

December 2011

RISK RETENTION GROUPS

Clarifications Could Facilitate States' Implementation of the Liability Risk Retention Act

On January 10, 2012, this report was reposted on the GAO website to correct information in appendix I that was not included in the previously posted file.

U.S. Government Accountability Office



Why GAO Did This Study

Congress authorized the creation of risk retention groups (RRG)—a group of similar businesses that creates its own insurance company to insure its risk—to increase the affordability and availability of commercial liability insurance. Through the Liability Risk Retention Act (LRRRA), Congress partially preempted state insurance laws to allow RRGs licensed in one state (the domiciliary state) to operate in all other states (nondomiciliary states) with minimal additional regulation. In a 2005 report ([GAO-05-536](#)), GAO noted concerns with the adequacy of RRG regulation. This report (1) describes changes in the financial condition of the RRG industry from 2004 to 2010; (2) examines the regulatory treatment of RRGs across domiciliary and nondomiciliary states; and (3) examines changes to federal and state regulatory practices regarding RRGs since 2004. GAO analyzed RRG financial data, surveyed state insurance regulators (96 percent response rate), and interviewed RRG industry representatives.

What GAO Recommends

To further facilitate states' implementation and help reduce the varying interpretations of LRRRA, Congress should consider the merits of clarifying certain LRRRA provisions regarding registration requirements, fees, and coverage. NAIC concurred with this matter for congressional consideration.

RISK RETENTION GROUPS

Clarifications Could Facilitate States' Implementation of the Liability Risk Retention Act

What GAO Found

Certain indicators suggest that the financial condition of the RRG industry in aggregate generally has remained profitable. In 2003, RRGs wrote about \$1.8 billion, or 1.17 percent of commercial liability insurance. In 2010, RRGs continued to comprise a small percentage of the total market, writing about \$2.5 billion—or about 3 percent of commercial liability coverage. Other financial indicators, such as ratios of RRG premiums earned compared to claims paid—also suggest profitability. In addition, the number of RRGs has increased since 2004, with the most growth occurring in health care-related lines. In 2010, more than 80 percent of RRGs were domiciled in Vermont, South Carolina, the District of Columbia, Nevada, Hawaii, and Arizona, but RRGs wrote about 95 percent of their premiums outside their state of domicile. Evidence suggests that RRGs may choose to domicile in a particular state, partly due to some financial and regulatory advantages such as lower minimum capitalization requirements. RRG representatives opined that RRGs have expanded the availability of commercial liability insurance—particularly in niche markets—but differed in their opinions of whether RRGs have improved its affordability.

Different interpretations of LRRRA have led to varying state regulatory practices and requirements in nondomiciliary states and disputes between state regulators and RRGs in areas such as registration requirements, fees, and types of coverage RRGs may write. For example, while some states have interpreted LRRRA to permit RRGs to write contractual liability coverage, others have not, and therefore may not allow RRGs to write this coverage in their state. RRGs have challenged requirements established by nondomiciliary states that RRGs assert are not permitted by LRRRA. However courts also have differed in their interpretations of LRRRA. Some regulators with whom GAO spoke indicated that their actions toward nondomiciled RRGs reflect an effort to use their limited regulatory authority to protect insureds in their states as well as address concerns about RRG solvency.

Some state regulatory practices for RRGs have changed since 2004, and federal legislation has been proposed. In 2005, GAO recommended implementation of more uniform, baseline state regulatory standards, including corporate governance standards to better protect RRG insureds. The National Association of Insurance Commissioners (NAIC) has since revised its accreditation standards to more closely align with those for traditional insurers which are subject to oversight in each state in which they operate. For example, all financial examinations of RRGs that have commenced during or after 2011 should use the risk-focused examination process. NAIC also has begun developing corporate governance standards that it plans to implement in the next few years. Proposed legislation would amend LRRRA to allow RRGs to provide commercial property insurance and also include a federal arbitrator to resolve disputes between RRGs and state insurance regulators. While some RRG representatives and state regulators supported this legislation, others expressed concerns about whether RRGs would be adequately capitalized to write commercial property insurance and about federal involvement in state regulation.

Contents

Letter		1
	Background	5
	RRGs Generally Reported Increased Profitability and Continue to Write the Majority of Their Business in Nondomiciliary States	8
	Varying Interpretations of LRRRA Result in Different Regulatory Treatment of RRGs across States	24
	NAIC Actions Address Some Regulatory Concerns, While Recent Federal and State Proposals May Affect Future RRG Operations	34
	Conclusions	43
	Matter for Congressional Consideration	44
	Agency Comments and Our Evaluation	44
Appendix I	Objectives, Scope, and Methodology	46
Appendix II	Comments from the National Association of Insurance Commissioners	51
Appendix III	GAO Contact and Staff Acknowledgments	53
Figures		
	Figure 1: RRG Premiums Written by Percentage of RRGs Writing Specified Dollar Amounts, 2004–2010	9
	Figure 2: Direct Premiums Written for the Overall Commercial Liability and Medical Professional Liability Industries, 2007–2010	10
	Figure 3: RRG Industry Average Net Written Premium, as a Percentage of Policyholder Surplus, 2004–2010	12
	Figure 4: RRG Average Return on Equity, 2004–2010	13
	Figure 5: RRG Industry Average Combined Ratio, 2004–2010	14
	Figure 6: Number of RRGs, and Percentage of Total RRGs with Combined Ratios above 100, 2006–2010	15
	Figure 7: Percentage of Overall RRG Gross Premiums by Business Line, 2004 and 2010	17
	Figure 8: RRGs Licensed by Business Line, 1991, 1996, 2001, 2004, and 2010	18
	Figure 9: Number of Active RRGs Domiciled by State, 2004 and 2010	19

Figure 10: Number of Operating RRGs by State, 2004 and 2010	21
Figure 11: Percentage of Premiums RRGs Wrote in Nondomiciliary States (Shown by Domiciliary State), 2004 and 2010	22

Abbreviations

GAAP	generally accepted accounting principles
LRRA	Liability Risk Retention Act
NAIC	National Association of Insurance Commissioners
NRRA	National Risk Retention Association
PLRRA	Product Liability Risk Retention Act
RBC	risk-based capital
ROE	return on equity
RRG	risk retention group
SAP	statutory accounting principles

View GAO-12-16 Key Component

- Risk Retention Groups: Survey of State Regulators ([GAO-12-17SP](#), December 2011), an E-supplement to [GAO-12-16](#)

This is a work of the U.S. government and is not subject to copyright protection in the United States. The published product may be reproduced and distributed in its entirety without further permission from GAO. However, because this work may contain copyrighted images or other material, permission from the copyright holder may be necessary if you wish to reproduce this material separately.



G A O

Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

December 8, 2011

The Honorable Michael Capuano
Ranking Member
Subcommittee on Oversight and Investigations
Committee on Financial Services
House of Representatives

The Honorable John Campbell
House of Representatives

Responding to shortages that constrained the availability and affordability of commercial liability insurance, Congress passed the Product Liability Risk Retention Act of 1981 (PLRRA) to authorize creation of risk retention groups (RRG)—similar businesses with similar risk exposures that create their own insurance company to self-insure their commercial liability risks on a group basis.¹ In 1986 Congress amended PLRRA by passing the Liability Risk Retention Act of 1986 (LRRRA), which allows RRGs to extend coverage beyond product liability into most of the commercial liability market and establishes a regulatory framework that partially preempts state insurance laws.²

LRRRA allows an RRG to be regulated primarily by its chartering (domiciliary) state, even when it sells insurance in other (nondomiciliary) states.³ With one regulator, RRGs differ from “traditional” insurers, which are subject to licensing and oversight by regulators in each state in which they operate. While LRRRA requires RRGs to provide to nondomiciliary state regulators copies of the RRG’s business plan or feasibility study and annual financial statements, it neither explicitly permits nor prohibits nondomiciliary states from requesting additional documentation or

¹Pub. L. No. 97-45, 95 Stat. 949 (1981) (codified, as amended, at 15 U.S.C. §§ 3901-06).

²Pub. L. No. 99-563, 100 Stat. 3170 (1986). As amended, LRRRA permits RRGs to offer commercial liability insurance, excluding worker’s compensation.

³See 15 U.S.C. §§ 3901-02. A domiciliary state is the state in which the RRG is chartered and primarily regulated, whereas a nondomiciliary state is any state in which the RRG is not chartered or regulated, but conducts business.

charging fees.⁴ LRRRA preempts the laws of nondomiciliary states to oversee RRGs selling insurance in their states except in specified circumstances.⁵

Congress intended for the regulatory framework established by LRRRA “to strike a balance between the RRGs’ need to be free of unjustified requirements and the public’s need for protection from insolvencies.”⁶ The legislative history indicates that Congress viewed RRGs as having incentives to practice effective risk management both in their own businesses and the RRG because the RRG is owned by insureds, who may have business assets at risk should the RRG become insolvent. To further encourage RRG members to establish adequate premiums and reserves, LRRRA prohibits RRGs from participation in state guaranty funds.⁷ According to recent data from the National Association of Insurance Commissioners (NAIC), eight RRGs became insolvent from 2004 to year-end 2010.⁸

Our 2005 report on RRGs noted that RRGs played a small but important role in increasing the availability and affordability of commercial liability insurance in niche markets, but that they operated in a regulatory environment characterized by varying state standards due to the partial preemption of state insurance laws by LRRRA.⁹ We found that RRGs might not consistently protect the best interest of owners/insureds due to a lack of uniform corporate governance standards. Our report was prompted by

⁴15 U.S.C. § 3902(d)(2)-(3). See 15 U.S.C. § 3902(a)(1)(B), which allows any state (domiciliary or nondomiciliary) to require payment of premium and other taxes, but does not mention fees.

⁵15 U.S.C. § 3902(a)(1).

⁶H.R. Rep. No. 99-865, at 12 (1986), *reprinted in* 1986 U.S.C.C.A.N. 5303, 5309; S. Rep. No. 99-294, at 13-14 (1986).

⁷Insurance insolvency guaranty funds typically are maintained by contributions of insurance companies operating in a particular state and are made available to settle the claims of insureds in the event of insolvency of traditional insurance companies.

⁸NAIC is a voluntary association of the heads of insurance departments from each state, the District of Columbia, and five U.S. territories that provides a national forum for addressing and resolving major insurance issues (including those concerning RRGs) and for promoting the development of consistent policies among the states.

⁹GAO, *Risk Retention Groups: Common Regulatory Standards and Greater Member Protections Are Needed*, [GAO-05-536](#) (Washington, D.C.: Aug. 15, 2005).

a rise in the formation of RRGs coupled with the failure of several large RRGs—22 RRGs failed between 1987 and 2003—which raised questions about the adequacy of the RRG regulatory environment and safeguards to protect RRG members/insureds and consumers.¹⁰ We recommended that the NAIC develop and implement a set of broad-based, uniform, baseline standards for RRG regulation. These standards should include regularly filing financial reports using a uniform accounting method, because both NAIC and some nondomiciliary states reported difficulty assessing the financial condition and solvency of RRGs reporting under generally accepted accounting principles (GAAP) as compared with the condition of RRGs reporting under statutory accounting principles (SAP).¹¹ We also recommended establishing minimum corporate governance standards, such as independent members on an RRG's board of directors.

As we also reported in 2005, some states may have modified policies and procedures to attract RRGs to domicile in the state, such as lowering statutory minimum capital and surplus requirements. Some regulators also expressed concerns over aspects of RRGs' operations that they would not be able to influence, such as minimum capital and surplus requirements for RRGs operating in but not domiciled in their state. The various interpretations of LRRRA by state insurance regulators have led to disputes and in some cases litigation between RRGs and states.¹² More recently, legislation has been proposed to develop a federal mechanism to arbitrate disputes between RRGs and states as well as to permit RRGs to offer commercial property coverage in addition to commercial liability coverage.¹³ Some state insurance regulators expressed concerns about the capital adequacy of RRGs wishing to incorporate commercial property coverage into their business lines.

¹⁰In 2003, 127 RRGs were licensed to write business.

¹¹SAP is a set of accounting principles dominant in the traditional insurance industry that is geared towards assessing solvency, and produces some variations from another set of accounting principles—GAAP—which are more widely used outside the insurance industry to assess the general performance of a business.

¹²See, e.g., *Ophthalmic Mut. Ins. Co. v. Musser*, 143 F.3d 1062 (7th Cir. 1998); *National Warranty Ins. Co. RRG v. Greenfield*, 214 F.3d 1073 (9th Cir. 2000).

¹³See, e.g., H.R. 2126, 112th Cong. (2011).

In light of regulatory and industry concerns, as well as recent proposals to expand LRRRA, you asked us to update our analysis from our 2005 report. This report (1) describes changes in the financial condition of the RRG industry from 2004 through 2010; (2) examines the regulatory treatment of RRGs across domiciliary and nondomiciliary states; and (3) examines changes to federal and state regulatory practices regarding RRGs since 2004.

To determine the financial condition of the RRG industry, we analyzed data on the commercial liability insurance market such as trends in the types of coverage provided, concentration of domiciled RRGs, and financial ratios based on data from NAIC. We also reviewed documentation from 2004 through 2010 from NAIC and the *Risk Retention Reporter*, a trade journal and industry data source. We determined that the data were sufficiently reliable for the purposes of our report. To evaluate the differences in regulatory treatment of RRGs across states, we reviewed and analyzed LRRRA and its legislative history. We conducted a web-based survey of insurance regulators in the 50 states and the District of Columbia (96 percent response rate) and interviewed 13 domiciliary and nondomiciliary state insurance regulators from a nonstatistical sample.¹⁴ States were selected based on the number of domiciled RRGs or the amount of premiums written by RRGs and perceived differences in regulatory treatment of RRGs in these states. We held two discussion groups with multiple RRG representatives that volunteered to participate and interviewed representatives from a nonstatistical sample of 11 RRGs. These RRGs were selected based on the amount of premiums written, state of domicile, number of states in which they operated, and type of insurance coverage provided. We are not able to generalize results from this sample to the entire RRG industry. Further, we interviewed representatives of two industry associations on their members' regulatory experiences operating in domiciliary and nondomiciliary states. We reviewed correspondence from state insurance regulators to RRG representatives about topics such as registration processes and fees charged to RRGs. To examine changes in regulatory practices since 2004, we analyzed documentation on and interviewed NAIC officials about changes to the accreditation process affecting RRGs and measures to develop corporate governance standards for RRGs. We also asked representatives of RRGs and state insurance departments, as

¹⁴The survey and corresponding results can be viewed at GAO-12-17SP.

well as an actuarial expert, about the potential impact of these efforts. Our web-based survey also asked about regulatory changes. Finally, we reviewed key legislation concerning RRGs that had been introduced at the federal and state levels since 2004. We conducted this performance audit from October 2010 to December 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Appendix I provides additional details about our objectives, scope, and methodology.

