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RRG Corporate Governance Status Update

by Arthur Perschetz, Baker & Daniels LLP

Unlike most traditional insurers, risk retenton groups (RRGs) are owned by member insureds to self-insure risks. The Liability Risk Retention Act of 1986 (LRRA) partly preempts state insurance law to create a single-state regulatory framework for RRGs even though RRGs are often multistate insurers. Additionally, since most RRGs (as captives) are not subject to the same standards for solvency regulation as traditional insurers, state requirements in areas such as financial reporting and corporate governance vary. Consequently, and as a result of the 2005 GAO Report, a number of proposals to implement additional governance requirements for RRGs have been put forth. This article focuses on the status of the proposed corporate governance standards at the NAIC and federal level.

2005 GAO Report

In response to notable RRG failures in the early 2000s, the United States Government Accountability Office (GAO) issued a report (Risk Retention Groups: Common Regulatory Standards and Greater Member Protections are Needed) that examined the effect of RRGs on insurance availability and affordability, and assessed whether the LRRA's preemption resulted in significant regulatory problems. According to the GAO, the partial preemption of state insurance laws resulted in widely divergent state regulatory standards, and because the LRRA does not specify characteristics of ownership or control, or establish governance safeguards, RRGs could potentially operate in a manner inconsistent with the best interests of its insureds. The GAO recommended that state insurance regulators adopt consistent regulatory standards for RRGs and that Congress consider granting partial preemption only to states that have minimum corporate governance requirements. Since its publication, the GAO Report has triggered three proposals for stricter RRG corporate governance standards: 1) NAIC Corporate Governance Standards for RRGs; 2) NAIC Accreditation Parts A, B and C (applicable to captive RRGs); and 3) the Risk Retention Modernization Act of 2010 (H.R. 4802). These proposals attempt to address many of the issues presented in the 2005 GAO Report.

Status of Proposals

NAIC Corporate Governance Standards

The NAIC has been trying to bolster the regulatory framework for RRGs since the number of RRGs increased in the late 1990s and through the 2000s – notably in states such as the District of Columbia, South Carolina, and Hawaii. In May 2007, the NAIC developed its Governance Standards for RRGs, which provide guidelines for eight substantive areas:

- *Independent Directors*
- *Service Provider Contracts*
- *Written Charter*
- *Audit Committee*
- *Governance Standards*
- *Business Conduct and Ethics*
- *Reporting Non-Compliance*
- *Enforcement*

These standards have been adopted by the NAIC membership and states may choose to utilize them as guidelines. No state has yet adopted the standards. NAIC representatives acknowledge that, as written, the standards do not provide a precise model that could easily be incorporated into state legislation. However, the NAIC is in the process of revising the standards so that state implementation would be straightforward. Consequently, the NAIC Risk Retention (C) Working Group is charged with the task of converting these standards to a Model (NAIC) Standard. Further, these standards could potentially be incorporated into the NAIC Financial Regulation Standards and Accreditation Program (discussed below). Currently, these standards are only partially referenced in the Part A accreditation requirements.

The NAIC will vote on whether these standards, including provisions concerning certain requirements for auditor independence, corporate governance, and internal control over financial reporting, will be applicable to RRGs at the NAIC National Meeting in August 2010. If determined to be applicable, RRG compliance would not be required until 2012 or 2013.

NAIC Financial Regulation Standards and Accreditation Program

The NAIC Accreditation Program establishes and maintains standards to promote sound insurance company financial solvency regulation. The accreditation standards, applicable to traditional insurers as of January 2010, is divided into three categories: Part A–Laws and Regulations, Part B–Regulatory Practices and Procedures, and Part C–Organizational and Personnel Practices. Currently, Parts

B and C do apply to captive RRGs – that is, RRGs organized as captive insurance companies (as opposed to a traditional insurance company). However, in 2008 and 2009, the NAIC Risk Retention Group (E) Task Force reviewed Parts B and C and made several revisions specifically applicable to captive RRGs. It is these revised Parts B and C standards that become effective January 1, 2011.

