

GAO

Report to the Chairman, Committee on
Financial Services, House of
Representatives

August 2005

RISK RETENTION GROUPS

Common Regulatory Standards and Greater Member Protections Are Needed



G A O

Accountability * Integrity * Reliability



Highlights of [GAO-05-536](#), a report to the Chairman, Committee on Financial Services, House of Representatives

Why GAO Did This Study

Congress authorized the creation of risk retention groups (RRG) to increase the availability and affordability of commercial liability insurance. An RRG is a group of similar businesses that creates its own insurance company to self-insure its risks. Through the Liability Risk Retention Act (LRRRA), Congress partly preempted state insurance law to create a single-state regulatory framework for RRGs, although RRGs are multistate insurers. Recent shortages of affordable liability insurance have increased RRG formations, but recent failures of several large RRGs also raised questions about the adequacy of RRG regulation. This report (1) examines the effect of RRGs on insurance availability and affordability; (2) assesses whether LRRRA's preemption has resulted in significant regulatory problems; and (3) evaluates the sufficiency of LRRRA's ownership, control, and governance provisions in protecting the best interests of the RRG insureds.

What GAO Recommends

To strengthen the overall regulation of RRGs, GAO recommends that state insurance regulators adopt consistent regulatory standards for RRGs. Moreover, GAO suggests that Congress consider (1) granting the partial preemption only to states that adopt the standards and (2) establishing minimum corporate governance standards for RRGs.

www.gao.gov/cgi-bin/getrpt?GA0-05-536.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Richard J. Hillman at (202) 512-8678 or hillmanr@gao.gov.

RISK RETENTION GROUPS

Common Regulatory Standards and Greater Member Protections Are Needed

What GAO Found

RRGs have had a small but important effect in increasing the availability and affordability of commercial liability insurance for certain groups. While RRGs have accounted for about \$1.8 billion or about 1.17 percent of all commercial liability insurance in 2003, members have benefited from consistent prices, targeted coverage, and programs designed to reduce risk. A recent shortage of affordable liability insurance prompted the creation of many new RRGs. More RRGs formed in 2002–2004 than in the previous 15 years—and about three-quarters of the new RRGs offered medical malpractice coverage.

LRRRA's partial preemption of state insurance laws has resulted in a regulatory environment characterized by widely varying state standards. In part, state requirements differ because some states charter RRGs as "captive" insurance companies, which operate under fewer restrictions than traditional insurers. As a result, most RRGs have domiciled in six states that offer captive charters (including some states that have limited experience in regulating RRGs) rather than in the states where they conduct most of their business. Additionally, because most RRGs (as captives) are not subject to the same uniform, baseline standards for solvency regulation as traditional insurers, state requirements in important areas such as financial reporting also vary. For example, some regulators may have difficulty assessing the financial condition of RRGs operating in their state because not all RRGs use the same accounting principles. Further, some evidence exists to support regulator assertions that domiciliary states may be relaxing chartering or other requirements to attract RRGs.

Because LRRRA does not specify characteristics of ownership and control, or establish governance safeguards, RRGs can be operated in ways that do not consistently protect the best interests of their insureds. For example, LRRRA does not explicitly require that the insureds contribute capital to the RRG or recognize that outside firms typically manage RRGs. Thus, some regulators believe that members without "skin in the game" will have less interest in the success and operation of their RRG and that RRGs would be chartered for purposes other than self-insurance, such as making profits for entrepreneurs who form and finance an RRG. LRRRA also provides no governance protections to counteract potential conflicts of interest between insureds and management companies. In fact, factors contributing to many RRG failures suggest that sometimes management companies have promoted their own interests at the expense of the insureds.

The combination of single-state regulation, growth in new domiciles, and wide variance in regulatory practices has increased the potential that RRGs would face greater solvency risks. As a result, GAO believes RRGs would benefit from uniform, baseline regulatory standards. Also, because many RRGs are run by management companies, they could benefit from corporate governance standards that would establish the insureds' authority over management.

Contents

Letter

Results in Brief	1
Background	5
RRGs Have Had a Small but Important Effect on Increasing the Availability and Affordability of Commercial Liability Insurance	8
LRRR's Regulatory Preemption Has Resulted in Widely Varying Requirements among States and Limited Confidence in RRG Regulation	12
RRG Failures Have Raised Questions about the Sufficiency of LRRR Provisions for RRG Ownership, Control, and Governance	25
Conclusions	48
Recommendations for Executive Action	65
Matters for Congressional Consideration	68
Agency Comments and Our Evaluation	68
	70

Appendixes

Appendix I: Objectives, Scope, and Methodology	72
Appendix II: Survey of State Regulators on Risk Retention Groups	79
Appendix III: Selected Differences between Statutory and Generally Accepted Accounting Principles as They Relate to Financial Reporting for RRGs	94
Appendix IV: Liquidated Risk Retention Groups (RRG), from 1990 through 2003	109
Appendix V: Comments from the National Association of Insurance Commissioners	113
Appendix VI: GAO Contact and Staff Acknowledgments	114

Tables

Table 1: Characteristics of States We Interviewed, Based on Years of Regulatory Experience and Number of RRGs Domiciled	76
Table 2: Differences in Regulatory Actions When Calculating Risk-Based Capital for Three RRGs, Modified GAAP Compared with SAP	108