Background

Traditional insurance companies sell insurance to the public and are subject to the licensing requirements and oversight of each state in which they operate. The licensing process allows states to determine if an insurer domiciled in another state but operating in their state meets the nondomiciliary state's regulatory requirements before granting the insurer permission to operate in their state. According to NAIC's uniform application process, which has been adopted by all states, an insurance company must show that it meets the nondomiciliary state's minimum statutory capital and surplus requirements, identify whether it is affiliated with other companies (that is, part of a holding company system), and submit biographical affidavits for all its officers, directors, and key managerial personnel. After licensing an insurer, regulators in nondomiciliary states can conduct financial examinations, issue an administrative cease-and-desist order to stop an insurance company from operating in their state, and withdraw the company's license to sell insurance in the state. In addition, most nondomiciliary states have "seasoning requirements" that call for an insurance company to successfully have operated in its state of domicile for anywhere from 1 to 5 years before it can qualify for a license.

Regulatory Framework for RRGs

Although RRGs have some regulatory relief due to the lead state regulatory framework established under LRRRA, they still are expected to comply with certain other laws administered by nondomiciliary states.¹⁵

¹⁵15 U.S.C. § 3902(a)(1).

For example, RRGs must pay applicable taxes on premiums and other taxes imposed by nondomiciliary (as well as domiciliary) states.¹⁶ LRA also imposes other measures that offer protections or safeguards to RRG members including the requirement that each RRG must submit to the domiciliary state insurance regulator a plan of operation or feasibility study that includes the coverages, deductibles, coverage limits, rates, and rating classification system for each line of insurance the RRG intends to offer.¹⁷ The RRG must (1) provide a copy of the plan or study to the insurance regulator in the nondomiciliary states in which the RRG intends to conduct business before it can write any insurance coverage in that state;¹⁸ (2) provide a copy of the group's annual financial statement (certified by an independent public accountant) to the insurance commissioner of each state in which it is doing business (the financial statement should include a statement of opinion on loss and loss adjustment expense reserves by a qualified loss reserve specialist or actuary);¹⁹ and (3) submit to an examination by a nondomiciliary state regulator to determine the RRG's financial condition, if the domiciliary state regulator has not begun or refuses to begin an examination.²⁰ Nondomiciliary, as well as domiciliary, states also may seek an injunction in a "court of competent jurisdiction" against RRGs that they believe are in hazardous financial condition.²¹

Other Self-Insurance Structures

RRGs are not the only form of self-insurers. "Captive insurance companies" (captives), also chartered and regulated by states, are established by single companies or groups of companies to self-insure their own risks. States chartering captives offer some regulatory relief to these companies based on the presumption that owners of captive

¹⁶*Id.* § 3902(a)(1)(B).

¹⁷*Id.* § 3902(d)(1).

¹⁸*Id.* § 3902(d)(2).

¹⁹*Id.* § 3902(d)(3). Loss reserve is the estimated liability, as it would appear in an insurer's financial statement, for unpaid insurance claims or losses that have occurred as of a given evaluation date. Loss reserves usually include losses incurred but not reported, losses due but not yet paid, and amounts not yet due. For individual claims, the loss reserve is the estimate of what ultimately will be paid out on that claim.

²⁰15 U.S.C. § 3902(a)(1)(E).

²¹*Id.* § 3902(a)(1)(H), (e), (f).

companies have sophisticated knowledge about managing their risks and would protect their own interests. States can charter RRGs under regulations intended for traditional insurers or for captives. Non-RRG captives exist largely to cover the risks of their parent, which can be one large company (pure captive) or a group of companies (group captives). Group captives share certain similarities with RRGs because they also comprise several companies, but group captives, unlike RRGs, do not have to insure similar risks. Further, captives may provide property coverage, while RRGs currently may not. Regulatory requirements for captives generally are less restrictive than those for traditional insurers. However, non-RRG captives, like traditional insurance companies, generally cannot conduct insurance transactions in any state except their domiciliary state, unless they become licensed in that other state.

NAIC and State Coordination

State insurance regulators that oversee both traditional insurers and RRGs participate in NAIC's voluntary accreditation program for the regulation of insurers' financial solvency.²² NAIC accreditation is a certification given to a state insurance department once it has demonstrated it has met and continues to meet an assortment of legal, financial, and organizational standards. According to NAIC officials, all 50 state insurance departments and the District of Columbia were accredited as of March 2011. NAIC developed its Financial Regulation Standards and Accreditation Program in 1989 and adopted its formal accreditation program in June 1990. The mission of the program is to establish and maintain standards to promote sound insurance company financial solvency regulation. To execute this mission, NAIC assesses how each state insurance department reviews and monitors the solvency regulation of multistate insurance companies and RRGs to ensure states have (1) adequate solvency laws and regulations to protect consumers, (2) effective financial analysis and examination processes, and (3) appropriate organizational and personnel practices.

²²In general, accreditation is a process by which a program has been certified as fulfilling certain standards by a national professional association.

RRGs Generally Reported Increased Profitability and Continue to Write the Majority of Their Business in Nondomiciliary States

Premiums Written by RRGs Generally Increased, Particularly in Health Care-Related Lines

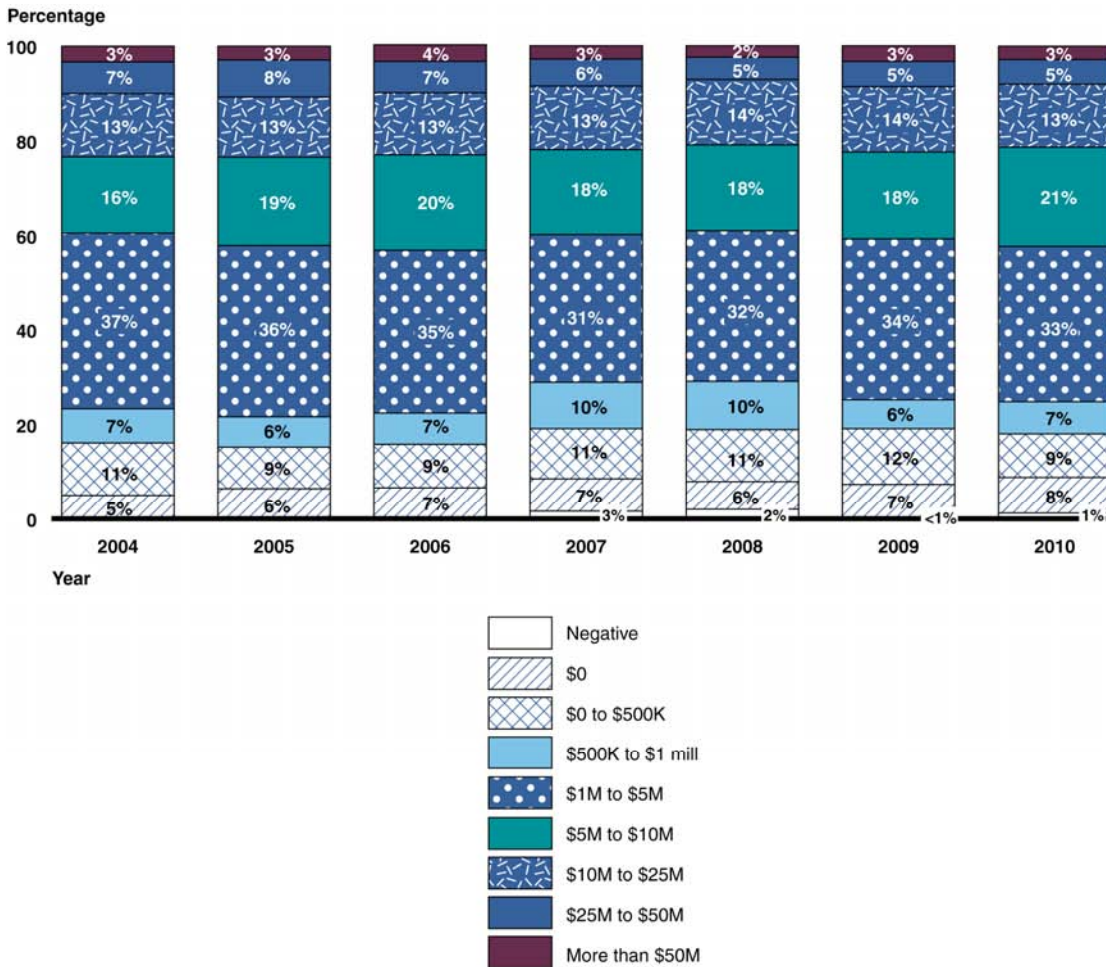
Based on data reported by RRGs to NAIC since 2004, RRGs in aggregate have shown an increase in premiums written and in their share of the broader commercial liability market.²³ In 2005, we reported that RRGs wrote about \$1.8 billion of commercial liability coverage, which constituted about 1.17 percent of the overall market in 2003.²⁴ According to NAIC data, in 2010 RRGs wrote about \$2.5 billion in premiums, which was about 3 percent of the total \$92 billion of commercial liability insurance coverage written industrywide.²⁵ An analysis of direct written premiums by dollar amount indicates that between 2004 and 2010, the largest percentage of RRGs (31 to 37 percent) wrote premiums between \$1 million and \$5 million (see fig. 1).

²³Premiums written are the total amount of premium charges in a particular period for all policies the insurer “writes.”

²⁴[GAO-05-536](#).

²⁵Commercial liability comprises various insurance lines, which include the liability portion of commercial multiple peril; other liability; products liability; commercial automobile (personal injury protection); other commercial automobile liability; warranty; and medical professional liability. The medical professional and other liability data consolidate occurrences (an event resulting in an insured loss during the policy period) and claims made (claims filed during the policy’s term or applicable reporting period). Workers’ compensation premiums for traditional insurance companies are excluded as RRGs cannot write this type of coverage. See 15 U.S.C. § 3901(a)(1). The difference in the total premiums written by RRGs and the total premiums written industrywide equals the coverage written by traditional insurance companies.

Figure 1: RRG Premiums Written by Percentage of RRGs Writing Specified Dollar Amounts, 2004–2010



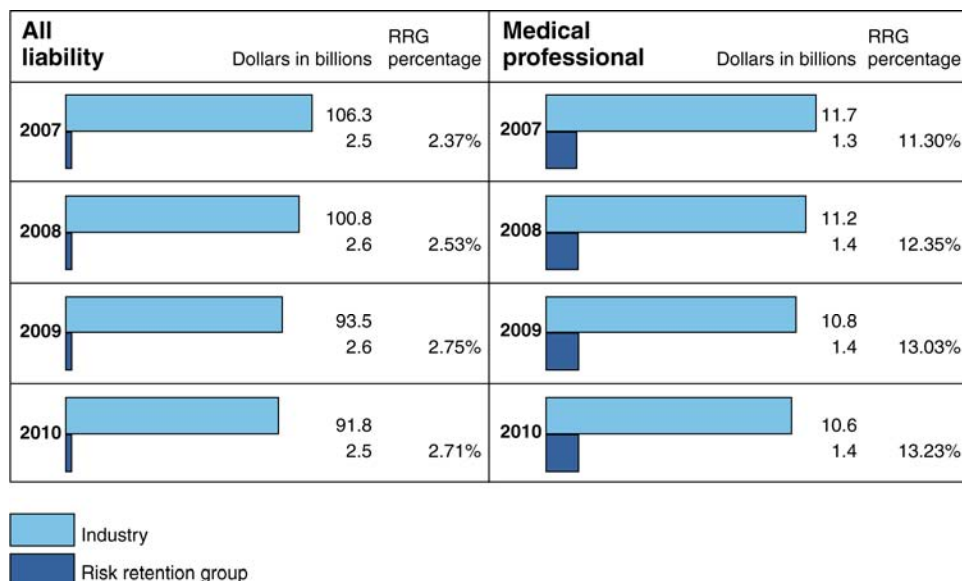
Source: GAO analysis of NAIC data.

Note: According to NAIC, negative premiums may be due to premiums returned to the purchasers of the policy after cancellation or the company writes little business and the direct written premiums are uncollectible.

Of the almost \$92 billion of commercial liability insurance written industrywide in 2010, about \$10.6 billion was written in the medical professional liability line—also known as medical malpractice. In an analysis of the premiums written for the medical professional liability line, RRGs had a higher share of this specific market compared with their share of the overall commercial liability market. RRGs wrote about 13 percent (\$1.4 billion of the total \$10.6 billion) of medical professional liability insurance in 2010 (see fig. 2). We

further discuss growth in the number of RRGs offering health care-related insurance later in this section.

Figure 2: Direct Premiums Written for the Overall Commercial Liability and Medical Professional Liability Industries, 2007–2010



Source: NAIC.

Note: Premiums written for workers' compensation insurance were excluded from this analysis as RRGs cannot provide this coverage. Separate data were not available for RRG direct written premiums for the medical professional liability line from 2004–2006.

Certain Indicators Suggest the RRG Industry Generally Has Remained Profitable

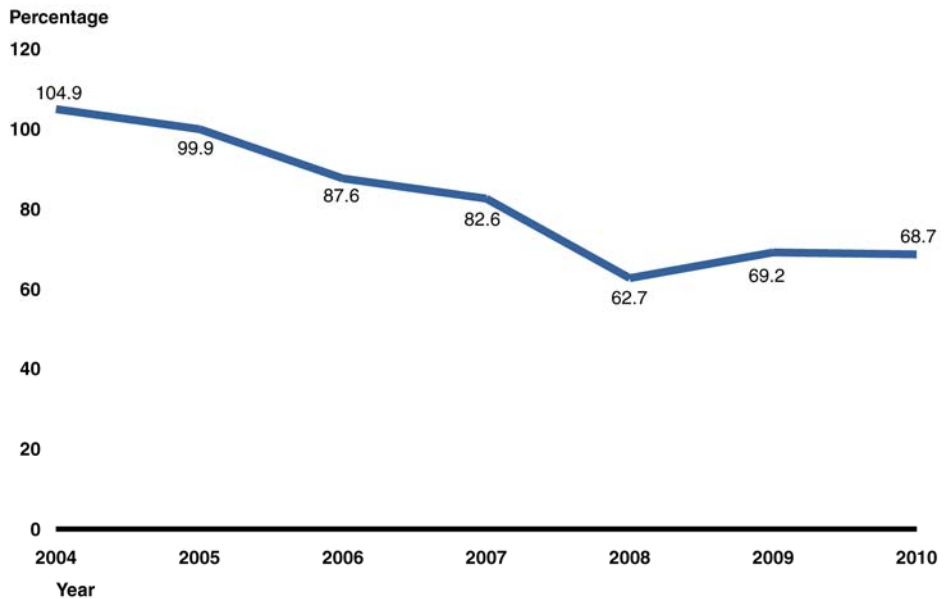
Based on several measures of financial strength or profitability, the RRG industry as a whole generally reported year-to-year gains from 2004 to 2010 (see fig. 3). A key factor in determining an insurer's overall financial strength is capital and surplus—also known as policyholder surplus—which reflects the amount by which an insurer's assets exceed its liabilities. Regulators require insurers to maintain adequate surplus so that an insurer can remain solvent even in the face of greater losses than predicted or lower earnings than projected. One of the indicators used to measure the adequacy of policyholder surplus is the ratio of an insurer's premiums written to its policyholder surplus, which measures an insurer's ability to pay claims given the volume of premiums written. A lower ratio of premiums written to surplus means an insurer has more net assets available relative to the amount of premiums written. According to the NAIC's Financial Analysis Handbook—Property/Casualty Edition and other general benchmarking guidelines from NAIC officials, the net written

premium-to-surplus ratios for property/casualty insurers in general would receive regulatory scrutiny for excessive leverage risk concerns for ratios greater than 250 to 300 percent, depending on the particular line of insurance.²⁶ If an insurer's ratio exceeds this range, a state regulator may conduct additional analyses of the insurer's financial solvency. According to NAIC officials, there is not an established benchmark for an acceptable premium-to-surplus ratio for the RRG industry. An analysis of NAIC data shows that on average, the industry's net written premium to policyholder surplus declined from 2004 to 2010, indicating that the financial strength of the industry during this time period has likely either improved or remained stable (see fig. 3).²⁷

²⁶Net written premiums are written premium less deductions for commissions and ceded reinsurance.

