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How Regulators, Lawyers, and RRGs View the Governance Standards in Vermont

By Christopher Diemel, Managing Editor, Risk Retention Reporter

While many domiciliary states are wrapping up the process of bringing their RRGs into compliance with revised governance standards for risk retention groups, Vermont got ahead of the NAIC deadline by beginning to bring its RRG into compliance in 2016. As a result, Vermont is a great case study for how effective, and perhaps how painful, the implementation of these new standards has been for the RRG industry.

Over the past month I interviewed a range of professionals engaged with the implementation of the new standards, from regulators to lawyers to the service providers for the RRGs themselves, to get their perspective on the implementation of the governance standards and what they mean for the RRG industry.

For the regulatory perspective I interviewed Sandy Bigglestone, director of captive insurance at the State of Vermont. On the legal side I spoke with Paul Frank + Collins P.C. President Stephanie Mapes and her colleague, Paul Frank + Collins Director Benjamin Gould. And for the RRG perspective I conferred with Kathryn Boucher, Director of Captive Management at Premier Insurance Management Services—the acting captive manager for American Excess Insurance Exchange, Risk Retention Group.

How the Industry Got Here

The current governance standards arose out of a report on risk retention groups produced in 2005 by the Government Accountability Office for the House Financial Services Committee. The report set out to determine if the Congressional vision for the *Liability Risk Retention Act*—namely the alleviation of shortages in affordable commercial liability coverages through the creation of RRGs—had been fulfilled. The GAO Report found RRGs did fulfill the intent of the *LRRA* by increasing the "availability and affordability" of coverage, but also raised significant questions about the regulation of RRGs.

The GAO report noted that the failure of four risk retention groups in 2003 pointed towards "significant regulatory problems" regarding risk retention groups, particularly "widely varying state standards."

"A major issue in the report was how different states were regulating RRGs back then; there were some states that were allowing RRGs to do things that weren't even allowed by the federal act, with investors that weren't owners and so on," said Mapes. "A lot of that has been cleaned up since the report was issued."

Mapes noted that the GAO report also found that RRGs were vulnerable to misgovernance, particularly in the form of entrepreneurial RRGs where the service providers were the major beneficiaries of the RRG. This misgovernance was a significant impetus for the creation of RRG governance standards, including the requirement for a majority of independent directors.

Overall, the creation and application of the RRG governance standards has been a long process for the industry, from drafting up the standards, to making them a part of the NAIC accreditation standards, to the process of bringing individual RRGs into compliance with them.

"Applying governance standards consistently to all RRGs has been more than a ten-year effort. Input was received from both regulators and industry throughout the process," said Biggelstone. "The governance standards should be viewed as a tool to help Board members meet their fiduciary responsibilities and promote uniformity in regulation. They encourage accountability and transparency to all stakeholders."

The Regulatory Outlook

As the leading risk retention group domicile, Vermont decided to get ahead of the game and began the process of bringing their RRGs into compliance with the new governance standards in 2016. Regulators in domiciliary states play a key role in drafting the governance standards for their state and then monitoring that those standards for being met by their domiciliary RRGs.

The early guidance memos from Vermont regulators regarding the governance standards addressed the specific interpretations of Vermont law regarding "director independence, material service provider contracts, audit committee and partner rotation requirements, board policies, and guidance for newly formed RRGs," said Bigglestone.

Bigglestone noted that many Vermont RRGs already had board policies and procedures like those required by the standards, leading to effortless implementation in some instances. However, some cases were more complex and "did call for further discussion and necessitated Vermont's involvement to help RRGs with the interpretation and best practices," said Bigglestone.

Vermont also took the approach of having some degree of scalability in the application of the governance standards by taking into consideration aspects of the RRG such as size, structure, and sophistication of the membership. "We consider all aspects of a RRG's operations when developing our examination plan, including closely-held RRGs whose members comply with their own strict governance standards that we may rely on," said Bigglestone.

In the past some non-domiciliary states have taken an aggressive stance towards RRGs, and as a domiciliary state Vermont often fields inquiries from non-domiciliary states. Bigglestone stated that "the financial condition of RRGs continues to be a regulatory focus for all states."

"The implementation of governance standards applies uniformly to all RRGs, whether licensed under traditional or captive insurance laws, and are intended to protect the interests of RRG owners/policyholders by eliminating the purported abuses and conflicts of interest with service providers trying to profit from RRGs. The desired impact should prove beneficial to state regulators, RRG policyholders, and the industry alike," said Bigglestone. "The standards imposed upon RRGs are not much different from the standards imposed upon traditional insurers, so no one can reasonably claim that RRGs aren't regulated. They may be regulated differently, but they are regulated responsibly."

The Legal Viewpoint

The biggest sticking points for both Stephanie Mapes and Benjamin Gould of Paul, Frank + Collins PC were the amount of work created by the governance standards and the rigidity in which they have been applied to the industry.