Figures

Figure 1: RRG Gross Premiums Written in 2003, by Time (Years) in Business	17
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Figure 2: Number of RRGs, by Business Area for Selected Years	19
Figure 3: Percentage of Estimated Gross Premiums RRGs Collected in 2004, by Business Area	20
Figure 4: Number of RRGs, by Formation Date	23
Figure 5: Number of RRGs, by Captive or Noncaptive Charter and State of Domicile, as of the End of 2004	30
Figure 6: Number of RRGs Chartered, by State, as of the End of 2004, and Amount of Direct Premiums Written by RRGs, by State, 2003	32
Figure 7: State Regulators' Opinion of the Adequacy of the Regulatory Protections or Safeguards Built into LRRRA	41
Figure 8: Permitted Wording of Guaranty Fund Disclosure in LRRRA	60
Figure 9: The Effect of Differences in Accounting for Acquisition Costs on Assets, Capital, and Surplus, GAAP Compared with SAP	97
Figure 10: Impact of Counting an LOC and Prepaid Expenses as Assets on the Balance Sheet, Modified GAAP Compared with SAP	99
Figure 11: Impact of Counting Acquisition Costs, LOCs, and Prepaid Expenses as Assets on the Balance Sheet, Modified GAAP Compared with SAP	100
Figure 12: Differences in the Calculation of Net Premiums Written to Policyholders' Surplus Ratio, Modified GAAP Compared with SAP	104
Figure 13: Differences in the Calculation of Reserves to Policyholders' Surplus Ratio, Modified GAAP Compared with SAP	106

Abbreviations

ANLIR	American National Lawyers Insurance Reciprocal Risk Retention Group
BRICO	Beverage Retailers Insurance Company Risk Retention Group
CEO	chief executive officer
CIC	Corporate Insurance Consultants
DIR	Doctors Insurance Risk Retention Group
FAST	Financial Analysis Solvency Tools
GAAP	generally accepted accounting principles
IRIS	Insurance Regulatory Information System
LOC	letter of credit
LRRA	Liability Risk Retention Act
NAIC	National Association of Insurance Commissioners
NPW:PS	net premiums written to policyholders' surplus
PMIC	Professional Mutual Insurance Company Risk Retention Group
RBC	risk-based capital
ROA	Reciprocal of America
RPG	risk purchasing group
RRG	risk retention group
RRR	<i>Risk Retention Reporter</i>
SAP	statutory accounting principles
SEC	Securities and Exchange Commission
TAC	total adjusted capital
TRA	The Reciprocal Alliance Risk Retention Group
TRG	The Reciprocal Group
VSC	vehicle service contract

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United States Government Accountability Office
Washington, D.C. 20548

August 15, 2005

The Honorable Michael G. Oxley
Chairman, Committee on Financial Services
House of Representatives

Dear Mr. Chairman:

In 1981, in response to recurring shortages of liability insurance, Congress passed the Product Risk Retention Liability Act, now known as the Liability Risk Retention Act (LRRRA), which authorized the creation of risk retention groups (RRG) to increase the availability and affordability of commercial liability insurance.¹ An RRG is a group of similar businesses with similar risk exposures, such as educational institutions or building contractors, which create their own insurance company to self-insure their risks on a group basis.² Through LRRRA, Congress first established a flexible framework that allowed states to develop their own standards for the formation and operation of RRGs. In light of the recent unavailability of affordable liability insurance, especially for medical malpractice coverage, interest in forming RRGs has greatly increased. In addition, some industry advocates now propose that RRGs be permitted to offer property coverage as well. However, the recent and notable failures of several large RRGs have raised questions about the adequacy of the RRG regulatory environment and whether existing safeguards, such as the requirement that each RRG provide copies of operational plans and annual financial statements to each state in which it operates, are sufficient to ensure that RRGs are operated and governed adequately to protect their insureds.

¹Pub. L. No. 97-45, 95 Stat. 949 (1981) (codified as amended at 15 U.S.C. §§ 3901-3906). LRRRA authorized the creation of RRGs and risk purchasing groups (RPG). RPGs are businesses with similar risk exposures that join to purchase liability insurance as a single entity. See 15 U.S.C. § 3901(a)(5). We do not evaluate RPGs in this report. See also GAO, *Insurance: Activity under the Product Liability Risk Retention Act of 1981*, [GAO/HRD-86-120BR](#) (Washington, D.C.: July 1986).

²The specific definitional requirements are set forth in 15 U.S.C. § 3901(a)(4).

LRRRA, expanded in 1986, facilitates the creation and operation of RRGs in several ways.³ Most notably, LRRRA partially preempts state insurance laws by allowing an RRG's formation and operations to be regulated primarily by the state in which it is chartered, its domiciliary state, even when it sells insurance in other states. LRRRA largely limits the oversight role of insurance regulators from nondomiciliary states (all states other than the chartering state) to the right to receive copies of an RRG's operational plans and annual financial statements. In having only one regulator, RRGs differ from "traditional" insurance companies, which are subject to licensing and oversight by regulators in each state in which they operate. Additionally, LRRRA prohibits RRGs from participating in state guaranty funds, which are available to settle the claims of insureds of a traditional insurance company should that company fail.

LRRRA's legislative history indicates a view that single-state regulation would provide adequate supervision of RRGs, largely because RRGs would be providing insurance coverage only to their own members, and not the public at large. While preemption is central to LRRRA's objective of facilitating the formation and efficient interstate operation of RRGs, Congress also expressed a view that LRRRA's prohibition on participating in guaranty funds would provide a strong incentive for RRGs to set adequate premiums and establish adequate reserves, as each RRG member would know that there would be no other source of funds (other than the RRG's own assets) from which to pay claims.⁴

RRGs are not the only mechanism by which businesses may establish self-insurance coverage. States also charter and regulate captive insurance companies, which are established by single companies or groups of companies to self-insure their own risks. Traditional insurance companies sell insurance to the general public and are licensed in all states in which they do business. In contrast, captive insurance companies largely insure only their owners, who have the ability to manage and retain their own risk. Thus, the degree of regulatory oversight required for captives is different

³Prior to its expansion in 1986, LRRRA only permitted RRGs to provide product liability insurance. As amended in 1986, the act permits RRGs to offer all types of liability insurance, excluding worker's compensation. The 1986 amendments also expanded the ability of nondomiciliary states to regulate RRGs doing business in their states.

⁴Insurance insolvency guaranty funds are maintained by contributions of insurance companies operating in a particular state and made available to pay the claims of insolvent insurance companies.

than that which is required for commercial insurers. States chartering captives offer some regulatory relief to these companies, based on the presumption that the owners of captive companies have sophisticated knowledge about managing their own risks and are motivated to protect their own interests. The captive is licensed in only one state and operates under the captive insurance law of that domicile. However, should the captive choose to conduct business outside its state of domicile, it would be subject to the licensing and oversight of each state because captives that are not also RRGs do not benefit from the partial preemption. Many states have recognized RRGs as a form of captive and charter them under their captive regulations.