Additionally, the Task Force is currently debating which Part A accreditation standards should apply to captive RRGs, in addition to whether provisions of the Annual Financial Reporting Model Regulation ("Model Audit Rule") should apply to captive RRGs. Notably, the Part A Standards address eighteen areas with requirements that incorporate portions of model laws and regulations:

- *Examination Authority*
- *Capital and Surplus Requirement*
- *NAIC Accounting Practices and Procedures*
- *Corrective Action*
- *Valuation of Investments*
- *Holding Company Systems*
- *Risk Limitation*
- *Investment Regulations*
- *Liabilities and Reserves*
- *Reinsurance Ceded*
- *Life and Health Reinsurance Agreements Model Regulation*
- *Credit for Reinsurance Model Regulation*
- *CPA Audits*
- *Actuarial Opinion*
- *Filings with NAIC*
- *Property/Casualty Actuarial Opinion Model Law*
- *CPA Audits–2001 Revisions to the MAR*
- *CPA Audits–2006 Revisions to the MAR.*

With respect to corporate governance, the Part A Standards incorporate some provisions of the Model Audit Rule, including the prohibition of a qualified independent CPA entering into indemnification agreements with regard to the audit of an insurer, as well as the Model Audit Rule provisions related to auditor independence, corporate governance, and internal control over financial reporting. For captive RRGs, most of the Part A Standards will require compliance with the Model Audit Rule or the NAIC Corporate Governance Standards. The majority of the Part A standards will become effective January 1, 2011. However, the standards specific to corporate governance and the Model Audit Rule have not officially been voted on yet and will be considered by the Financial Regulation Standards and Accreditation (F) Committee at its August 2010 meeting. If determined to be applicable, these requirements will probably not go into effect until 2012 or 2013.

Federal Legislation: H.R. 4802

Proposed by Rep. Dennis Moore (D-KS) and John Campbell (R-CA) in March 2010, the Risk Retention Modernization Act of 2010 (H.R. 4802) is aimed at reducing property insurance costs and increasing coverage availability, particularly in higher-risk areas prone to natural disasters. Moreover, H.R. 4802 also contains requirements relating to the implementation of a federal dispute resolution process to resolve issues between states and RRGs, by expanding the LRRA to allow RRGs to write commercial property coverage, and new corporate governance standards comparable to those suggested in the 2005 GAO Report.

The NAIC has not taken an official position on H.R. 4802, but it is generally known to be supportive of improved corporate governance standards, but against the proposed expansion to allow commercial property insurance to be written by RRGs. Regardless, since Rep. Moore is soon retiring and no notable progress has been made since the bill's introduction, H.R. 4802 is not expected to be passed by the 111th Congress this year. There is a growing constituency of supporters for increased RRG corporate governance standards, however, that hopes the 112th Congress will have the ability to pass a similar bill after it is re-introduced, perhaps this time in the Senate as well.

Conclusion

Increased corporate governance requirements for RRGs have recently been proposed for many years at the NAIC and federal level. It seems more likely than ever before that the regulatory landscape where RRGs once operated with little restriction will soon be marked with increased regulation and stricter requirements that may deter their initial formation. Further, certain members of Congress have requested the GAO to conduct additional studies regarding the potentially inconsistent regulatory treatment of RRGs in states in which they are entitled under federal law to do business but are not chartered. Consequently, as more proposals are set forth, it is uncertain whether the solutions would reinforce or underscore the foundation of the LRRA. One concern is that, despite which proposals may be adopted, the majority of RRGs face the possibility of not only having to comply with the many proposed rules and regulations, but also spending more capital simply to conform to the increased regulatory requirements.

About the author: Arthur Perschetz is counsel with the law firm of Baker & Daniels LLP. Mr. Perschetz speaks frequently at a wide array of conferences, and his articles have appeared in numerous publications, including the Protected Cell Captive Handbook. He is actively involved in captive industry organizations and serves on many boards and committees. *He would like to acknowledge fellow Baker & Daniels attorneys Jason Kimpel, Abhishek Dube, and Jared Danilson for their assistance with the article.*

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