²⁷In some states, RRGs are allowed to use letters of credit as assets, which in some cases can result in a varied interpretation of the financial condition of an RRG based on the accounting principle used for financial reporting. Information on select differences between accounting principles as they relate to financial reporting for RRGs are available in appendix III of [GAO-05-536](#).

Figure 3: RRG Industry Average Net Written Premium, as a Percentage of Policyholder Surplus, 2004–2010



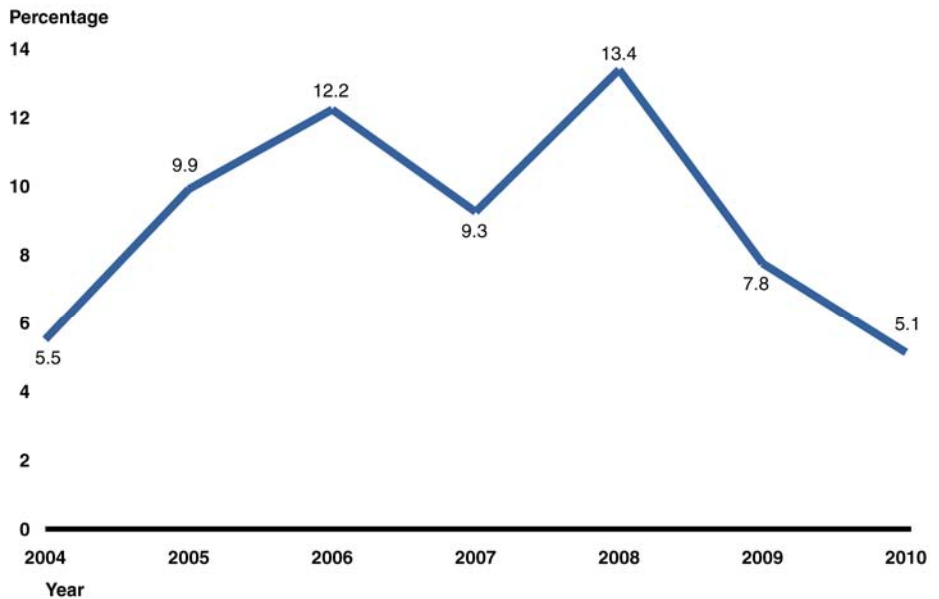
Source: GAO analysis of NAIC data.

Note: Analysis includes RRGs with positive net written premiums. RRGs with negative and zero written premiums are excluded. The average annual ratios are unweighted averages, that is, we computed ratios for individual RRGs and used these to determine an average ratio for all RRGs.

Another indicator of financial strength is return on policyholder surplus, or return on equity (ROE).²⁸ ROE is generally calculated as the ratio of net income to equity, or in the case of insurers, policyholder surplus. From 2004 to 2010, the average ROE in the RRG industry fluctuated, with a high of 13.4 percent in 2008 and a low of 5.1 percent in 2010 (see fig. 4). While no clear trend was visible over the 7-year period we analyzed, the average ROE for each year generally indicated profitability for the RRG industry.

²⁸ROE is expressed as a percent of the mean of prior and current year-end policyholder surplus. This ratio measures a company's overall after-tax profitability from underwriting and investment activity.

Figure 4: RRG Average Return on Equity, 2004–2010



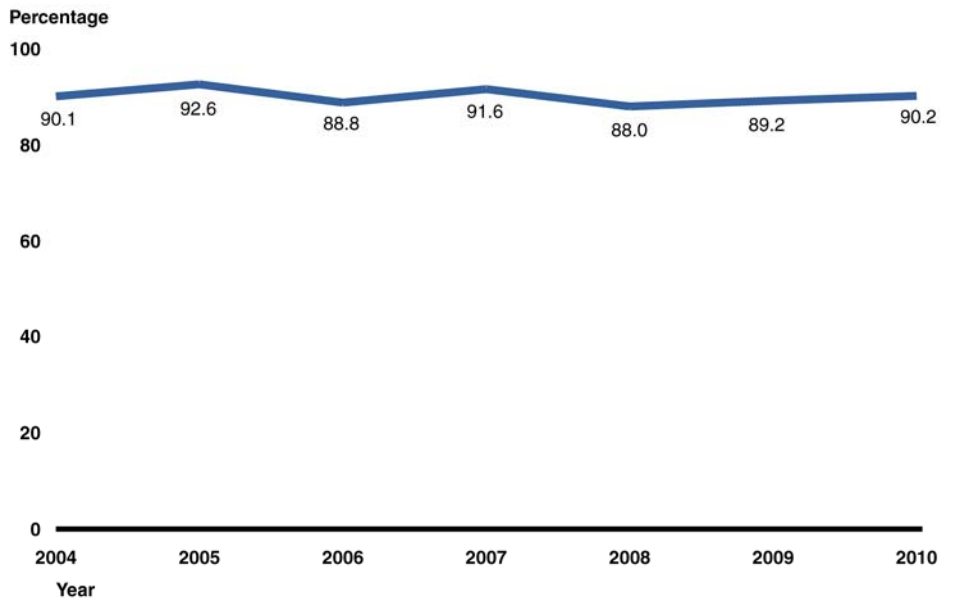
Source: GAO analysis of NAIC data.

Note: Analysis includes RRGs with positive net written premiums. RRGs with negative and zero written premiums or without ROE data as provided by NAIC are excluded. The average annual ratios are unweighted averages, that is, we computed ratios for individual RRGs and used these to determine an average ratio for all RRGs.

The combined ratio is another measure of an insurer’s financial strength and profitability.²⁹ This ratio shows the claims and related expenses incurred by an insurer as a percentage of the premiums earned. According to NAIC officials, a combined ratio of less than 100 indicates an underwriting profit (gain)—that is, premiums collected were higher than the claims paid and related expenses—while a combined ratio above 100 can be an indicator of an unprofitable insurer that could be in a hazardous financial condition. An analysis of NAIC data shows that the average combined ratio for RRGs that filed financial statements ranged from a high of 92.6 percent in 2005 to a low of 88 percent in 2008 (see fig. 5). The average combined ratio in 2010 was 90.2.

²⁹Two ratios, the loss ratio and the expense ratio, constitute the combined ratio. The loss ratio is calculated by dividing incurred losses plus loss adjustment expense by earned premiums. The expense ratio is calculated by dividing all other expenses by either written or earned premiums.

Figure 5: RRG Industry Average Combined Ratio, 2004–2010

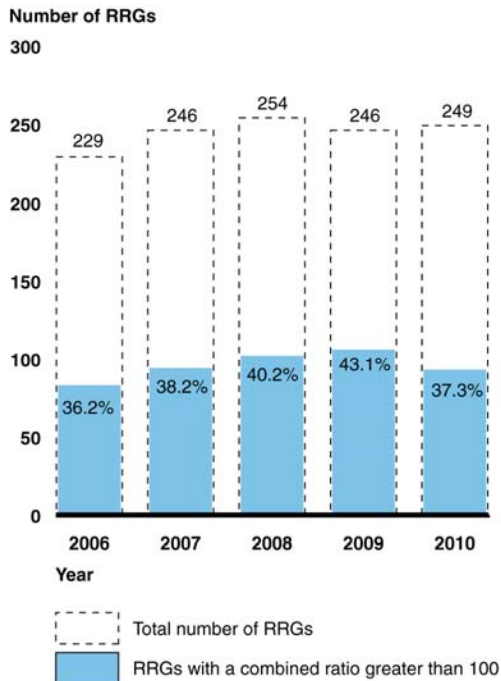


Source: GAO analysis of NAIC data.

Note: The combined ratio for each year is based on the number of RRGs that filed financial statements with NAIC. According to NAIC officials, RRG financial statements generally are filed using GAAP or modified GAAP and are reconciled to SAP. NAIC calculates the ratios using the data from financial statements as filed by the insurers. NAIC's formulas and benchmarks for financial ratios are based on SAP.

Also based on NAIC data, the percentage of RRGs with a combined ratio above 100 fluctuated from 2006 to 2010 (see fig. 6). For example, 36 percent of the RRGs writing premiums in 2006 had a combined ratio above 100. These percentages increased from 2007 to 2009, with a high of 43 percent in 2009, and decreased to about 37 percent in 2010. Together, these data indicate that while most RRGs appear to have been profitable in any one year, a sizeable but relatively stable percentage in each year could have experienced some financial challenges.

Figure 6: Number of RRGs, and Percentage of Total RRGs with Combined Ratios above 100, 2006–2010



Source: GAO analysis of NAIC data.

Note: The percentage is based on the total number of active RRGs each year with positive net premiums written.

Although the reported financial condition of RRGs appeared favorable in most years since 2004, according to NAIC officials, the recent financial crisis also affected the RRG industry. Capital sources for RRGs became more constrained as banks became more stressed and tightened their lending practices, prompting concern by state regulators about the financial condition of some RRGs. Industry participants with whom we spoke said that some RRGs may have found the experience especially challenging, particularly in instances in which the RRGs were in part capitalized by letters of credit from financial institutions adversely affected by the recent

financial crisis.³⁰ An NAIC official said that similar to the rest of the insurance industry, RRGs have earned less income on their investments. In addition, one insurance regulator said that some RRGs had invested in the real estate market, and the resulting devaluation of these assets affected their balance sheets, particularly those of smaller RRGs.

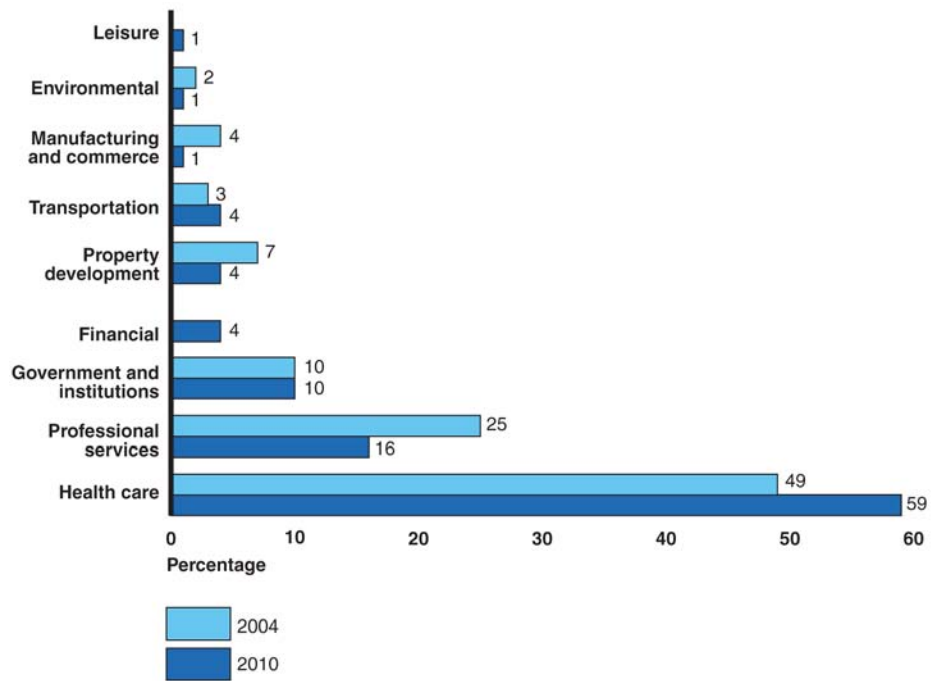
The Total Number of RRGs Increased Since 2004, with Most Growth Occurring in Health Care-Related RRGs

In 2004 and 2010, most RRGs were concentrated on health care-related lines of business. According to data from the *Risk Retention Reporter*, in both years the top four business lines for RRGs in terms of gross premiums were (1) health care; (2) professional services; (3) government and institutions; and (4) property development (see fig. 7).³¹

³⁰For an RRG, a letter of credit is a document issued by a financial institution on behalf of a beneficiary (for example, the insurance commissioner) stating the amount of credit the customer has available, and that the institution will honor drafts up to the amount written by the customer. An irrevocable letter of credit could not be canceled or amended without the beneficiary's approval.

³¹Gross premiums are the premiums paid by the original insureds.

Figure 7: Percentage of Overall RRG Gross Premiums by Business Line, 2004 and 2010



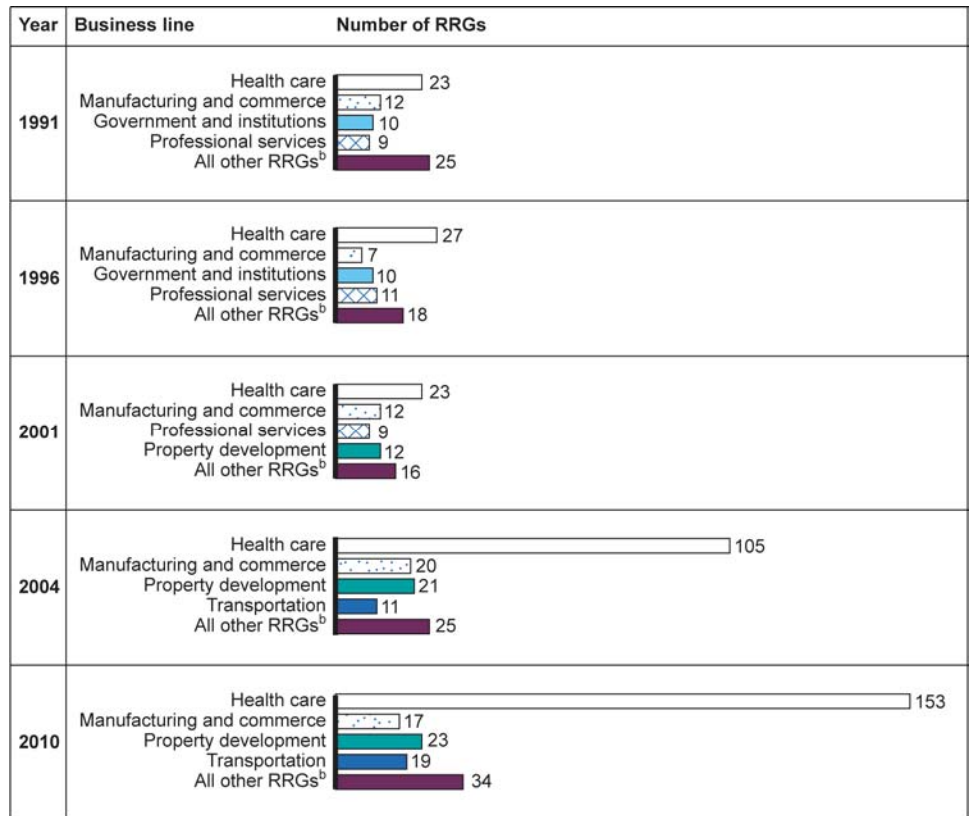
Source: GAO analysis of *Risk Retention Reporter* data.