In light of proposals to expand LRRRA, and recent shortages of affordable liability insurance, you requested that we assess how well RRGs have achieved LRRRA's legislative goals of making commercial liability insurance available and affordable. This report (1) examines the effect RRGs have had on the availability and affordability of commercial liability insurance; (2) assesses whether LRRRA's partial preemption of state insurance laws has resulted in any significant regulatory problems; and (3) evaluates the sufficiency of LRRRA's ownership, control, and governance provisions for protecting the best interests of the insureds.

To ascertain the effect of RRGs on the availability and affordability of commercial liability insurance, we surveyed regulators in all 50 states and the District of Columbia and interviewed representatives from eight RRGs serving different markets. In addition, we obtained information from the National Association of Insurance Commissioners (NAIC) that estimated the share of the commercial liability insurance market that RRGs held in 2003.⁵ To determine if LRRRA's partial preemption of state insurance laws has resulted in significant regulatory problems, we surveyed all state insurance departments to obtain information on their regulatory experiences and obtained more specific information from regulators in 14 states, including some that do not domicile RRGs. To understand the regulatory framework, especially the capitalization and financial reporting standards under which most RRGs are regulated, we compared the regulatory standards of the six states (Arizona, the District of Columbia, Hawaii, Nevada, South Carolina, and Vermont) that had chartered the most RRGs as of June 30, 2004. To assess the sufficiency of LRRRA's ownership, control, and governance provisions in protecting the best interests of the insureds, we identified provisions in LRRRA that relate to these issues and reviewed LRRRA's legislative history to ascertain Congress' concerns about these issues.⁶ Since LRRRA largely delegates the regulation of the formation and operation of RRGs to the domiciliary states, we reviewed the statutory provisions of the six leading domiciliary states to determine whether they addressed ownership, control, and governance, and interviewed their regulators to identify insurance departmental policies. To understand how the regulators implemented these statutes and policies, we reviewed the chartering documents of the three RRGs most recently domiciled by each of the leading domiciliary states. Finally, we identified whether factors related to the ownership, control, or governance of RRGs contributed or, in some cases, were alleged to have contributed to RRG failures. We conducted our review from November 2003 through July 2005 in accordance with generally accepted government auditing standards. Appendix I contains a more detailed description of our objectives, scope, and methodology.

⁵NAIC is a voluntary association of the heads of insurance departments from each state, the District of Columbia, and five U.S. territories. For the purpose of this report, we refer to the District of Columbia as a state. NAIC 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.

⁶By governance, we mean the manner in which an RRG's governing body, such as a board of directors, and management direct and control the RRG, including the means by which directors and management are held accountable for their actions.

Results in Brief

RRGs have had a small but important effect in increasing the availability and affordability of commercial liability insurance for certain groups with limited access to insurance. In 2003, according to NAIC estimates, RRGs provided about \$1.8 billion or 1.17 percent of all commercial liability insurance. While the overall impact on the liability market has been small, most state regulators we surveyed believed that RRGs have increased the availability and affordability of insurance for groups that have had difficulties obtaining affordable coverage such as healthcare providers, building contractors, and commercial trucking firms. According to state regulators and RRG industry representatives, members have benefited in several important ways by using RRGs to self-insure their risks.⁷ These benefits include controlling their costs by targeting their coverage to the specific needs of members and designing programs to reduce risks. The representatives indicated that RRGs might not always benefit from the lowest insurance prices but could benefit from prices that remained stable over time. In recent years, a shortage of affordable liability insurance also prompted the creation of many new RRGs. From 2002 through 2004, 117 RRGs were formed, more than the total formed over the previous 15 years. In particular, a shortage of affordable medical malpractice insurance prompted healthcare providers to form about three-quarters of the new RRGs. As a result, more than half of all currently operating RRGs provide insurance in healthcare-related areas.

LRRRA's partial preemption of state insurance laws has resulted in a regulatory environment characterized by widely varying state standards and limited regulator confidence in the system. In part, state requirements differ because some states charter RRGs as captive insurance companies, which operate under less restrictive regulation than traditional insurers. A captive charter offers RRGs several advantages: For example, initial capitalization standards are usually easier to meet because states allow captives to start their operations with less capital than traditional insurers and use letters of credit rather than cash to meet capitalization requirements. As a result of these and other advantages, the majority of RRGs have domiciled in six states—Arizona, the District of Columbia, Hawaii, Nevada, South Carolina, and Vermont—that allow them to be chartered as captive insurers rather than in the states where they conduct

⁷In order to obtain more specific examples about how RRGs have benefited their membership, we interviewed and reviewed documents from eight RRGs representing a variety of industries, most of which have been in business for at least 5 years. See appendix I for more information.

most of their business. In addition, states chartering RRGs as captives also vary in how they regulate RRGs on an ongoing basis. These variations exist because LRRRA grants domiciliary states the discretion and authority to regulate the formation and multistate operation of RRGs and because as captives most RRGs are not subject to uniform, baseline standards, such as those set forth in NAIC's financial accreditation standards for regulation of traditional multistate insurers. For example, five of the six leading domiciliary states allow RRGs to use a modified version of generally accepted accounting principles (GAAP), rather than statutory accounting principles (SAP), when filing financial statements. As a result, some nondomiciliary state regulators have difficulty interpreting these reports, especially since traditional insurers must file using SAP. Additionally, only 8 regulators of 42 responding to a particular survey question considered that LRRRA's provisions adequately protected RRG insureds, often because of their concerns about a lack of uniform, baseline standards and perception that they needed additional regulatory authority. Finally, some evidence exists to support regulator assertions that some domiciliary states may be creating lenient regulatory environments to encourage RRGs to domicile in their state. For example, in the past 4 years, two leading domiciliary states have allowed RRGs to relocate their charters, even though the RRGs were subject to unresolved regulatory actions in their original state of domicile.