"The real problem with the governance standards is that they made them so incredibly detailed," said Mapes. "We've done a lot of work with our clients to bring them into compliance with the standards. The memo we initially sent out to our clients was four or five pages. We've got the process down now, and we tried to make it as easy for our clients as possible, but I feel it's never great to make the lawyers rich."

Mapes stressed that some RRGs are still forming because they were unable to obtain coverage from the commercial market. Two recent examples of this trend are Recreation RRG, which formed to provide coverage to members of United States Hang Gliding and Paragliding Association, Inc., and DAN RRG, Inc., which provides coverage to scuba diving professionals and dive stores. For both Recreation and DAN, the RRG was formed after Lloyd's ceased writing the coverage the members needed to pursue their activities.

Mapes said that groups such as Recreation and DAN tend to be quite small and for such groups "the standards can be a financial burden."

Early in the process of implementing the governance standards it seemed the board independence requirement might pose some problem, but that hasn't been the case.

"There seems to be a popular misconception when it comes to board independence, that an independent director of an RRG needs to be truly independent like financially-disinterested directors are and that's not the case with the RRG governance standards," said Gould. "The standards explicitly make clear that an individual who's an insured of the RRG or a representative of a company that is insured by the RRG is considered independent. This portion of the standards is driven toward making sure that the RRG is governed by its shareholders. So at least as far as our clients are concerned we've had no issues getting them to comply. If you get these entrepreneurial RRGs where the service providers are reluctant to give out that control then maybe that's the issue."

Gould does have other concerns with the governance standards, though. Mirroring Mapes, Gould stated the documentation required for the governance standards is problematic, particularly for smaller, more closely held RRGs.

"[For these smaller groups], the parent company has all sorts of succession planning protocols in place. Other protocols for review of financial statements, board evaluations, and continuing education are all being handled at the parent level and for the RRGS to have to show their own compliance to the regulators is duplicative and results in a lot of extra work," said Gould.

Gould stated that having smaller groups adhere to the same standards as large, established RRGs can be problematic. Gould also mentioned that there is some variance in the application of the standards by domiciles. "Some regulators are certainly willing to judge the sufficiency of compliance based on the size of the RRG, the type of business they are writing, and their overall structure," said Gould. "We've seen other domiciles requesting a level of detail, a level of compliance that seems to go beyond what the statutory mandates are."

For Mapes, the governance standards are one part of a series of regulations that arose from the GAO report: "When you add it together I like to call it death by a thousand cuts, the holding company act, the governance standards, and now the oncoming cyber regulation*."

Both Mapes and Gould believe a softer touch towards RRG regulation would be beneficial. "If you've seen one RRG, you've seen one RRG," said Gould. "As a result having these governance standards as a one size fits all solution doesn't seem to be a good way of addressing the problem they were trying to solve."

Ed. Note: It remains unclear if the cyber regulation under development at the NAIC will become a part of the accreditation standards.

The RRG Perspective

American Excess Ins. Exchange, RRG (AEIX) is a Vermont-domiciled reciprocal risk retention group that provides primary and excess hospital professional liability to its members. While AEIX is approaching its 20th anniversary as a Vermont-domiciled reciprocal risk retention group, the program was initially started in 1990 in response to the hard professional liability market present in the mid-1980s.

"The original RRG was formed in 1990 as a Vermont-domiciled stock RRG that acted as a fronting company for a Bermuda group captive insurance company," said Kathryn Boucher, director of captive management for Premier Insurance Management Services, acting captive manager for AEIX. "When Vermont amended its statutes to allow risk retention groups to form as reciprocals, AEIX was formed and assumed the liabilities from its predecessor companies. This evolution created significant operating efficiencies for the program."

The application of the governance standards has been one of several evolutions AEIX has undergone, from the restructuring as a Vermont-domiciled reciprocal RRG to adapting to current soft market conditions. According to Boucher the soft market forced "AEIX to evolve into a company that is efficient and differentiated by its full spectrum of services and resources it provides to its members to help them safeguard assets, enhance patient safety, and inspire innovation."

Boucher said that AEIX viewed the governance standards "as an opportunity to both look back and improve AEIX's governance documents as well as to look to the future and implement changes that will provide flexibility as AEIX evolves and grows." As one of the first reciprocal RRGs in Vermont, the initial governance documents drawn up "were very broad." Through years of operation, and AEIX's legal team's experience forming other reciprocal RRGs, AEIX was able to completely revamp their governance documents, even though the process was not strictly required under the new governance standards.

"While we were revamping the existing governance documents, we took the opportunity to add in features that will facilitate future growth for AEIX, such as additional classes of members and broadening the language to allow for new lines of business," said Boucher. "The most challenging part of the new governance standards for AEIX was to implement the wide variety of new requirements efficiently, so it didn't become an administrative headache to comply and to stay in compliance in the future."

Overall Boucher feels good about the governance standards and their impact on the RRG industry. "I think the majority of RRGs were well governed prior to the governance standards being adopted, but there were exceptions, and those exceptions were impacting the credibility of the entire RRG industry. I think the revised standards address the issues that were identified in the GAO study and ensure transparency when it comes to relationships with board members and material service providers," said Boucher.

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