Note: Percentages are rounded to the nearest whole number. In 2010, the actual percentage for the financial business line was 3.6 percent and for transportation, 3.8 percent.

The majority of RRGs licensed in 2004 and 2010 offered health care-related insurance (see fig. 8). According to our analysis of data from the *Risk Retention Reporter*, 148 of the 153 health care-related RRGs (97 percent) wrote medical malpractice coverage in 2010. The medical malpractice industry generally has been characterized as volatile because of the risks associated with providing this line of insurance. Health care providers sought alternative sources of insurance after some of the largest medical malpractice insurance providers exited the market because of declining profits, partly caused by market instability and high and unpredictable losses—factors that contribute to the high risk of providing medical malpractice insurance.³²

³²GAO, *Medical Malpractice Insurance: Multiple Factors Have Contributed to Increased Premium Rates*, GAO-03-702 (Washington, D.C.: Jun. 27, 2003).

Figure 8: RRGs Licensed by Business Line, 1991, 1996, 2001, 2004, and 2010^a



Source: GAO analysis of Risk Retention Reporter data.

^aData for 1991, 1996, 2001, and 2004 are as reported in [GAO-05-536](#). Data for 2010 are as of April 2010.

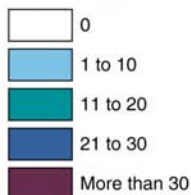
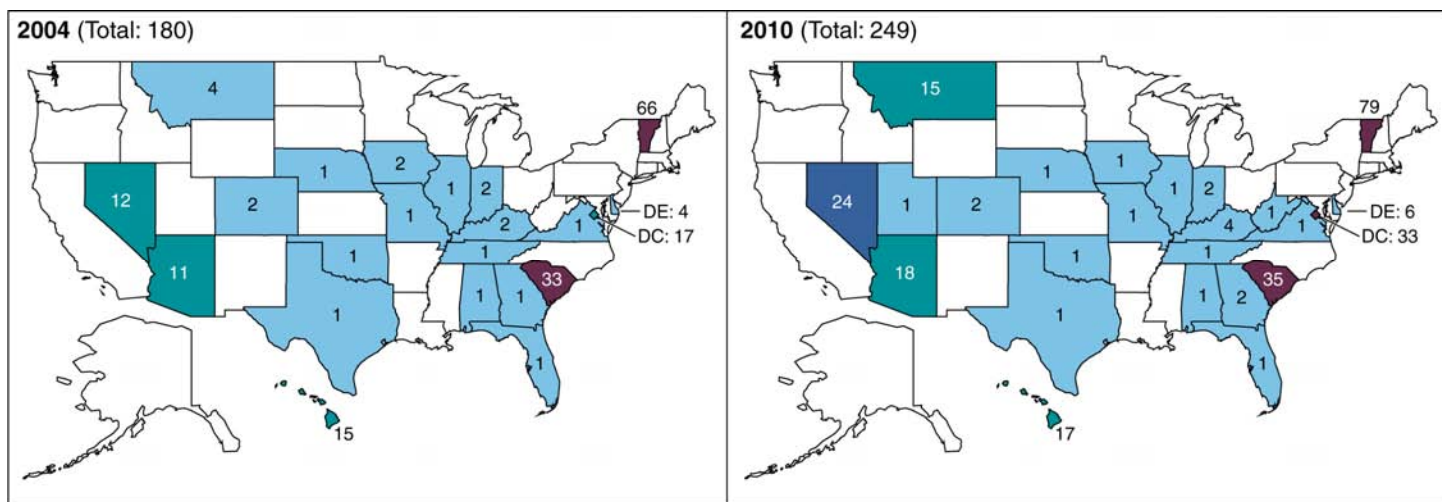
^bFor each year, we show only the business lines with the highest number of RRGs. RRGs that were not in these business lines are included in the “All other RRGs” category.

According to an RRG industry representative, although the overall liability insurance market currently is soft—which may be described as a period during which premiums are low, capital and competition are high, and demand for RRGs is lower—the RRG industry has continued to grow, especially in the area of medical malpractice coverage. Nine of the 13 state insurance regulators we interviewed affirmed that the majority of RRGs domiciled or operating in their states provide insurance for various health care-related lines, such as medical malpractice and liability insurance for nursing homes.

Although Most RRGs Are Domiciled in One of a Few States, They Wrote the Majority of Business Outside Their State of Domicile

Although they conducted business nationwide, similar to what we reported in 2005 more than 80 percent of active RRGs in 2010 were domiciled in five states and the District of Columbia.³³ Based on an analysis of data from NAIC, the states with the most domiciled RRGs as of 2010 were Vermont, South Carolina, the District of Columbia, Nevada, Arizona, and Hawaii (see fig. 9). Montana, which was not one of the leading domiciliary states when we reported in 2005, accounted for about 16 percent of the increase of domiciled RRGs in 2010. As of 2010, 24 states had domiciled RRGs.

Figure 9: Number of Active RRGs Domiciled by State, 2004 and 2010



Source: GAO analysis of NAIC data; map (MapInfo).

Note: U.S. territories (American Samoa, Guam, Northern Mariana Islands, Puerto Rico, and the Virgin Islands) and Canada are excluded.

³³According to NAIC, “active” includes RRGs writing insurance premiums, formed but not yet writing insurance premiums, under receivership, or in liquidation. “Inactive” RRGs were excluded.

RRGs may decide to domicile in a particular state for one or more reasons. First, RRGs are more likely to domicile in a state that permits their formation as a captive, which may not be one of the states in which the RRGs write the majority of their business. Some states allow RRGs to be chartered as captives because they only provide coverage to their owners and do not sell insurance to the public. Further, regulatory requirements for captive insurers generally are less restrictive than those for traditional insurers. According to the *Risk Retention Reporter*, about 20 states charter and regulate RRGs under captive legislation.³⁴ Second, according to NAIC officials with whom we spoke, states that allow RRGs to operate under captive laws often have less stringent financial requirements. NAIC officials also said that RRGs tend to gravitate to states that have lower capitalization requirements and in which the regulators are looking to promote the RRG industry as a source of revenue for the state. Finally, according to 9 of 13 state insurance regulators we interviewed, in addition to lower minimum capital and surplus requirements, RRGs may choose to domicile in certain states because of the state's expertise with regulating RRGs and knowledge of the industry.

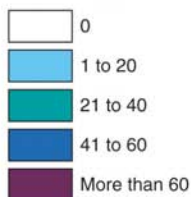
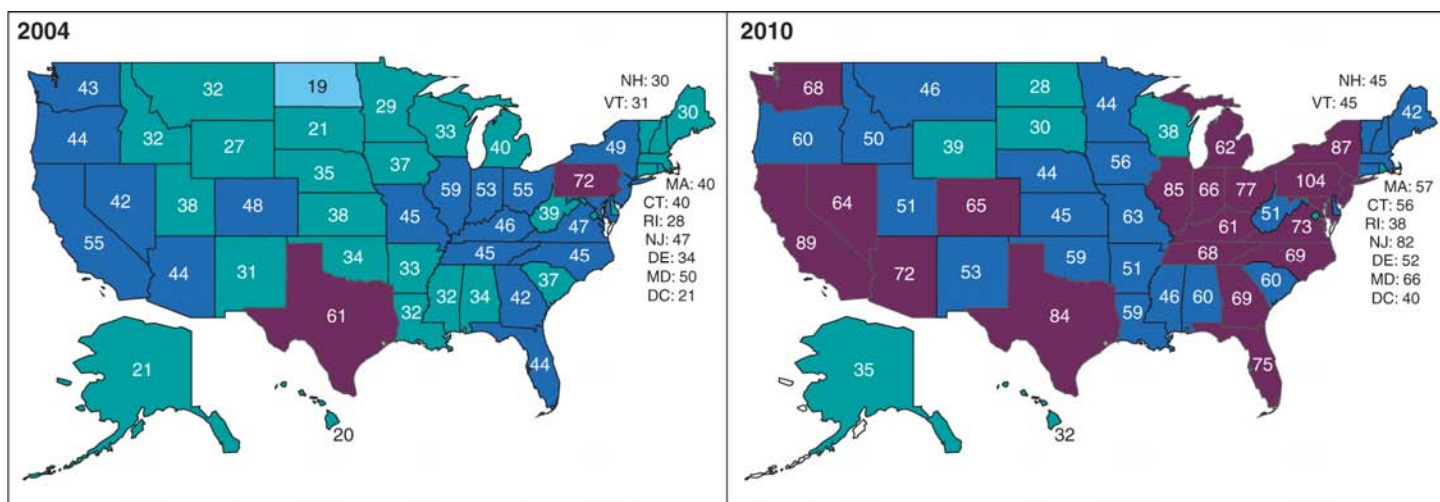
Evidence from our interviews and survey of state insurance regulators also suggests that lower capitalization requirements were a factor in RRGs choosing to domicile in those states. For example, in our interviews with insurance regulators representing 8 of the top 10 domiciliary states, 4 regulators reported that the minimum amount of capital required to domicile in their state was \$500,000, 3 regulators reported a minimum requirement of \$1 million, and 1 regulator reported \$400,000. However, six of the regulators also reported that additional capital could be required.³⁵ Our interviews and state regulator survey also indicated that two domiciliary states reduced their minimum capital and surplus requirement since our 2005 report. For example, one domiciliary state's minimum capital requirement decreased from \$500,000 to \$400,000, while another state's decreased from \$700,000 to \$500,000. While RRGs tend to domicile in a few states, they operate and write business in all 50

³⁴According to the *Risk Retention Reporter*, the laws of three states are silent about whether RRGs can form under captive legislation.

³⁵According to these domiciliary state regulators, regardless of the statutory minimum required, regulators may require an increased minimum capital amount based on factors such as an assessment of the RRG's proposed business plan—including the volume of premiums written and the types of coverage offered.

states and the District of Columbia (see fig. 10). Collectively, between 2004 and 2010, the number of operating RRGs increased by about 50 percent.

Figure 10: Number of Operating RRGs by State, 2004 and 2010



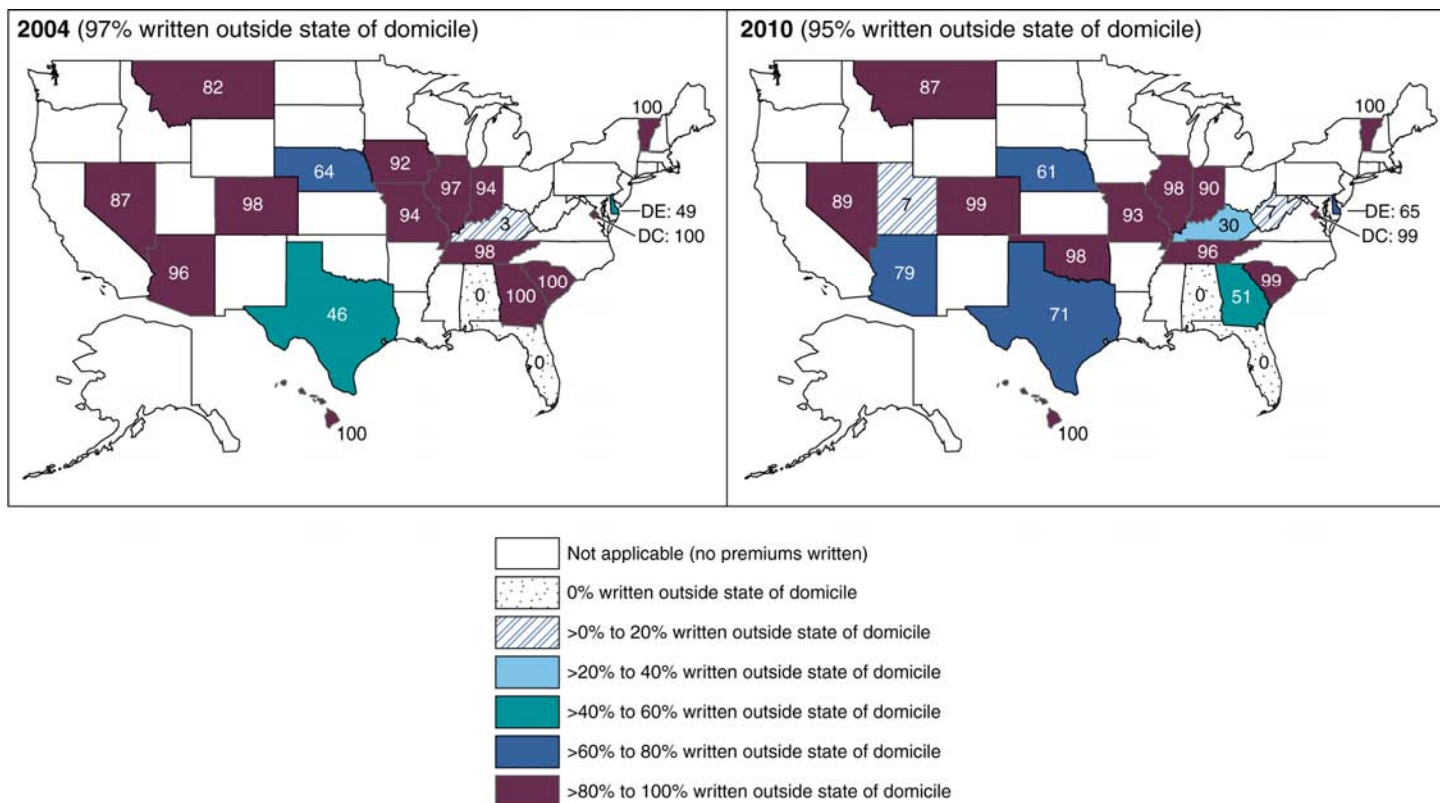
Source: GAO analysis of NAIC data; map (MapInfo).

Note: RRGs that operate on a multistate basis are counted more than once.