Because (other than requiring that owners must also be insureds) LRRRA does not impose minimum characteristics of ownership and control for RRGs or establish minimum governance requirements, RRGs can be operated in ways that do not consistently protect the best interests of their insureds. While RRGs were authorized for the purpose of providing self-insurance, LRRRA does not explicitly require that all of the insureds contribute toward the capitalization of the RRG. Consequently, some of the six leading domiciliary states do not expect RRG insureds to contribute anything more than insurance premiums, and some regulators are concerned that members without "skin in the game" will have less interest in the success of their RRG. In addition, even though LRRRA's legislative history indicates that the single-state regulatory framework was premised, in part, on insureds having adequate incentives to exercise control over their RRG, some of the six leading domiciliary states do not expect insureds to have the ability to elect their governing body (such as a board of directors). Because not all insureds actually participate in the formation or financing of their RRGs, some regulators are concerned that those RRGs may be operated for the financial benefit of the "entrepreneurs" who do provide the financing. An entrepreneur could be an individual insured or

the company hired to manage the daily operations of the RRG. LRRRA also does not include provisions regarding the management of RRGs, such as governance protections to counteract potential conflicts of interest between management companies and insureds. In contrast, Congress previously addressed a similar situation within the mutual fund industry by passing legislation intended to minimize potential conflicts of interest between mutual fund shareholders and management companies. The circumstances surrounding more than half of past RRG failures we examined suggest that management companies or managers have promoted their own interests at the expense of the insureds—for example, by charging excessive management fees or promoting transactions unfavorable to the RRG. Regulators knowledgeable about these failures said that the insureds likely were more interested in obtaining affordable insurance than assuming the responsibilities of owning an insurance company. Consequently, even though an insured's insurance policy may have stated that the RRG lacked guaranty fund coverage, the insureds may not have been fully aware of this restriction or the consequences of lacking such protection. Further, LRRRA does not require RRGs to disclose to prospective claimants, those who submit claims for loss, that the RRGs would not benefit from guaranty fund protection should they fail. This can be of special consequence to certain claimants—consumers who purchase extended service contracts from the insureds of RRGs—because contracts issued by these insureds take on the appearance of insurance when, in most cases, they are not.

This report contains recommendations for the states, as well as matters for congressional consideration that, if implemented, would create a more consistent regulatory framework for overseeing the chartering and management of RRGs, provide more reliable information about the financial condition of RRGs, and provide RRG members needed protections to help ensure that companies managing RRGs operate in the insureds' best interests. In addition, enhancing the availability and contents of the guaranty fund disclosure would provide RRG insureds, as well as consumers who purchase extended service contracts from RRG insureds, a better understanding of the lack of guaranty fund coverage. Finally, these recommendations would strengthen NAIC's ability to achieve its goals of improving the quality and consistency of state insurance regulation.

We requested comments on a draft of this report from NAIC. The Executive Vice President and CEO, National Association of Insurance Commissioners, provided written comments on a draft of this report. NAIC generally agreed with our approach and methodology and our description

of the regulation of risk retention groups. NAIC's comments are discussed later in this report and are reprinted in appendix V. NAIC and several of the states also provided technical comments, which we incorporated as appropriate.

Background

In the legislative history, RRGs were described as essentially insurance “cooperatives,” whose members pool funds to spread and assume all or a portion of their own commercial liability risk exposure—and who are engaged in businesses and activities with similar or related risks.⁸ Specifically, RRGs may be owned only by individuals or businesses that are insured by the RRG or by an organization that is owned solely by insureds of the RRG.⁹ In the legislative history, Congress expressed the view that RRGs had the potential to increase the availability of commercial liability insurance for businesses and reduce liability premiums, at least when insurance is difficult to obtain (during hard markets) because members would set rates more closely tied to their own claims experience. In addition, LRRRA was intended to provide businesses, especially small ones, an opportunity to reduce insurance costs and promote greater competition among insurers when they set insurance rates.¹⁰ Because RRGs are owned by insureds that may have business assets at risk should the RRG be unable to pay claims, they would have greater incentives to practice effective risk management both in their own businesses and the RRG. The elimination of duplicative and sometimes contradictory regulation by multiple states was designed to facilitate the formation and interstate operation of RRGs.¹¹ “The (regulatory) framework established by LRRRA attempts to strike a balance between the RRGs’ need to be free of

⁸Liability insurance includes coverage for all sums that the insured becomes legally obligated to pay because of bodily injury, property damage, or other wrongs to which an insurance policy could apply.

⁹15 U.S.C. § 3902(a)(4)(E).

¹⁰See H. Rep. No. 97-190, at 4 (1981), *reprinted in* 1981 U.S.C.A.A.N. 1432, 1441; S. Rep. No. 97-172, at 1 (1981).

¹¹See H. Rep. No. 97-190, at 12 (1981), *reprinted in* 1981 U.S.C.A.A.N. 1432, 1441; S. Rep. 97-172, at 11 (1981).

unjustified requirements and the public's need for protection from insolvencies."¹²

RRGs are not the only form of self-insurance companies; "captive insurance companies" (captives) also self-insure the risks of their owners. States can charter RRGs under regulations intended for traditional insurers or for captive insurers. Non-RRG captives largely exist solely to cover the risks of their parent, which can be one large company (pure captive) or a group of companies (group captives).¹³ Group captives share certain similarities with RRGs because they also are composed of several companies, but group captives, unlike RRGs, do not have to insure similar risks. Further, captives may provide property coverage, which RRGs may not. Regulatory requirements for captives generally are less restrictive than those for traditional insurance companies because, for example, many pure captives are wholly owned insurance subsidiaries of a single business or organization. If a pure captive failed, only the assets of the parent would be at risk. Finally, unlike captive RRGs, other captive insurers generally cannot conduct insurance transactions in any state except their domiciliary state, unless they become licensed in that other state (just as a traditional company would) and subject to that state's regulatory oversight.¹⁴

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

¹³Other variations of captive insurance companies exist. For example, a hybrid form of the captive company is the trade association or industry captive, which is formed and operated by a business fraternal organization or trade association.

