



**REPORT OF THE GENERAL ACCOUNTABILITY OFFICE ON RISK
RETENTION GROUPS**

Stephanie J. Mapes
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The long awaited report of the GAO was finally released on September 14, 2005. The purpose of the report is to advise Congress on the effectiveness of the federal Liability Risk Retention Act (“LRRRA”) in accomplishing its stated purpose of increasing the availability and affordability of commercial liability insurance. In addition, in light of the partial preemption under the LRRRA of state insurance law to create a simplified and cost effective single-state regulatory framework, and recent concerns about the adequacy of the regulation of risk retention groups, the report assesses whether the LRRRA’s preemption has resulted in significant regulatory problems, and evaluates the sufficiency of LRRRA’s ownership, control and governance provisions. A copy of the full report is available at <http://www.gao.gov/new.items/d05536.pdf>.

The GAO concludes that the LRRRA has indeed served its intended purpose of increasing the availability and affordability of liability insurance for members that experienced difficulty obtaining coverage. The number of risk retention groups has increased dramatically in recent years in response to shortages of capacity and coverage. The report states that the best example of this is the large number of risk retention groups formed over the last three years to provide medical malpractice insurance. (GAO Report p. 65).

The GAO also concludes that insurance regulators, working in conjunction with the NAIC, should develop a set of uniform baseline standards for regulating risk retention groups. The report finds that the regulatory standards applied by the leading risk retention group domiciles (meaning those states where the most risk retention groups have been formed) differ drastically in some instances. Risk retention groups are largely regulated by states in which they write little or no business. The regulators in the states where the groups conduct their business must rely on the regulators in the state of domicile. The lack of consistency of regulation by the domiciliary states has created in the non-domiciliary regulators a lack of trust and confidence, and a level of confusion.

One major point of confusion surrounds the lack of consistency in financial reporting among the states. State insurance regulators are used to receiving reports based on Statutory Accounting Principles (SAP) and run all of their solvency ratios and tests on SAP based financials. They are unfamiliar with Generally Accepted Accounting Practices (GAAP) reporting allowed and mandated by some states, and even more confused by the use of “modified” GAAP which allows Letters of Credit and Surplus Notes to be counted as capital. The GAO concludes that such inconsistencies coupled with the introduction of new domiciles less experienced than Vermont in regulating risk retention groups, and an increase in the number of risk retention groups writing medical malpractice coverage (historically subject to high and unpredictable losses) has increased the risk of future insolvencies.

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The report specifically recognizes that the regulatory structure applicable to risk retention groups need not be identical to that used to regulate the traditional insurance industry. (GAO Report p. 65). The report cites the two year negotiation period between the NAIC and the State of Vermont on how the NAIC accreditation standards should and should not apply to risk retention groups. (GAO Report p. 34). As a result of Vermont's long fought battle, which occurred when the NAIC began its 1993 accreditation process of the State of Vermont, the NAIC determined that risk retention groups were sufficiently different from traditional insurers and that the laws necessary for effective solvency regulation in the traditional insurance industry should not apply to risk retention groups. Substitute standards were not, however, formally developed. The GAO suggests that more consistent standards be developed, and should include consistent accounting methods, compliance with state Insurance Holding Company Acts, and minimum standards for the qualification and number of staff that insurance departments must have available to charter risk retention groups. (GAO Report p. 66). It also suggests that these standards reflect the regulatory best practices of the more experienced domiciles.

Finally, the GAO concludes that the LRRRA's provisions for the ownership, control and governance of risk retention groups may not be sufficient to protect the best interests of the insureds. The entire rationale for regulating risk retention groups in a manner less onerous than traditional insurance companies is that the groups will be motivated to succeed given the identity of the insureds and the owners. Legislative history also cites the lack of state solvency and guaranty fund protection as an incentive for risk retention groups to be self disciplined and succeed. Nonetheless, the GAO concludes that risk retention group insureds have been left vulnerable to misgovernance. (GAO Report p. 66). Culprits cited include: the chartering of "entrepreneurial risk retention groups" (GAO Report p. 53) where a few insureds or service providers may retain control of the group for their own personal gain; the lack of capital contributions by all insureds above and beyond premium payments; the permission granted by some domiciles for capital to be contributed by non-insureds; and the need for all insureds to possess the right to nominate and appoint directors. An analogy was made to mutual fund regulation where mutual funds rely on outside managers to operate them and are subject to inherent conflicts of interest. It was suggested that remedial action draw upon principles of the Investment Company Act of 1940; namely, provisions regulating the number of disinterested directors serving on the board and regulatory oversight of contracts between management companies or other significant service providers and risk retention groups. In summary, the GAO suggests:

- all insureds, and only insureds have the right to nominate and appoint the board;
- all insureds contribute to capital and surplus beyond their premium;
- a majority of the board of a risk retention group consist of independent directors;
- safeguards be provided for negotiating the terms of management contracts; and
- members be better educated on the risks of owning a risk retention group, and the disclosure of no guaranty fund protection be provided on all policy applications and marketing materials and not just on the policy.