NAIC data also show that more than half of the RRGs in both 2004 and 2010 wrote premiums in two or fewer states, and two-thirds of the RRGs wrote premiums in fewer than 10 states in both years. Of all the direct premiums written by RRGs, about 97 percent and 95 percent were written outside the state of domicile in 2004 and 2010, respectively (see fig. 11). The nondomiciliary states in which RRGs wrote most of their business in 2004 were Pennsylvania (\$308 million), New York (\$226 million), California (\$210 million) and Massachusetts (\$114 million). In 2010, RRGs again wrote the majority of their business in these states: \$369 million in Pennsylvania, \$366 million in New York, \$230 million in California, and \$172 million in Massachusetts. In 2005, we noted that, according to NAIC, 73 of 115 RRGs active in 2003 (63 percent) did not write any business in their state of domicile. According to data from NAIC,

168 of the 249 RRGs active in 2010 (67 percent) did not write any business in their state of domicile.³⁶

Figure 11: Percentage of Premiums RRGs Wrote in Nondomiciliary States (Shown by Domiciliary State), 2004 and 2010



Source: GAO analysis of NAIC data; map (MapInfo).

Nondomiciliary state insurance regulators we interviewed expressed concerns about the amount of RRG business in their states and their limited authority to regulate RRGs providing coverage to their state’s insureds. In our 2005 report, some nondomiciliary regulators expressed concerns that domiciliary states were lowering their regulatory standards to attract RRGs for economic development purposes. Similarly, NAIC officials we interviewed said that when RRGs write the majority of their business outside their state of domicile, the domiciliary state regulator

³⁶In 2010, 19 of the 249 active RRGs did not write any premiums.

does not have “skin in the game” and cannot protect insureds who might be affected if an RRG became insolvent. According to an NAIC official, these states may allow actions that RRGs find favorable, but that are not in the best interest of the insureds.

Industry Participants’ Views Differed on the Impact of RRGs on the Availability and Affordability of Commercial Liability Insurance

Based on our interviews and survey of state insurance regulators, RRG industry participants had different views about the effects RRGs have had on the availability and, to a lesser extent, the affordability of commercial liability insurance. RRG representatives with whom we spoke generally believed that RRGs have increased the availability of such insurance. According to industry participants, RRGs have been providing coverage in niche markets in which consumers otherwise might not be able to obtain insurance (that is, from traditional insurers). However, one insurance regulator with whom we spoke said that commercial liability insurance has been readily available through traditional insurers, and therefore questioned the need for mechanisms such as RRGs to obtain this type of insurance. Our survey of state insurance regulators further suggests that regulators generally had different views than RRG representatives about the impact of RRGs on availability. In our survey, 17 out of the 49 state insurance regulators who responded (35 percent) said that RRGs have expanded the availability of commercial liability insurance for groups that would otherwise have difficulty obtaining coverage. Conversely, 8 of the regulators (16 percent) responded that RRGs have not expanded availability, while 24 regulators (49 percent) did not have an opinion.³⁷

Industry participants were unsure of the impact of RRGs on the affordability of commercial liability insurance. Some industry participants with whom we spoke said that RRGs would not continue to exist if their rates were not affordable. Other industry participants said that it was difficult for them to assess the impact of RRGs on affordability, but acknowledged that RRGs played a role in the insurance market. NAIC officials with whom we spoke said that the affordability of rates offered by RRGs has not been determined, as RRGs are not required to file their premium rates with nondomiciliary state regulators. Therefore, an analysis has not been conducted to compare RRG rates to those of

³⁷One state did not respond to this survey as state employees were furloughed for a part of the period in which this survey was open. Another state insurance regulator did not completely respond to all survey questions, therefore this regulator’s responses were omitted from our analyses.

traditional insurers. In addition, an actuarial expert with whom we spoke said that the rates and language included in each policy written by traditional commercial insurers and by RRGs would need to be obtained to make a true comparison, because this information differs among insurers and among RRGs. In our survey, 13 of 48 respondents (27 percent) said that RRGs have improved affordability of commercial liability insurance for groups that would otherwise have difficulty obtaining coverage. Nine regulators (19 percent) responded that RRGs have not improved affordability while 27 regulators (54 percent) did not have an opinion.

Varying Interpretations of LRRRA Result in Different Regulatory Treatment of RRGs across States

State Insurance Regulators and RRGs Have Differed on Registration Processes and Requirements LRRRA Allows in Nondomiciliary States

Apart from the submission of required documentation, LRRRA does not provide for a specific process for RRGs to register to conduct business in nondomiciliary states. States and RRGs have disagreed on issues relating to registration such as the level of documentation required and review and approval processes.

Interpretations about what documentation can be required vary by state. Based on our analysis of interview and survey responses, some RRG industry representatives and state insurance regulators interpreted LRRRA's failure to mention registration as an indication that submission of the specified documents in LRRRA is all that can be required by a nondomiciliary state before allowing an RRG to operate in that state. Others interpreted LRRRA's silence on registration in nondomiciliary states to mean that states can impose their own requirements. Responses to our survey of state insurance regulators indicate that states have varying registration requirements and practices, but respondents generally reported that RRGs must submit required documentation as outlined in LRRRA. However, regulators also provided information on additional information and documentation their states required to fulfill individual state registration processes. For example, a few states will accept NAIC's

uniform application form, while another state requires a state-specific registration form. An RRG representative with whom we spoke said that using NAIC's uniform application form instead of state-specific forms would simplify the registration process and make it more beneficial to RRGs.

An RRG representative said that one state requires a listing of all other states in which the RRG is registering and the status of the registration in each state; copies of any condition or contingencies placed on the RRG by its domiciliary state; copies of requirements or restrictions placed on RRG members; copies of soliciting and marketing materials including membership and subscription agreements; and projected premiums for the next 3 years for the state in which the RRG is applying as well as nationwide, among other requirements. According to another RRG representative, one nondomiciliary state requires specific forms for biographical affidavits of officers and directors, including Social Security numbers. In documentation from state insurance regulators that we received from an RRG industry association, as a part of the registration process one state required the name, physical address and mailing address of all agents or brokers for the RRG, and a copy of each examination of the RRG, among other requirements. Representatives from the RRG industry maintain that state regulatory practices such as registration requirements beyond what is specified in LRRRA "encroached" on LRRRA's partial preemption of state insurance laws.

RRG representatives said that there is a fear among RRGs that repeated objections to states' requests for information will lead to RRGs being targeted by state insurance offices. They also feared that providing information would lead to more onerous requests. However, one state insurance regulator with whom we spoke said that the additional document requests were intended to provide the regulators with necessary information to understand the operations of the RRGs providing coverage in their states. Further, the regulator stated that information requested is often the same information provided to the domiciliary state regulator and that domiciliary regulators may be slow to send the information or sometimes may not provide it. Two state insurance regulators said that sometimes the information requested is subject to a confidentiality agreement between the state and the RRG, which makes it challenging for regulators to share information. To alleviate this issue, one state insurance regulator suggested developing a mechanism that would allow for a central repository of RRG financial data for information-sharing purposes.

States and RRGs also have disagreed about registration and approval processes. While some states require certain information in order to approve RRGs' registrations, RRG representatives with whom we spoke said that LRRRA does not require RRGs to go through a regulatory review and approval process by state regulators to conduct business in nondomiciliary states. In 2009, the *Risk Retention Reporter* surveyed captive managers representing 260 RRGs to determine whether nondomiciliary states were "encroaching" on LRRRA preemptions.³⁸ In the 2009 survey, 44 percent of RRGs responded that states made operation contingent upon regulatory review and approval, while 56 percent found that states did not. Also in the 2009 survey, 47 percent of respondents said they were subject to "impermissible" requests for information, while 53 percent said that they were not subject to such requests.

RRG representatives with whom we spoke said that even after completing the registration process for some nondomiciliary states, the RRG still may not be recognized as registered, or such recognition may take several years. For example, according to an RRG representative with whom we spoke, an RRG sent a letter to a nondomiciliary state in May 2006 with notification of its intent to do business. The RRG did not receive a letter approving its registration until April 2008. Another RRG representative said that an RRG filed the documents required by LRRRA to register in about 40 states. About one-third of the states responded affirmatively to the submissions for this RRG without any further questions. Another one-third of states responded to the RRG with additional questions before allowing the RRG to conduct business in those states. The remaining states did not respond to the RRG's registration filings.

Some states have mandatory waiting periods before a traditional insurer, domiciled RRG, or nondomiciled RRG can begin writing business in their state. In our survey of state insurance regulators, 3 of 49 states reported having such a waiting period. However, the waiting period can be longer for traditional insurers and domiciled RRGs than for nondomiciled RRGs. For example, one state reported that its mandatory waiting period for traditional insurers and domiciled RRGs was 90 to 120 days, and 15 to 30 days for nondomiciled RRGs. Another state did not have a minimum or maximum waiting period, but traditional insurers and domiciled RRGs could not write

³⁸"Special Report: Impact on Risk Retention Groups of State Encroachment of Liability Risk Retention Act Preemptions," *Risk Retention Reporter* (January 2009). The response rate for this survey was 45 percent, representing 118 RRGs.

business until their state issued a license, and the waiting period for nondomiciled RRGs to begin writing business in the state was 60 days. A third state reported no waiting period for traditional insurers and domiciled RRGs and a waiting period of 30 to 60 days for nondomiciled RRGs.

NAIC has not taken a position on the legality or utility of different state approaches to the interpretation of LRRRA or state regulation of RRG activities. NAIC published its Risk Retention and Purchasing Group Handbook in 1999 to provide guidance to domiciliary states that have adopted NAIC's Model Risk Retention Act.³⁹ The purpose of the handbook is to present advisory information on issues that have arisen or can be expected to arise when regulating RRGs under LRRRA. For example, while the handbook provides information on the notice and registration process for nondomiciliary states, it does not take a position on different state approaches.

As a result of state regulators' varying interpretations of LRRRA, registration requirements may differ across states. As previously noted, some RRGs believe that some states have registration requirements that go beyond what is allowed under LRRRA, and in some cases, these requirements have caused delays in an RRG's ability to begin operating in those states. Conversely, some state regulators believe such requirements are necessary as well as allowable under LRRRA. These differing interpretations have resulted in an environment of uncertainty for both RRGs and regulators and, according to RRGs, are a potential regulatory burden not intended by LRRRA.

State Insurance Regulators and RRGs Differ on Their Interpretation of Fees Allowed under LRRRA

LRRRA allows nondomiciliary states to require RRGs to pay premium and other taxes but does not explicitly state whether nondomiciliary insurance regulators can or cannot charge fees. The silence of LRRRA on fees has prompted state insurance regulators and RRG representatives to interpret the law differently. Both domiciliary and nondomiciliary state insurance regulators routinely charge RRGs one-time registration fees, annual

³⁹NAIC's model laws are designed to create a national standard by providing guidance to states on implementing laws that affect the insurance industry. The Model Risk Retention Act, developed in 2002, aims to present a model for state regulation of the formation and operation of RRGs and purchasing groups (any group of persons with similar or related liability risks who form an organization for the purpose of purchasing commercial liability insurance).

renewal fees, and filing fees. Based on our survey of state insurance regulators, the amount of fees charged varies across states and may differ based on whether the RRG is domiciled in the state. Among the respondents, most reported that they charged RRGs (domiciled and nondomiciled) initial and annual fees to operate in their state. Specifically, among the 37 states identifying specific fees charged to insurers, most reported that they charged RRGs with some of the same types of fees applicable to traditional property/casualty insurers.

In addition, the responses indicated that premium taxes—which LRRRA specifically authorizes—vary across states and in some cases have a complex structure. For example, premium tax rates may be different for domiciled or nondomiciled RRGs or for traditional property/casualty insurers. In addition, a few states reported incremental tax rates based on the volume of premiums written by the RRG. Further, some states implement a “retaliatory” premium tax rate—meaning a state taxes out-of-state insurance companies operating in its jurisdiction in the same way that the state’s own insurance companies are taxed by other states.

A majority of RRG representatives with whom we spoke said that varying fees other than premium taxes that nondomiciliary states charged RRGs were expensive and a financial burden and were also inconsistent with LRRRA. For example, one RRG representative said that the insurer, which operates in 50 states and the District of Columbia with total national premiums of \$124 million, paid in excess of \$500,000 in combined state fees to conduct business outside its domiciliary state. A smaller RRG that wrote premiums of about \$1 million said it paid \$6,000 to \$7,000 in additional fees. Three RRG representatives said that their RRGs often “pay fees under protest,” while other RRG representatives said that they often paid the fees because paying was less expensive than litigation against the states.

RRGs have challenged requirements established by nondomiciliary states that RRGs believe are preempted, and therefore not permitted, by LRRRA. For example, in *National Risk Retention Association v. Brown*, a U.S. district court found that LRRRA does not authorize a nondomiciliary state to require RRGs domiciled in another state to pay annual, application, or policy form review fees as part of registration or examination requirements before being allowed to do business in that state.⁴⁰

⁴⁰927 F. Supp. 195 (M.D. La. 1996), *aff'd*, 114 F.3d 1183 (5th Cir. 1997).

However, the court did not hold that all fees nondomiciliary states charged necessarily were prohibited but that the types of fees charged in that case were broader than those allowed by the registration and examination requirements enumerated in LRRRA. In *Attorneys' Liability Assurance Society, Inc. v. Fitzgerald* the court also addressed the issue of fees.⁴¹ In that case, a state statute required nondomiciled RRGs to pay a fee of a certain percentage of their business written in that state. The court held that such a fee was not permitted, as LRRRA permits only taxes by nondomiciliary states, and such a fee was not considered a tax. The fee in this case was to be used for regulatory purposes only, and therefore was considered an impermissible attempt to regulate an RRG by a nondomiciliary state.

As a result of differing interpretations of LRRRA, fee structures vary across states. While some RRGs believe some of these fees go beyond what is allowed by LRRRA, state regulators believe these fees are permissible. While the impact on RRGs of fees charged in some states is not clear, several RRG industry participants with whom we spoke said that fees may be more challenging for smaller RRGs and RRGs operating in multiple states. In addition, this variation of fees across states also contributes to the uncertainty under which RRGs and state regulators operate.

Regulators, RRGs, and Courts Also Differed on the Types of Coverage That RRGs Can Offer and What Constitutes Discrimination as Prohibited by LRRRA

LRRRA allows RRGs to provide commercial liability insurance and provides a general definition of liability.⁴² However, beyond its general definition, LRRRA is silent on the specific types of liability insurance that RRGs can provide, which has resulted in differences of interpretation by RRGs and state insurance regulators about the types of liability coverage permitted under LRRRA. In our survey of state insurance regulators, 6 of 49 regulators responded that they had between one and five differences of interpretation

⁴¹174 F. Supp. 2d 619 (W.D. Mich. 2001).