¹⁴To address the potential complexities of multiple state regulation, when captives do need to sell in other states, they typically pay another insurance company already admitted (that is, licensed to operate) by that state, known as a fronting company, to issue policies. The fronting company then insures the risks back to the captive.

In contrast to the single-state regulation that LRRRA provides for RRGs, traditional insurers, as well as other non-RRG captive insurers, are subject to the licensing requirements and oversight of each nondomiciliary state in which they operate. The licensing process allows states to determine if an insurer domiciled in another state meets the nondomiciliary state's regulatory requirements before granting the insurer permission to operate in its 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.¹⁵ 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. However, most state regulators will not even license an insurance company domiciled in another state to operate in their state unless the company has been in operation for several years. As reflected in each state's "seasoning requirements," an insurance company must have successfully operated in its state of domicile for anywhere from 1 to 5 years before qualifying to receive a license from another state.¹⁶ RRGs, in contrast, are required only to register with the regulator of the state in which they intend to sell insurance and provide copies of certain documents originally provided to domiciliary regulators.

¹⁵NAIC has developed an application process allowing insurers to file copies of the same application for admission in numerous states. This application is designed for established, solidly performing companies that are in good standing in their domiciliary state.

¹⁶These requirements are known as "seasoning requirements for authority to transact business."

Although RRGs receive regulatory relief under LRRRA, they still are expected to comply with certain other laws administered by the states in which they operate, but are not chartered (nondomiciliary states), and are required to pay applicable premium and other taxes imposed by nondomiciliary states.¹⁷ In addition to registering with other states, LRRRA also imposes other requirements that offer protections or safeguards to RRG members: LRRRA requires each RRG to (1) provide a plan of operation to the insurance commissioner of each state in which it plans to do business prior to offering insurance in that state, (2) provide a copy of the group's annual financial statement to the insurance commissioner of each state in which it is doing business, 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. 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.¹⁸

In conjunction with the regulatory relief Congress granted to RRGs, it prohibited RRGs from participating in state guaranty funds, believing that this restriction would provide RRG members a strong incentive to establish adequate premiums and reserves. All states have established guaranty funds, funded by insurance companies, to pay the claims of policyholders in the event that an insurance company fails. Without guaranty fund protection, in the event an RRG becomes insolvent, RRG insureds and their claimants could be exposed to all losses resulting from claims that exceed the ability of the RRG to pay.

¹⁷LRRRA provides a list of powers retained by nondomiciliary states, including the authority to require RRGs to comply with laws regarding unfair claim settlement practices and unfair trade and deceptive practices. See 15 U.S.C. § 3902(a)(1). Further, LRRRA's exemption does not extend to laws governing business and industry generally, such as civil rights laws, generally applicable criminal laws, and corporate laws.

¹⁸See 15 U.S.C. § 3902(a)(1)(H).

Finally, in terms of structure, RRG and captive insurance companies bear a certain resemblance to mutual fund companies.¹⁹ For example, RRGs, captive insurance companies, and mutual fund companies employ the services of a management company to administer their operations. RRGs and captive insurers generally hire “captive management” companies to administer company operations, such as day-to-day operational decisions, financial reporting, liaison with state insurance departments, or locating sources of reinsurance.²⁰ Similarly, a typical mutual fund has no employees but is created and operated by another party, the adviser, which contracts with the fund, for a fee, to administer operations. For example, the adviser would be responsible for selecting and managing the mutual fund’s portfolio. However, Congress recognized that the external management of mutual funds by investment advisers creates an inherent conflict between the adviser’s duties to the fund shareholders and the adviser’s interests in maximizing its own profits, a situation that could adversely affect fund shareholders. One way in which Congress addressed this conflict is the regulatory scheme established by the Investment Company Act of 1940, which includes certain safeguards to protect the interests of fund shareholders. For example, a fund’s board of directors must contain a certain percentage of independent directors—directors without any significant relationship to the advisers.

RRGs Have Had a Small but Important Effect on Increasing the Availability and Affordability of Commercial Liability Insurance

RRGs have had a small but important effect on increasing the availability and affordability of commercial liability insurance, specifically for groups that have had limited access to liability insurance. According to NAIC estimates, in 2003 RRGs sold just over 1 percent of all commercial liability insurance in the United States. However, many state regulators, even those who had reservations about the regulatory oversight of RRGs, believe RRGs have filled a void in the market. Regulators from the six leading domiciliary states also observed that RRGs were important to certain groups that could not find affordable coverage from a traditional insurance company and offered RRG insureds other benefits such as tailored

¹⁹Mutual funds are distinct legal entities owned by their shareholders and permit shareholders to invest in an array of securities such as stocks issued by public corporations. See GAO, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition*, GAO/GGD-00-126 (Washington, D.C.: June 2000) for additional information.

²⁰Reinsurance is a form of insurance that insurance companies buy for their own protection. Insurance companies purchase reinsurance to reduce their possible maximum loss by giving (ceding) a portion of their liability to reinsurance companies.

coverage. Furthermore, RRGs, while tending to be relatively small in size compared with traditional insurers, serve a wide variety of organizations and businesses, although the majority served the healthcare industry. Difficulties in finding affordable commercial liability insurance prompted the creation of more RRGs from 2002 through 2004 than in the previous 15 years. Three-quarters of the RRGs formed in this period responded to a recent shortage of, and high prices for, medical malpractice insurance. However, studies have characterized the medical malpractice industry as volatile because of the risks associated with providing this line of insurance.

RRGs Have Represented a Small but Increasing Part of the Commercial Liability Insurance Market

RRGs have constituted a very small part of the commercial liability market. According to NAIC estimates, in 2003 a total of 115 RRGs sold 1.17 percent of all commercial liability insurance in the United States. This accounted for about \$1.8 billion of a total of \$150 billion in gross premiums for all commercial liability lines of insurance.²¹ We are focusing on 2003 market share to match the time frame of our other financial analyses of gross premiums.

