, of course, greater for the group than for member individuals or firms, they will not likely approach those of a commercial insurer.

- Isolation #1. Lack of access to the national and international insurance system, lack of regulatory supervision, the fact that they are not subject to recognized financial rating, and limited access to the public equity and debt markets leaves Risk Retention Groups and their members relatively on their own in the event of underwriting or financial stresses. A Risk Retention Group can't "join the club" simply because there is no "club" to join – yet. None of this is helped by the exclusion of Risk Retention Groups from state insolvency guaranty funds.

- Isolation #2. A Risk Retention Group is limited in its ratemaking capacity in two ways. First, because of lack of access to insurance industry collectives and rating bureaus, it is restricted to what its own hired actuaries can come up with. Second, as a practical economic matter, a Risk Retention Group will be under continuing pressure to price insurance and services lower than commercial market rates – if only slightly – in order to keep its members. It's tough enough to beat insurers at the underwriting game on the "level playing field" of market rates. Thus, the pressure to discount commercial rate levels puts enormous added pressure on investments and other performance.

- Membership "Pressures" #1. Risk Retention Groups in actuality are insurance companies, but as a practical matter most will tend to be run more as "business clubs". The inclination to seek – and obtain – special considerations and exceptions to underwriting rules, rate classifications and claim settlement standards will be pronounced, and the compulsion to go along – especially with influential members – will be almost irresistible. A Risk Retention Group that winds up with more exceptions than rules will not survive for very long.

- Membership "Pressures" #2. Member loyalty, investment and continuing commitment are essential. This means that the Risk Retention Group will almost constantly have to sell itself to its members – both as to service and dollar savings. Members, as investors, will also expect to see some tangible returns especially after a few years. Without commitment, loyalty lasts until the next renewal notice, and you can be certain that the relatives, friends and former insurance agents an brokers will be out trying very hard to win back lost business.

  The Risk Retention Group that does not build into its plans strong deterrents to member departure from the group is running a high risk of significant defections at the first upturn of the commercial market cycle – if not the first renewal season.

- Supervision. Beyond the lack of regulatory supervision and guidance referred to above, many Risk Retention Groups will find it tempting not to hire professional underwriting and financial managers. Almost everyone in a Risk Retention Group will have a relative or friend in the "insurance business" and the "advice" will be fast, thick and apparently free. Keeping in mind that behind every bit of "free advice" there is usually a sales presentation; non-professional, part-time Risk Retention Group trustees or directors will have to be very careful indeed.