⁴²According to LRRRA, "liability – (A) means legal liability for damages (including costs of defense, legal costs and fees, and other claims expenses) because of injuries to other persons, damage to their property, or other damage or loss to such other persons resulting from or arising out of – (i) any business (whether profit or nonprofit), trade, product, services (including professional services), premises, or operations, or (ii) any activity of any state or local government, or any agency or political subdivision thereof; and (B) does not include personal risk liability and an employer's liability with respect to its employees other than legal liability under the Federal Employers' Liability Act." 15 U.S.C. § 3901(a)(2).

with other state insurance regulators about the definition of commercial liability insurance in the last 24 months. One regulator reported more than 10 differences. In our interviews, five regulators said they believed that insurance lines such as contractual liability (for example, vehicle service or builder warranties) and stop-loss coverage were not permitted under LRRRA.⁴³ In some cases, nondomiciliary state insurance regulators have not allowed RRGs to provide insurance in their state that they believe does not fit the definition of liability under LRRRA. For example, one nondomiciliary state regulator said it denied the registration of an RRG that planned to offer contractual liability insurance. In addition, an RRG representative reported its registration application was denied in five states because regulators did not believe contractual liability coverage fell within the definition of liability in LRRRA. Further, one domiciliary state insurance regulator we interviewed said the state believed contractual liability coverage was permitted under LRRRA; however, the state generally did not allow this coverage to be offered in the state to “avoid the politics of the issue.” This regulator, along with three other regulators with whom we spoke, said that the RRG industry needed a clearer definition of contractual liability or the types of coverage permissible under LRRRA. Differences in interpretation of the types of coverage permitted under LRRRA have led to litigation between states and RRGs.

States and federal courts also have differed in their interpretations. For example, in *Auto Dealers RRG v. Steve Poizner*, an RRG provided stop-loss insurance that covered liability by its members, employees of California automobile dealers that maintained self-funded employee benefit plans.⁴⁴ The California insurance office issued a cease-and-desist order because it believed that the RRG was providing health insurance, not liability insurance as defined by LRRRA. The RRG challenged the California insurance office’s cease-and-desist order in federal court, and the court issued a preliminary injunction blocking the cease-and-desist order. However, the court never decided the case on its merits—that is, the court never decided whether the RRG was issuing valid liability insurance policies—because the RRG decided to stop pursuing the case and instead stopped issuing policies in California. In *Attorneys’ Liability*

⁴³Contractual liability insurance covers liability of the insured that is assumed in a contract under specified conditions. Stop-loss refers to any provision in a policy designed to end an insurer’s losses at a given point.

⁴⁴No. Civ. 07-2660 FCD KJM (E.D. Cal., Mar. 7, 2008).

Assurance Society, Inc. v. Fitzgerald (discussed previously), the court held that LRRRA permitted an RRG to cover liability by its members for wrongful employment practices.⁴⁵ The court held that while RRGs specifically were not to cover workers' compensation, the types of coverage provided by the RRG at issue in the case were permissible under the broad scope of LRRRA.

Federal courts have rendered varying decisions relating to what is considered prohibited discrimination per LRRRA's state financial responsibility requirements. These financial responsibility requirements consist of state or local provisions that establish conditions for obtaining a license or undertaking certain activities. For example, many states require that anyone registering a motor vehicle demonstrate proof of financial responsibility (show that the owner of the vehicle has financial means sufficient to compensate any injured persons). State laws may provide that financial responsibility can be shown by coverage in a liability insurance policy by an insurer that is regulated by the state and protected by the state's guaranty fund. LRRRA does not preempt state authority to apply financial responsibility standards as long as those standards do not discriminate against RRGs within the meaning of LRRRA.⁴⁶ For example, in *National Warranty Insurance Company RRG v. Greenfield*, the U.S. Court of Appeals for the Ninth Circuit held that LRRRA preempted provisions of the Oregon Service Contract Act that required automobile dealers to obtain liability insurance from an insurer that was a member of the Oregon Insurance Guaranty Association.⁴⁷ Because RRGs do not participate in state guaranty associations, the Oregon law effectively excluded RRGs from providing liability insurance to automobile dealers. Thus, the court held that Oregon could not exclude coverage from all RRGs because that would discriminate against RRGs. However, Oregon could exclude coverage from a particular RRG if it could show that the RRG was financially unsound or otherwise dangerous to those who relied on insurance purchased pursuant to the Oregon Service Contract Act. In another case, *Charter Risk Retention Group Insurance Company v. Rolka*, a U.S. district court noted similarly that discrimination against RRGs as a whole is prohibited under LRRRA.⁴⁸ However, state laws

⁴⁵174 F. Supp.2d 619.

⁴⁶15 U.S.C. §§ 3902(a)(4), 3905(d).

⁴⁷214 F.3d 1073 (9th Cir. 2000).

⁴⁸796 F. Supp. 154, 159 (M.D. Pa. 1992).

relating specifically to financial responsibility requirements could be valid, if they caused a *particular* RRG to be excluded if it lacked acceptable evidence of financial responsibility for a state license or permit, as long as they did not discriminate against RRGs as a whole.⁴⁹

Other courts have interpreted the provisions of LRRRA prohibiting discrimination against RRGs differently. In *Ophthalmic Mutual Insurance Company v. Musser*, the U.S. Court of Appeals for the Seventh Circuit affirmed a district court decision that LRRRA does not preempt a Wisconsin requirement that health providers offer proof of financial responsibility to do business in the state by obtaining professional liability insurance coverage from insurers authorized to do business in Wisconsin, although it effectively excludes nondomiciliary RRGs from operating in that state.⁵⁰ The court found that the challenged statute neither impermissibly regulated RRGs nor was intended to discriminate against them, and therefore is not preempted by LRRRA. The court concluded that the Wisconsin requirement fit within the saving clause of LRRRA providing that states are not bound by LRRRA when crafting statutes concerning financial responsibility, as long as the statutes were not intended to discriminate against RRGs. Similarly, in *Mears Transport Group v. State*, the U.S. Court of Appeals for the Eleventh Circuit held that LRRRA did not preempt a Florida law requiring owners or operators of for-hire passenger transportation vehicles to provide evidence of financial responsibility by having a motor vehicle liability policy issued by an insurer that is a member of the Florida Insurance Guaranty Association.⁵¹ Although RRGs effectively are disallowed from doing business in Florida under this law, as they are not permitted to be members of guaranty associations under LRRRA, the court held that the Florida law does not single out RRGs for exclusion, as RRGs are one of many types of insurance carriers ineligible for membership in the guaranty association. Therefore, the court held that the Florida law was not *intended* to be discriminatory. Since the Florida law is “precisely the type of state financial responsibility law that

⁴⁹*Id.* at 159 n.6. The court did not decide this case on the merits, but denied the defendant’s motion to dismiss on the grounds that the case did not involve a federal question, by holding that the case involved interpretation of a federal law, LRRRA, which was a federal question.

⁵⁰143 F.3d 1062, 1070 (7th Cir. 1998).

⁵¹34 F.3d 1013 (11th Cir. 1994).

Congress expressly exempted from the preemption provisions of LRRRA,” according to the court, it is allowed and not preempted by LRRRA.⁵²

Different interpretations of the types of coverage permitted under LRRRA have resulted in the inability of some RRGs to provide coverage in certain states. And, in cases in which RRGs choose to pursue legal action when states deny their ability to provide that coverage, the RRGs may incur substantial legal fees. As previously noted, different interpretations by federal courts on issues such as permissible coverage types and what constitutes discrimination under LRRRA can further contribute to an uncertain regulatory environment for RRGs and state insurance regulators.

State Insurance Regulators Have Expressed Concerns about the Capitalization and Solvency of Some RRGs

Because LRRRA does not comprehensively address the capitalization or solvency requirements of RRGs, states can develop their own statutory minimum capital and surplus requirements for RRGs domiciled in their state. According to some state insurance regulators with whom we spoke, these requirements are based on the type of insurance coverage offered, the volume of business the RRG intends to write, and other factors. Two nondomiciliary state insurance regulators with whom we spoke indicated concerns about the capitalization and solvency of RRGs operating in their states, and two regulators support increasing the minimum capital requirement. In addition, some states allow RRGs, unlike traditional insurers, to meet and maintain their minimum capital and surplus requirements in the form of an irrevocable letter of credit rather than cash. Data from NAIC show that as of June 2010, 62 RRGs were capitalized with letters of credit.

Although RRGs write most of their business outside their state of domicile, nondomiciliary state insurance regulators must rely on domiciliary regulators to establish minimum capitalization and solvency requirements for their domiciled RRGs—and ensure that the requirements are commensurate with the type of coverage provided and the volume of premiums written. Some RRG representatives with whom we spoke believed that there is a lack of confidence in the RRG regulatory environment or that some states prefer their own authority to regulate RRGs writing business in their state. Two state insurance

⁵²*Id.* at 1016.

regulators and four RRG representatives said they believed that some of these issues will be resolved through NAIC's efforts to develop uniform, baseline standards for the regulation of RRGs.

NAIC Actions Address Some Regulatory Concerns, While Recent Federal and State Proposals May Affect Future RRG Operations

Revised Accreditation Standards Address Some Regulatory Concerns with RRGs' Financial Solvency Practices

Our 2005 report found that the wide variance in solvency regulation among domiciliary states, along with the growth of the RRG industry, increased the potential for future solvency risks. In response to recommendations from our 2005 report to provide a more uniform regulatory environment for RRGs, NAIC revised its accreditation standards to include standards for the way in which states regulate RRG solvency.⁵³ These new standards went into effect on January 1, 2011. NAIC also began to address our recommendations to develop corporate governance standards concerning ownership and operational issues within RRGs. Initial discussions in 2005 led to the development of draft corporate governance standards by 2007, and later in 2010 NAIC working groups initiated steps toward integrating these standards into the RRG oversight process. In addition, NAIC has started the process to integrate corporate governance standards into its accreditation standards, so that states would be required to review RRG's corporate governance standards to be accredited. The groups' discussions were open to

⁵³NAIC's accreditation standards are minimum standards that state regulators must meet to remain accredited with NAIC. NAIC's full accreditation review of a state's solvency regulation of multistate insurance companies occurs once every 5 years and includes the examination of (1) the state's relevant laws and regulations, (2) the financial analyses and examinations conducted by the insurance department, and (3) the department's organizational and personnel practices.

Financial Reporting
Requirements for RRGs Made
More Similar to Those for
Traditional Insurers

interested parties, including RRG representatives. For instance, the National Risk Retention Association (NRRRA), told us it actively participated in NAIC working groups. The revisions to the financial accreditation standards for state insurance departments' oversight of domiciled RRGs more closely align the standards applied to the oversight of RRGs with those that are applied to traditional insurers. The revisions affect key areas of RRGs' financial solvency oversight, including revising accounting requirements for annual financial reporting and making financial examinations risk-focused.

Among the recent revisions to NAIC's accreditation standards is a new requirement that applies to RRGs that do not file their annual financial statements using SAP: these statements must contain a reconciliation to SAP, effective January 1, 2011. According to NAIC, in 2010, 72 RRGs reported filing their financial statement using SAP and 177 reported using another accounting principle such as GAAP. The reconciliation is designed to indicate to regulators how the accounting principles used in financial statements result in figures different from those that SAP would have produced. RRGs can include this reconciliation in the footnotes to the financial statement. This new standard aims to address some of the challenges identified in our 2005 report that arose from the use of different accounting principles, such as difficulties in assessing the financial condition of RRGs reported by some nondomiciliary state insurance regulators more accustomed to SAP. The new standards also move financial reporting requirements for RRGs closer to those of traditional insurers.⁵⁴ Our survey responses from state insurance regulators showed that 32 state regulators reported requiring SAP for financial reporting, 14 reported requiring GAAP or a modified version of GAAP and 3 reported a choice of accounting principles within their requirements.⁵⁵

Financial reporting practices for RRGs still vary and the choice of accounting method can produce different conclusions about a company's

⁵⁴Statutory accounting principles were established and promulgated by NAIC for the insurance industry.

⁵⁵A total of 49 states responded to the survey.

financial strength.⁵⁶ NAIC analysts continue to report that allowing financial statements using different accounting principles, even when reconciled to SAP in the footnotes, diminishes the usefulness of their underlying data and analysis tools because the tools were designed around data extracted from financial statements based on SAP. Statements filed using other accounting principles can produce distorted results when looked at through traditional computerized analysis tools. As a result, NAIC must then revise the analyses to produce information useful to state regulators, which requires more staff resources. In prior reports we have noted that NAIC's solvency analysis is an important supplement to the overall solvency monitoring performed by states and can help states focus their examination resources on potentially troubled companies, including flagging financial ratios that are outside the usual range for additional regulatory attention.⁵⁷ Further, the choice of accounting method can have important repercussions for certain RRGs. For example, representatives of two RRGs with whom we spoke reported letters of credit to be critical for some RRGs to meet minimum capitalization requirements; and as a result, they often preferred to file their financial statements using GAAP where letters of credit can, in some states, improve the RRG's appearance of financial solvency.

Risk-Focused Examinations
Already Required of Traditional
Insurers, Now Required for
RRGs

The revised accreditation standards also require all RRGs to have risk-focused examinations in an effort to implement more uniform baseline standards for RRG regulation, applicable to all financial examinations of RRGs commencing on or after January 1, 2011. Risk-focused examinations emphasize reviews of higher-risk areas and tend to be more specialized and tailored to individual companies. Risk-focused examinations are already a regulatory requirement for traditional insurers. Nondomiciliary states have the right to review the results of these examinations for RRGs.

⁵⁶The differences in the two sets of accounting principles reflect the different purposes for which each was developed and each produces a different, and not necessarily comparable, financial picture of a business. SAP generally meets the needs of insurance regulators, the primary users of insurance financial statements, and stresses the measurement of an insurer's ability to pay claims and remain solvent in order to protect owner/insureds. However, GAAP provides guidance that businesses follow in preparing their general purpose financial statements that provide users, such as investors and creditors, with useful information that allows them to assess a business's ongoing financial performance.

⁵⁷GAO, *Insurance Regulation: The NAIC Accreditation Program Can Be Improved*, [GAO-01-948](#) (Washington, D.C.: Aug. 31, 2001).

Three representatives of RRGs with whom we spoke supported the move to risk-focused examinations because they believed more uniform regulatory activities among domiciliary states would result in more trust among state regulators and ultimately would benefit the RRG industry. However, six representatives also acknowledged some potential challenges in implementing risk-focused examinations for some RRGs, particularly the smaller ones. For example, they said it could increase financial costs and regulatory burden for these RRGs because state regulators might need to hire more specialized auditors for more detailed reviews, and pass on the associated costs to the RRGs in the form of examination fees. NARRA also expressed its concern about the efficiency and effectiveness of risk-focused examinations for small liability insurance companies, which compose the majority of RRGs. NARRA characterized the impact on small RRGs as excessively expensive without yielding commensurate benefit, and held that implementing risk-focused examinations for small RRGs would run counter to the intent of LARRA. In its letter to NAIC, NARRA questioned the cost-effectiveness of the more rigorous examinations for certain RRGs based on characteristics such as the RRG's size, its impact in nondomiciliary states, and the structure of its membership.