While RRGs' share of the commercial liability market was quite small, market share and the overall amount of business RRGs wrote increased since 2002. For example, RRG market share increased from 0.89 percent in 2002 to 1.46 percent in 2004.²² However, in terms of commercial liability gross premiums, the increase in the amount of business written by RRGs is more noticeable. The amount of business that RRGs collectively wrote about doubled, from \$1.2 billion in 2002 to \$2.3 billion in 2004. During this same period, the amount of commercial liability written by traditional insurers increased by about 21 percent, from \$129 billion to \$156 billion. In addition, RRGs increased their presence in the market for medical malpractice insurance. From 2002 through 2004, the amount of medical malpractice written by RRGs increased from \$497 million to \$1.1 billion,

²¹In 2003, 127 RRGs were licensed to write business but we asked NAIC to include only the 115 RRGs that actively wrote premiums. NAIC's analysis is based on the amount of gross premiums written by RRGs divided by the total amount of gross premiums written by all insurers for commercial liability insurance. Gross premiums represent the total amount of business that an insurance company sells (direct premiums) plus business assumed from other carriers (assumed premiums).

²²We verified that NAIC's 2003 data correctly listed RRGs—that is, did not inadvertently include or omit any insurers. However, we did not perform this verification for the 2002 or 2004 data.

which increased their share of the medical malpractice market from 4.04 percent to 7.27 percent.

According to State Regulators, RRGs Have Filled Voids in Markets, Allowing Numerous Groups to Obtain Benefits of Coverage

Despite the relatively small share of the market that RRGs hold, most state regulators we surveyed who had an opinion—33 of 36—indicated that RRGs have expanded the availability and affordability of commercial liability insurance for groups that otherwise would have had difficulty in obtaining coverage.²³ This consistency of opinion is notable because 18 of those 33 regulators made this assertion even though they later expressed reservations about the adequacy of LRRAs' regulatory safeguards.²⁴ About one-third of the 33 regulators also made more specific comments about the contributions of RRGs. Of these, five regulators reported that RRGs had expanded the availability of medical malpractice insurance for nursing homes, adult foster care homes, hospitals, and physicians. One regulator also reported that RRGs had assisted commercial truckers in meeting their insurance needs.

Regulators from states that had domiciled the most RRGs as of the end of 2004—Arizona, the District of Columbia, Hawaii, Nevada, South Carolina, and Vermont—provided additional insights.²⁵ Regulators from most of these states recognized that the overall impact of RRGs in expanding the availability of insurance was quite small. However, they said that the coverage RRGs provided was important because certain groups could not find affordable insurance from a traditional insurance company. All of these regulators cited medical malpractice insurance as an area where RRGs increased the affordability and availability of insurance but they also identified other areas. For example, regulators from Hawaii and Nevada reported that RRGs have been important in addressing a shortage of insurance for construction contractors. The six regulators all indicated (to some extent) that by forming their own insurance companies, RRG members also could control costs by designing insurance coverage

²³We surveyed insurance departments from all 50 states and the District of Columbia about their regulatory experiences with RRGs. Of these, all but one—the State of Maryland—responded to our survey. Of the respondents, 36 gave an opinion for the question on whether RRGs had expanded the availability and affordability of insurance.

²⁴For more information, see the next section where we present the results of regulatory responses to the questions on the adequacy of LRRAs' safeguards.

²⁵As of the end of 2004, these six states had chartered 88 percent of all RRGs.

targeted to their specific needs and develop programs to reduce specific risks. In contrast, as noted by the Arizona regulator, traditional insurers were likely to take a short-term view of the market, underpricing their coverage when they had competition and later overpricing their coverage to recoup losses. He also noted insurers might exit a market altogether if they perceived the business to be unprofitable, as exemplified in the medical malpractice market. Regulators from Vermont and Hawaii, states that have the most experience in chartering RRGs, added that successful RRGs have members that are interested in staying in business for the “long haul” and are actively involved in running their RRGs. RRG representatives added that RRG members, at any given time, might not necessarily benefit from the cheapest insurance prices but could benefit from prices that were stable over time. Additionally, as indicated by trade group representatives, including the National Risk Retention Association, RRGs have proved especially advantageous for small and mid-sized businesses.

In order to obtain more specific information about how RRGs have benefited their membership, we interviewed representatives of and reviewed documents supplied by six RRGs that have been in business for more than 5 years, as well as two more recently established RRGs. Overall, these eight RRGs had anywhere from 2 to more than 14,500 members.²⁶ They provided coverage to a variety of insureds, including educational institutions, hospitals, attorneys, and building contractors. The following three examples illustrate some of the services and activities RRGs provide or undertake.

- An RRG that insures about 1,100 schools, universities, and related organizations throughout the United States offers options tailored to its members, such as educators’ legal liability coverage and coverage for students enrolled in courses offering off-campus internships. According to an RRG representative, the RRG maintains a claims database to help it accurately and competitively price its policies. Members also benefit from risk-management services, such as training and courses on sexual harassment and tenure litigation, and work with specialists to develop loss-control programs.
- An RRG that reported that it insures 730 of the nation’s approximately 3,000 public housing authorities provides coverage for risks such as pesticide exposure, law enforcement liability, and lead-based paint

²⁶The RRG with more than 14,500 members serves attorneys.

liability. The RRG indicated that while premium rates have fluctuated, they are similar to prices from about 15 years ago. The RRG also offers risk-management programs, such as those for reducing fires, and also reported that as a result of conducting member inspections it recently compiled more than 2,000 recommendations on how to reduce covered risks.