Four state insurance regulators with whom we spoke also said that requiring risk-focused examinations might not be an efficient use of resources, particularly for small RRGs that represent the majority of the RRG population. Three state insurance departments we interviewed reported having already implemented risk-focused examinations for their domiciled RRGs. Based on its experience conducting risk-focused examinations, one domiciliary state regulator recommended that criteria be used to determine the efficiency and effectiveness of applying a risk-focused examination to an RRG. For example, the regulator recommended that risk-focused examinations should be required for RRGs with more than \$10 million in direct written premiums, owned and operated by a group of shareholders with unrestricted membership, and registered to operate in at least 15 states. Alternatively, the regulator suggested leaving it at the discretion of the domiciliary state regulator to decide whether the risk-focused approach would be the most efficient approach to oversee a particular RRG.

According to NAIC officials, the possibility of exempting certain types of RRGs from the risk-focused examination requirement was considered in working groups. However, they also expressed concern about whether alternative examinations would qualify as full-scope examinations in accordance with NAIC's guidance on examinations as outlined in the

Financial Condition Examiners Handbook. The guidance requires RRGs to undergo full-scope examinations at least once every 5 years, or in accordance with the respective state law if it requires more frequent examinations.⁵⁸ NAIC decided that the risk-focused examination process was flexible enough to allow examiners to tailor examinations to fit the unique characteristics of RRGs.

RRG Oversight Could be Affected by Future Developments with NAIC and Federal Legislation

NAIC Plans to Incorporate Risk-Based Capital Analyses into RRG Oversight, as Already Done for Traditional Insurers

NAIC's risk-based capital (RBC) system was created to provide a capital adequacy standard for traditional insurers that creates a financial safety net, is uniform among the states, and provides regulatory authority for timely action. The RBC formulas can be technical and involve a number of components. Each of the primary insurance types—such as property/casualty, life or health—has a separate RBC formula that emphasizes the material risks common for that particular insurance type. Regulatory actions may be triggered by the RBC calculation for an insurer, and actions may include requiring the insurance company to issue comprehensive financial plans, issue corrective orders, or authorize the take-over of the insurer.⁵⁹

NAIC officials said that they are pursuing the use of RBC calculations in the oversight of RRGs as part of the accreditation process. While regulators may voluntarily include RBC calculations in the financial examinations of RRGs, these calculations are not specifically required. According to NAIC officials, it is expected that RBC will be incorporated into the accreditation standards. If incorporated into the accreditation standards, regulators would be expected to incorporate RBC calculations into their broader financial analyses to determine whether any actions

⁵⁸The Risk Retention Group (E) Task Force formed the RRGs and Risk-Focused Examinations Subgroup in 2010 to consider possible exemptions to the risk-focused examination process for RRGs.

⁵⁹A completed RBC calculation of a company is considered confidential and not available to the public.

would be necessary, although, unlike traditional insurers, the RBC calculations for RRGs do not automatically trigger regulatory actions.

While five RRG representatives we interviewed generally supported NAIC's revisions to the accreditation standards in the RRG industry, three representatives expressed some concern about how meaningful an RBC analysis would be as a requirement in RRG oversight. For example, they said that the use of RBC for small RRGs, which tend to use GAAP accounting and rely more heavily on letters of credit to meet their capitalization requirements, might not be useful. Five state insurance regulators we interviewed were also unsure of the usefulness of incorporating RBC calculations into the accreditation standards, particularly in situations in which otherwise healthy RRGs could fare poorly when RBC calculations were applied. An actuarial expert we interviewed also expressed concern that an RBC requirement could lead to an overemphasis on the RBC figures for regulators and undue pressure on otherwise sound RRGs to increase capital. According to an NAIC working group analysis, an RBC formula using figures based on GAAP could result in different numbers compared with RBC calculations using figures based on SAP, potentially changing the picture of that RRG's financial condition. However, the working group also said that using figures determined under GAAP might not unreasonably alter the RBC conclusions for most RRGs and still could be meaningful.

NAIC Has Developed Corporate Governance Standards for RRGs, but Has Not Implemented Them

In response to our 2005 recommendations to establish minimum corporate governance standards for the RRG industry, NAIC developed such standards for RRGs but has not yet implemented them with a model act or through their accreditation standards. NAIC officials reported that they expect these corporate governance standards to be incorporated into the Model Risk Retention Act by the end of 2011. Further, the officials said that in 2012 they will consider adopting corporate governance standards as part of the accreditation standards.

An RRG is often operated by a management company or another service provider that generally supplies key services. However, the potential for abuse arises if the interests of a management company are not aligned with the interests of the RRG insureds to achieve long-term solvency and obtain self-insurance at an affordable price. In our 2005 report, we found behavior suggesting that management companies and affiliated service providers promoted their own interests at the expense of the RRG insureds in 10 of the 16 cases of RRG failures we examined. LRRRA includes no provisions for governance controls that could help mitigate the risk to RRG insureds from potential abuses by other interests, such as

their management companies, should these companies choose not to operate in the best interest of RRG insureds.

In response to GAO's recommendations, NAIC's working groups have included corporate governance standards as part of their efforts to develop uniform baseline standards for RRGs. NAIC first adopted corporate governance standards for RRGs in June 2007 as a separate stand-alone guidance that was not incorporated into the accreditation standards. As of October 2011, the revisions to the Model Risk Retention Act that include corporate governance standards had been reviewed, but not yet approved, by the NAIC member states. As of November 2011 these revisions were approved and NAIC had adopted corporate governance standards into the Model Risk Retention Act. However, corporate governance standards are not yet a part of the accreditation standards and NAIC officials said that they will not begin discussions on adopting these standards into the accreditation requirements until 2012.

Three state insurance regulators with whom we spoke expressed support for corporate governance standards as a requirement for RRGs because they felt it would improve transparency of the management of RRGs. While five regulators generally did not think implementing corporate governance standards would be burdensome for RRGs, one regulator did expect that some RRGs, depending on their size, could find the implementation of some standards, such as the requirement for an audit committee, to be a challenge. Representatives of two large RRGs with whom we spoke supported corporate governance standards as good business practice. However, four representatives of RRGs also expressed concern about the cost of implementing these standards for smaller RRGs, particularly those without their own internal counsel.

Some Legislative Proposals
Would Allow RRGs to Insure
Commercial Property and
Provide for Federal Arbitration
and Governance Standards

Recent federal legislative proposals to amend LRRRA, if passed, would offer new options to RRGs.⁶⁰ One proposed change would expand the type of insurance RRGs may provide to include commercial property coverage. RRG representatives with whom we spoke generally favored amending LRRRA to allow RRGs to provide commercial property insurance coverage. For example, one representative said the differences in the risk

⁶⁰For example, the Risk Retention Modernization Act of 2011 (H.R. 2126, 112th Cong. (2011)) was introduced in the U.S. House of Representatives in June 2011, and a similar bill, The Risk Retention Modernization Act of 2010 (H.R.4802, 111th Cong. (2010)), was introduced in the 111th Congress in the prior year.

profile between commercial property coverage and commercial liability coverage is a potential opportunity to manage their risks more strategically.

In addition, six RRG representatives we interviewed felt that allowing coverage of commercial property insurance constituted a removal of restrictions on providing insurance products that could be a natural extension of their core line of business. For example, an RRG that offers professional liability coverage to dentists currently cannot underwrite coverage for dental equipment. Similarly, one representative of an RRG offering commercial liability insurance products to the construction business said that the RRG could not offer property insurance related to the same homes constructed under their insurance coverage. Another RRG representative said their clients would like the option to bundle their property coverage with a wide range of specialized insurance products they purchase from the RRG for both convenience and cost-effectiveness. Eight RRG representatives we interviewed were concerned that some RRGs entering the commercial property market might not have adequate capital to cover the potentially severe losses that are a part of that line of coverage. Four RRG representatives also said that they would expect the domiciliary state regulator to review any changes to an RRG's business plan to ensure that it had an appropriate capital base for its underwriting coverage and risk profile.

Ten regulators with whom we spoke expressed concerns about RRGs entering the commercial property insurance market because of the potential risks to owner/insureds and consumers. For example, six regulators expressed concern that if an RRG was unable to pay the potentially severe losses associated with some lines of property insurance, the RRG members could be at financial risk. RRGs cannot participate in state guaranty funds that otherwise could help pay losses in such cases. In our survey of state insurance regulators, we asked whether they thought LRRAs should be amended to enable RRGs to provide commercial property insurance. Among the responses, 32 regulators did not think LRRAs should be so amended while 5 thought LRRAs should be amended to allow RRGs to provide property insurance.⁶¹ Three of the five regulators that favored amending LRRAs in this way were from the 10 states with the highest RRG gross premiums in 2010.

⁶¹Twelve respondents had "no opinion."

The proposed legislation also would grant authority to a federal entity, such as the recently created Federal Insurance Office in the Department of the Treasury, to oversee state compliance with the regulatory preemptions in LRRRA. For example, the office would resolve disagreements about whether LRRRA preempts any regulatory actions by a state.⁶² Among the state insurance regulators we surveyed, 29 said that the federal government should not have a primary role in arbitrating disputes between state regulators and RRGs, while 6 said that the federal government should have a primary role.⁶³ We also asked regulators which department or agency they thought should have this authority if the federal government were to arbitrate disputes between states and RRGs. Twenty-nine regulators responded with no opinion, while 13 regulators indicated their preference for the Federal Insurance Office and 6 regulators indicated other agencies including the Department of Commerce.⁶⁴

Another proposed change would have the Federal Insurance Office issue corporate governance standards for RRGs that would preempt any corporate governance standards under state laws.⁶⁵ Five state regulators with whom we spoke also favored developing an arbitration mechanism, while five regulators did not think corporate governance standards would be burdensome for RRGs to implement. While seven RRG representatives we interviewed generally supported establishing a federal arbitration mechanism as a more efficient and cost-effective way of resolving disputes, four representatives also expressed concern about potential encroachment into state regulatory activities by a federal entity.

⁶²If passed, the Risk Retention Modernization Act of 2011 (H.R. 2126, 112th Cong. (2011)) would designate the Federal Insurance Office as a federal arbitrator.

⁶³Fourteen respondents stated “no opinion.”

⁶⁴One respondent did not provide a response to the question.

⁶⁵If passed, the Risk Retention Modernization Act of 2011 (H.R. 2126, 112th Cong. (2011)) also would establish such a requirement for the Federal Insurance Office to set corporate governance standards for RRGs.

Conclusions

In establishing the Liability Risk Retention Act, Congress allowed RRGs to provide commercial liability insurance to RRG members and established a lead-state regulatory framework. While constituting a small portion of the total liability insurance market, the amount of premiums written by RRGs increased from 2004 to 2010 and the financial condition of the RRG industry generally has remained profitable during this same period. Based on our analysis, RRGs appear to have maintained a relatively consistent presence in the market, primarily providing coverage in niche markets such as medical professional liability insurance and other health care-related insurance lines.

RRGs have continued to domicile in one of a few states but write most of their business in other states, highlighting the importance of LRRRA's provisions governing the rights and actions available to regulators in nondomiciliary states as well as the types of coverage allowed under LRRRA. However, states have interpreted these provisions differently, due in part to LRRRA's silence on certain issues such as registration requirements, fees, and the types of insurance coverage RRGs can write, sometimes resulting in litigation between state insurance regulators and RRGs. In addition, some federal courts to which these disputes have been brought also have interpreted LRRRA differently. As a result, RRGs and state insurance regulators have continued to operate in an environment with some uncertainty, potentially affecting RRGs' operations as well as the ability of state regulators to take actions deemed necessary to protect insureds in their states.

To establish a more consistent regulatory environment for the members of RRGs and their claimants, our previous report recommended the development of broad-based, uniform, baseline standards for the regulation of RRGs. NAIC has made progress addressing these concerns, including requiring accredited states to implement risk-focused examinations and risk-based capital analyses, as well as developing corporate governance standards for the RRG industry. Further, NAIC has made efforts to more closely align the accreditation standards for RRGs with those of traditional insurance companies. Because some of these standards only recently were implemented or have not yet been implemented, it is too early to evaluate their effect on the RRG industry and its regulation.

Matter for Congressional Consideration

To reduce the varying interpretations of LRRRA, which have led to uncertainty and disagreements among RRGs and state insurance regulators, and at the same time continue to facilitate the formation and efficient operation of RRGs, Congress should consider clarifying certain LRRRA provisions. For example, clarifying whether (1) RRG registration requirements beyond those currently specified in LRRRA are permitted in nondomiciliary states and (2) fees in addition to premium and other taxes could be charged to RRGs by nondomiciliary states in which they operate. Congress also should consider providing a more specific definition of the types of insurance coverage permitted under LRRRA.

Agency Comments and Our Evaluation

We requested comments on a draft of this report from the National Association of Insurance Commissioners. NAIC provided written comments, which are reproduced in full in appendix II. NAIC also provided technical comments, which we incorporated as appropriate.

NAIC agreed that Congress should consider the merits of clarifying certain aspects of LRRRA, in particular by providing more specific definitions of the type of insurance coverage permitted under the LRRRA. NAIC further recommended that the definition of “commercial liability insurance” be included for consideration since disagreements concerning the scope of this definition have led to disputes between the states and RRGs that, without further clarification, may continue. NAIC also provided several additional comments.

- NAIC provided clarification regarding the status of their Risk Based Capital Models (RBC) and corporate governance standards as it relates to NAIC’s accreditation standards for RRGs, which we incorporated into the draft.
- NAIC expressed concern with the methodology we used to calculate the annual average ratios in figures 3 and 4, and suggested we either use an alternate methodology or more clearly describe the one we used. We added a more detailed description of our methodology to each of the figures.
- NAIC clarified that when analyzing the ratio of premiums to policyholder surplus, whether or not a state allows a letter of credit as an admitted asset can change the results of such an analysis. We agree and added an explanatory footnote.

As agreed with your offices, unless you publicly release its contents earlier, we plan no further distribution of this report until 30 days from its date of issue. At that time, we will send copies of this report to the Chairman and Ranking Member of the Senate Committee on Banking, Housing and Urban Affairs; the Chairman and Ranking Member of the House Financial Services Committee; the Ranking Member of the Subcommittee on Oversight and Investigations, House Financial Services; and to the Chief Executive Officer of NAIC. In addition, the report will be available at no charge on the GAO website at <http://www.gao.gov>.

If you or your staff members have any questions about this report, please contact me at (202) 512-7022 or cackleya@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix III.



Alicia Puente Cackley
Director, Financial Markets and
Community Investment

Appendix I: Objectives, Scope, and Methodology

Our objectives were to (1) describe changes in the financial condition of the risk retention group (RRG) industry from 2004–2010; (2) examine the regulatory treatment of RRGs across domiciliary and nondomiciliary states; and (3) examine changes to federal and state regulatory practices regarding RRGs since 2004.

To determine the extent to which the financial condition of the RRG industry has changed since 2004, we examined previous GAO reports, various financial indicators from data provided by the National Association of Insurance Commissioners (NAIC) and the *Risk Retention Reporter*, a trade journal and data source for the industry. We interviewed representatives of two industry associations on their members' regulatory experiences operating in domiciliary and nondomiciliary states. We reviewed correspondence from state insurance regulators to RRG representatives about topics such as registration processes and fees charged to RRGs. NAIC officials calculated the overall market share of RRGs in the commercial liability insurance market for each year during 2004–2010 and the overall market share of RRGs in the medical professional liability line for 2007–2010 only. We examined the amount of premiums written by RRGs and traditional property/casualty insurers for commercial liability insurance in all 50 states, the District of Columbia, the U.S. territories (American Samoa, Guam, Northern Mariana Islands, Puerto Rico, and the Virgin Islands), and Canada. To ensure data were comparable, we limited our analysis to commercial liability lines of insurance that RRGs are allowed write. We examined and analyzed RRG industry data on financial indicators of profitability and ability to pay claims, such as policyholder surplus, return on equity and combined ratio for 2004–2010. To determine the number of RRGs domiciled in and operating by state, and the percentage of direct written premiums written outside the state of domicile, we analyzed information provided by NAIC.

To assess the reliability of NAIC data we received, we (1) performed electronic testing for obvious errors in accuracy and completeness; and (2) worked with agency officials to identify any data concerns. When we found discrepancies, such as data that were inconsistent, we notified agency officials and worked with these officials to correct the discrepancies before conducting our analysis. We determined that the data were sufficiently reliable for the purposes of our report.

To compare the concentration of RRGs by business area, we used data from 2004 and 2010 from the *Risk Retention Reporter*. We also obtained data from this source for the number of RRGs licensed by business area. Data from the *Risk Retention Reporter* were as of April 2010. We did not

attempt to verify these data, but did interview officials of the *Risk Retention Reporter* to discuss their data collection methods. We determined that the data were sufficiently reliable for the purposes of our report.

Overall, we used interviews, a Web-based survey, and analysis of the Liability Risk Retention Act of 1986 (LRRRA) with other available documentation to determine potential inconsistencies in the regulatory treatment and regulatory environment of RRGs in domiciliary and nondomiciliary states. We reviewed and analyzed LRRRA and its legislative history. To determine states' rules and regulations for RRGs domiciled or operating in those states, we designed and administered a Web-based survey of state insurance regulators in all 50 states and the District of Columbia. Specifically, the survey asked about each state's (1) requirements for RRGs domiciled in state; (2) role as a host (nondomiciliary) state regulator for RRGs operating in state; (3) applicable fees, taxes, and registration requirements; (4) regulatory experiences such as conducting examinations of, taking administrative actions against, and filing civil or criminal lawsuits against RRGs; and (5) opinions on LRRRA. A copy of the questionnaire and results are available in the e-supplement to this report, [GAO-12-17SP](#). The Web-based survey was administered from May 19, 2011, through July 25, 2011. Respondents were sent an e-mail invitation to complete the survey on a GAO Web server using a unique username and password. Throughout the data collection period, nonrespondents received reminder e-mails and telephone calls. The final response rate was 49 out of 51 states including the District of Columbia (96 percent).¹

The practical difficulties of conducting any survey may introduce nonsampling errors, such as difficulties interpreting a particular question, which can introduce unwanted variability into the survey results. We took steps to minimize nonsampling errors by pretesting the questionnaire over the telephone in March and April 2011 with four state insurance regulators (in both domiciliary and nondomiciliary states) and with NAIC officials. We conducted pretests to make sure that the questions were clear and unbiased, the data and information were readily obtainable, and

¹According to officials from the state of Minnesota, the state did not respond to this survey because state employees were furloughed for a part of the period in which this survey was open. Maryland did not completely respond to all survey questions, therefore this regulator's responses were omitted from our analyses.

the questionnaire did not place an undue burden on respondents. We made appropriate revisions to the content and format of the questionnaire after the pretests. After the data were collected, we identified unanswered questions and inconsistencies in some responses. We conducted follow-up with the specific states by e-mail and telephone to obtain responses to unanswered survey questions and confirm the accuracy of responses to several key questions, including applicable fees, premium tax rates, waiting periods, and regulatory actions. We received a 100 percent response rate to our follow-up questions and response confirmations.

While many of the questions on the 2004 and 2011 surveys are similar, slight differences in wording or question format could result in slightly different responses between the two surveys.² All data analysis programs used for this report were independently verified for accuracy. Due to the wide variety of responses to some of our open-ended questions, preparing statistics and summary presentation of findings to these questions was not possible in some cases. Therefore, in some cases we provided qualitative explanations with examples of responses we received.

To obtain the information and opinions on the regulatory treatment of RRGs across domiciliary and nondomiciliary states, we interviewed 13 regulators from domiciliary and nondomiciliary states representing a nonstatistical sample of states selected for RRG business activity and perceived differences in their regulatory treatment of RRGs. The nine domiciliary states—Delaware, Florida, Hawaii, Illinois, Montana, Nevada, South Carolina, Vermont, and the District of Columbia—included eight that were among the top 10 states that domiciled the highest number of RRGs or had the highest amounts of written premiums as of December 31, 2010.³ For states that do not have domiciled RRGs, we identified and selected those in which RRGs were writing the highest amounts of total premiums as of year-end 2010. Those four states were California, Massachusetts, New York and Pennsylvania. Views of other domiciliary and nondomiciliary insurance regulators were obtained through our Web-

²Information on the methodology and results of the 2004 questionnaire is available in appendixes I and II of the previous report, [GAO-05-536](#).

³The eight states that placed among the top 10 domiciliary states with the highest amounts of RRGs or direct written premiums as of year-end 2010 were: Delaware, Hawaii, Illinois, Montana, Nevada, South Carolina, Vermont, and the District of Columbia.

based survey. To obtain comparable data, the same topics were included in the Web-based survey and in interviews with domiciliary and nondomiciliary state insurance regulators.

We also obtained information and opinions on the regulatory treatment of RRGs across states from RRG representatives. First, we conducted two discussion groups at the 2011 annual conference for a captive industry association. We coordinated with the industry association to determine which conference participants had specific knowledge of and were representatives of the RRG industry. To determine which individuals to select to participate in our discussion groups, we developed an invitation letter that the industry association e-mailed to the identified RRG industry representatives. The letter also included a questionnaire to aid in identifying the organization name, title, and industry type of the RRG representative. We received 10 completed questionnaires from conference registrants expressing interest in participating in the discussion groups.⁴ Based on the information provided in the questionnaire, we assembled discussion group volunteers into two groups: (1) RRG owner/insureds and (2) captive/RRG managers. For conference attendees who did not respond to the questionnaire by the deadline in the invitation but wanted to participate, we provided blank questionnaires at the registration table and before the discussion groups. Those who met the criteria for either group were allowed to participate in the discussion groups. We excluded individuals from industry associations whom we previously interviewed and state insurance regulatory agencies, as their views were captured in the GAO-administered Web survey. Second, we selected a non-statistical sample of 11 RRGs that operate on a multistate basis and represent a variety of business areas, insurance products, domiciliary states, and a range of direct written premiums to obtain their perspectives on the regulatory treatment of RRGs across domiciliary and nondomiciliary states. We excluded RRGs that we previously interviewed and RRGs that domiciled and operated only in their domiciliary state. We are not able to generalize results from this sample to the entire RRG industry. To obtain comparable

⁴One respondent was a domiciliary state regulator, and therefore was excluded from the focus groups. A separate interview was scheduled to obtain the views of this regulator. In addition, one representative of a captive management company that provides service to RRGs could not attend the discussion group and was interviewed by telephone at a later date.

data, we covered the same topics in these interviews as in the discussion groups noted above.

To determine the extent to which state and federal regulatory practices affecting RRGs have changed since 2004, we reviewed regulations, guidance, and legislative and regulatory proposals and interviewed stakeholders. More specifically, we reviewed NAIC literature and guidance to state insurance departments about RRG oversight. We also interviewed NAIC officials about efforts to address recommendations from our 2005 report, including revisions to NAIC's state accreditation process and progress with developing and implementing corporate governance standards for RRGs. We attended NAIC working group meetings concerning implementation of accreditation standards and approval of updates to the RRG Handbook and corporate governance standards for RRGs. We also obtained information about RRGs' regulatory environment and views on the potential impact of NAIC's changes to the accreditation standards from the 13 select domiciliary and nondomiciliary state insurance regulators mentioned above. In addition, we obtained information on any changes to state regulations affecting RRGs since 2004 through our Web-based survey of regulators. We interviewed an actuarial expert about the revisions to the accreditation standards. Furthermore, we obtained views from representatives of RRGs on their primary challenges and NAIC's efforts to establish broad based uniform standards for the oversight of RRGs. More specifically, we spoke with the discussion group participants and representatives from 11 select RRGs mentioned in the previous paragraph. The criteria for selection of these RRGs are described above. We excluded those RRGs we already interviewed and RRGs that domiciled and operated in only their home state. We are not able to generalize results from this sample to the entire RRG industry. We also reviewed documentation we received from RRG representatives related to their regulatory experiences and the expected impact of the revised accreditation standards. Finally, we reviewed key legislation concerning RRGs that had been introduced at the federal and state level since 2004 to identify recent changes in laws and regulations affecting RRGs.

We conducted this performance audit from October 2010 to December 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Comments from the National Association of Insurance Commissioners



November 30, 2011

Ms. Alicia Puente Cackley
Director, Financial Markets and Community Investment
U.S. Government Accountability Office
441 G. Street, NW
Washington, DC 20548

Dear Ms. Puente Cackley,

Thank you for providing the National Association of Insurance Commissioners (NAIC) with an opportunity to submit comments on the GAO's draft report, *Risk Retention Groups: Clarifications Could Facilitate States' Implementation of the Liability Risk Retention Act* (GAO-12-16).

As a general comment, we agree Congress should consider the merits of clarifying certain aspects of the LRRRA. The GAO draft report mentions Congress should consider providing more specific definitions of the type of insurance coverage permitted under the LRRRA. The NAIC would further recommend Congress consider clarifying the definition of "commercial liability insurance." Some RRGs and their domiciliary states have taken a broader view of what constitutes commercial liability insurance than may have been originally intended by Congress. This in turn is causing confusion and leading to disputes between the states. Without legislation or further guidance these disputes most likely will continue.

We would also like to provide additional clarification regarding the NAIC's accreditation standards for Risk Based Capital Models (RBC) and corporate governance standards. Although the NAIC Risk Retention Group (E) Task Force has recommended RBC should become an accreditation requirement, the Financial Regulation Standards and Accreditation (F) Committee has not yet adopted this recommendation. However, since this does not appear to be a contentious issue it is anticipated the Financial Regulation Standards and Accreditation (F) Committee will adopt the Task Force's recommendation and make RBC an accreditation standard for RRGs.

Corporate governance standards will be incorporated into the NAIC's Model Risk Retention Act, having been adopted by the NAIC Property and Casualty Insurance Committee (C) on November 5, 2011. The NAIC membership is expected to adopt the corporate governance standards for RRGs by this year end. After the final adoption of the corporate governance standards, the Financial Regulation Standards and Accreditation (F) Committee will begin considering whether the standards will become an accreditation requirement. These discussions are expected to begin in March 2012.

EXECUTIVE OFFICE 444 North Capitol Street NW, Suite 701, Washington, DC 20001-1509

CENTRAL OFFICE 2301 McGee Street, Suite 800, Kansas City, MO 64108-2662

CAPITAL MARKETS & INVESTMENT ANALYSIS OFFICE 48 Wall Street, 6th Floor, New York, NY 10005-2906

p | 202 471 3990 f | 816 460 7493

p | 816 842 3600 f | 816 783 8175

p | 212 398 9000 f | 212 382 4207

www.naic.org

**Appendix II: Comments from the National
Association of Insurance Commissioners**

Additionally, the NAIC has concerns with the methodology used to calculate Figure 3 and Figure 4 in the Report, as it appears the GAO added together the legal entity ratios and then divided by an average number of entities for a given year to arrive at another ratio. It is our understanding the GAO's rationale for using this methodology stems from the desire to capture the experience of a large number of small RRGs. The NAIC recommends the GAO use one of the following approaches: (1) sum the numerators and denominators of each entity and then divide the total numerator and total denominator to arrive at a ratio; or (2) create two or three RRG groupings based on direct premium size and then repeat #1 for each. If the GAO insists on using the current methodology, the NAIC requests a more detailed description of the methodology to better inform readers of the report.

Finally, we would like to make a clarification regarding the financial position of RRGs. The comparison of the ratio of net written premium to policyholder surplus ignores one important fact. RRGs are allowed, in some states, to recognize a letter of credit as an admitted asset. However, both Statutory Accounting Principles (SAP) and Generally Accepted Accounting Principles (GAAP) do not allow a letter of credit to be treated as an admitted asset. If the analysis were repeated without counting the letters of credit, the financial position of RRGs would look very different than presented.

Please do not hesitate to contact me if you have any questions regarding our comments. We value our ongoing relationship with the GAO and appreciate your continued interest in state-based insurance regulation.

Sincerely,



Andrew J. Beal
Chief Operating Officer and Chief Legal Officer

Appendix III: GAO Contact and Staff Acknowledgments

GAO Contact

Alicia Puente Cackley, (202) 512-7022 or cackleya@gao.gov

Staff Acknowledgments

In addition to the individual named above, Patrick A. Ward, Assistant Director; Susan Baker ;William Chatlos; Shamiah Kerney; Jill Lacey; May Lee; Marc Molino; Patricia Moye; Daniel Newman; Jasmine Persaud; and Barbara Roesmann also made major contributions to this report.

GAO's Mission

The Government Accountability Office, the audit, evaluation, and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's website (www.gao.gov). Each weekday afternoon, GAO posts on its website newly released reports, testimony, and correspondence. To have GAO e-mail you a list of newly posted products, go to www.gao.gov and select "E-mail Updates."

Order by Phone

The price of each GAO publication reflects GAO's actual cost of production and distribution and depends on the number of pages in the publication and whether the publication is printed in color or black and white. Pricing and ordering information is posted on GAO's website, <http://www.gao.gov/ordering.htm>.

Place orders by calling (202) 512-6000, toll free (866) 801-7077, or TDD (202) 512-2537.

Orders may be paid for using American Express, Discover Card, MasterCard, Visa, check, or money order. Call for additional information.

Connect with GAO

Connect with GAO on [Facebook](#), [Flickr](#), [Twitter](#), and [YouTube](#). Subscribe to our [RSS Feeds](#) or [E-mail Updates](#). Listen to our [Podcasts](#). Visit GAO on the web at www.gao.gov.

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Website: www.gao.gov/fraudnet/fraudnet.htm

E-mail: fraudnet@gao.gov

Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Ralph Dawn, Managing Director, dawnr@gao.gov, (202) 512-4400
U.S. Government Accountability Office, 441 G Street NW, Room 7125
Washington, DC 20548

Public Affairs

Chuck Young, Managing Director, youngc1@gao.gov, (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, DC 20548