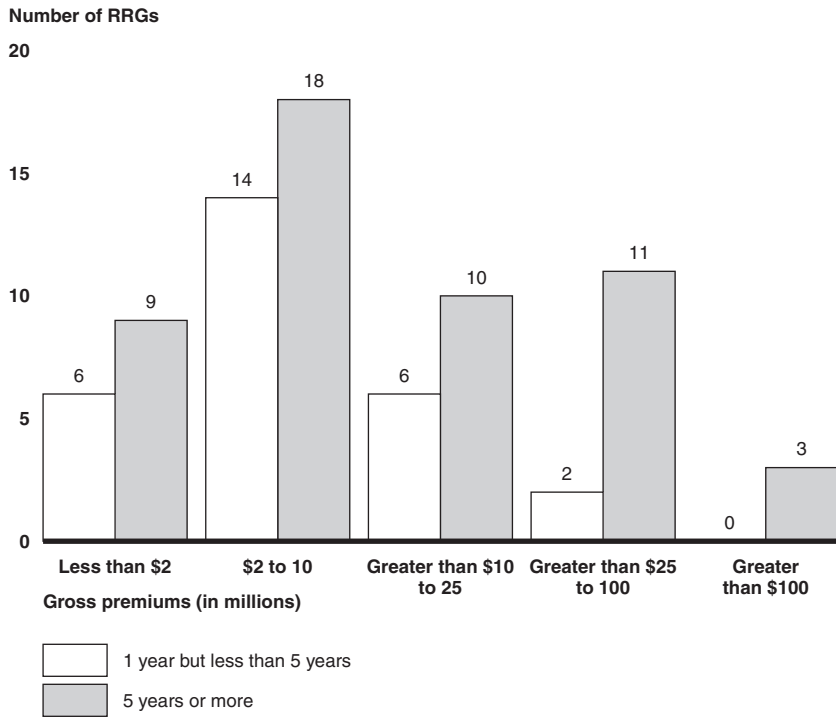
- An RRG that primarily provides insurance to about 45 hospitals in California and Nevada offers general and professional coverage such as personal and bodily injury and employee benefit liability. The RRG also offers a variety of risk-management services specifically aimed at reducing losses and controlling risks in hospitals. According to an RRG official, adequately managing risk within the RRG has allowed for more accurate pricing of the liability coverage available to members.

RRGs Have Remained Relatively Small in Size Compared with Traditional Insurers but Serve a Wide Variety of Markets

Generally, RRGs have remained relatively small compared with traditional insurers. Based on our analysis of 2003 financial data submitted to NAIC, 47 of the 79 RRGs (almost 60 percent) that had been in business at least 1 year, wrote less than \$10 million in gross premiums, whereas only 644 of 2,392 traditional insurers (27 percent) wrote less than \$10 million. In contrast, 1,118 traditional insurers (almost 47 percent) wrote more than \$50 million in gross premiums for 2003 compared with six RRGs (8 percent). Further, these six RRGs (all of which had been in business for at least 1 year) accounted for 52 percent of all gross premiums that RRGs wrote in 2003. This information suggests that just a few RRGs account for a disproportionate amount of the RRG market.

Additionally, RRGs that wrote the most business tended to have been in business the longest. For example, as measured by gross premiums written, of the 16 RRGs that sold more than \$25 million annually, 14 had been in business 5 years or more (see fig. 1). Yet, the length of time an RRG has been in operation is not always the best predictor of an RRG's size. For example, of the 51 RRGs that had been in business for 5 or more years, 27 still wrote \$10 million or less in gross premiums.

Figure 1: RRG Gross Premiums Written in 2003, by Time (Years) in Business



Source: GAO analysis of NAIC data.

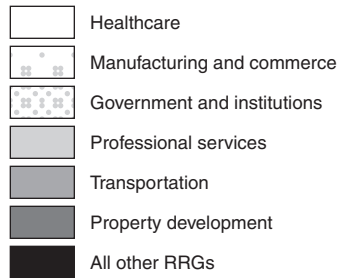
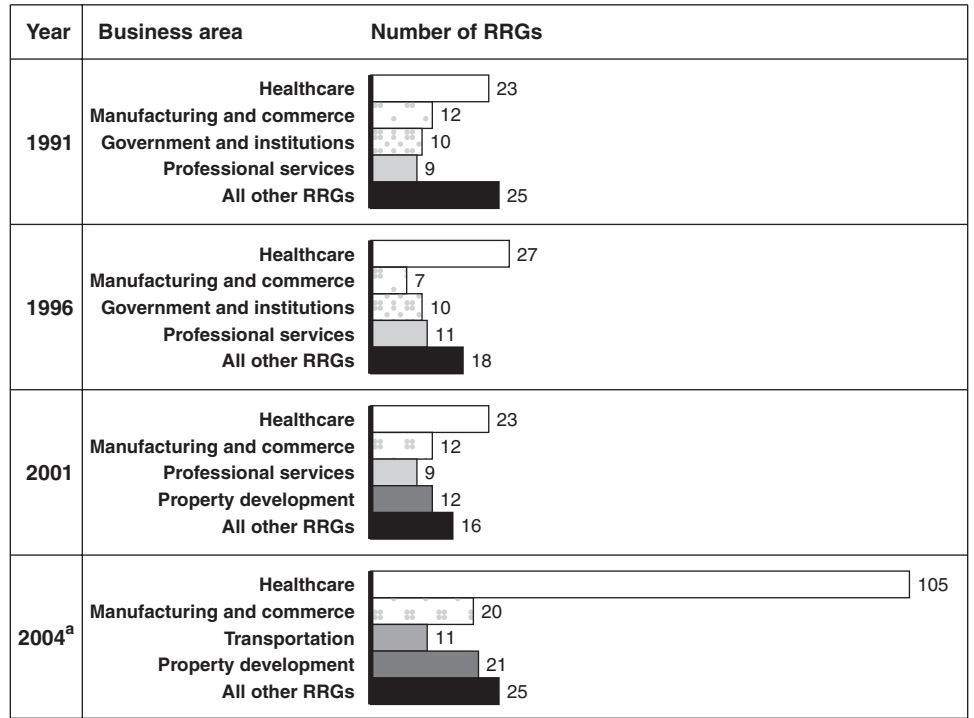
^aThis figure compares the amount of gross premiums written in 2003 by the 79 RRGs that had been in business for at least 1 year. Of the 79, 51 had at least 5 years of business experience, and 28 had between 1 and 5 years.

According to the *Risk Retention Reporter (RRR)*, a trade journal that has covered RRGs since 1986, RRGs insure a wide variety of organizations and businesses.²⁷ According to estimates published in *RRR*, in 2004 105 RRGs (more than half of the 182 in operation at that time) served the healthcare sector (for example, hospitals, nursing homes, and doctors). In 1991, RRGs serving physicians and hospitals accounted for about 90 percent of healthcare RRGs. However, by 2004, largely because of a recent increase in nursing homes forming RRGs, this percentage decreased to about 74 percent.²⁸ In addition, in 2004, 21 RRGs served the property development area (for example, contractors and homebuilders), and 20 served the manufacturing and commerce area (for example, manufacturers and distributors). Other leading business areas that RRGs served include professional services (for example, attorneys and architects), and government and institutions (for example, educational and religious institutions). Figure 2 shows how the distribution of RRGs by business area has changed since 1991.

²⁷Since NAIC does not collect information on the business areas served by insurance companies, including RRGs, we obtained this information from *RRR*. Over the years, *RRR* has surveyed RRGs, for example, asking RRGs to project their premiums. The 2004 data we cited are based on projections published by *RRR* in its October 2004 issue. To arrive at these estimates, *RRR* projected the total number of RRGs based on the number it identified operating as of the end of September 2004 and the total amount of premium based on information obtained from its annual survey of RRGs. For 2004, *RRR* reported a survey response rate of about 75 percent.

²⁸In 2004, according to our analysis of RRG information collected by *RRR*, about 43 percent (45) of healthcare RRGs insured hospitals and their affiliates, 31 percent (33) insured physicians, and 18 percent (19) served nursing homes. However, the number of RRGs covering hospitals and physicians has increased since 1991. In 1991, 8 RRGs provided coverage to hospitals and their affiliates, and 13 RRGs provided coverage to physicians.

Figure 2: Number of RRGs, by Business Area for Selected Years

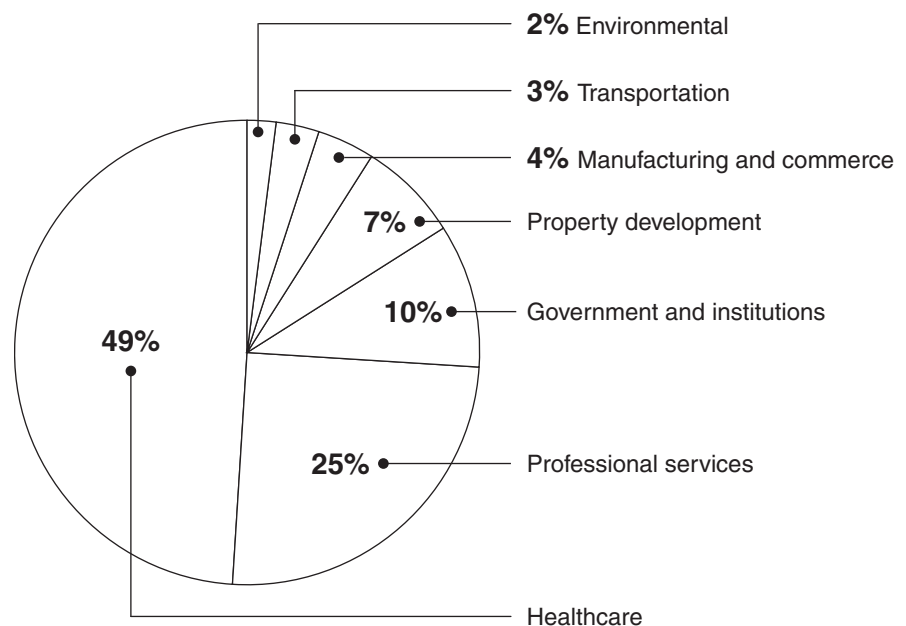


Source: Risk Retention Reporter.

^aThe RRG numbers that *RRR* projected for 2004 are based on the number of RRGs the journal identified operating as of the end of September 2004. For each year, we show only the four business areas with the highest number of RRGs, and group all other areas in a fifth category.

Additionally, according to *RRR*'s estimates, almost half of all RRG premiums collected in 2004 were in the healthcare area (see fig. 3). The professional services and government and institutions business areas accounted for the second and third largest percentage of estimated gross premiums collected, respectively.²⁹

Figure 3: Percentage of Estimated Gross Premiums RRGs Collected in 2004, by Business Area



Source: *Risk Retention Reporter*.

Note: Gross premium data estimates are based on information *RRR* collected from RRGs during a 2004 survey. *RRR* reported projections for all of 2004 in October 2004.

²⁹While relatively few in number, RRGs serving the professional services business area still accounted for a high percentage of estimated gross premiums written by RRGs. One reason may be membership numbers. According to *RRR*, RRGs in the professional services business area had the highest number of members of all business areas.

In looking at other characteristics of RRGs, according to an NAIC analysis, the average annual failure rate for RRGs was somewhat higher than the average annual failure rate for all other property and casualty insurers. Between 1987 and 2003, the average annual failure rate for RRGs was 1.83 percent compared with the 0.78 percent failure rate for property and casualty insurers.³⁰ Over this period, NAIC determined that a total of 22 RRGs failed, with between no and five RRGs failing each year.³¹ In comparison, NAIC determined that a total of 385 traditional insurers failed, with between 5 and 57 insurance companies failing each year. Although the difference in failure rates was statistically significant, it should be noted that the comparison may not be entirely parallel. NAIC compared RRGs that can sell only commercial liability insurance to businesses with insurers that can sell all lines of property and casualty (liability) for commercial and personal purposes.³² Moreover, because NAIC included all property-casualty insurers, no analysis was done to adjust for size and longevity.

³⁰To determine the failure rate for RRGs and traditional insurance companies, NAIC compared the total number of “failed” insurance companies each year with the total number of insurance companies writing business in each year. NAIC characterized insurance companies as “failed” if a state regulator placed the company into rehabilitation, conservation, or liquidation. See appendix I for more information about NAIC’s methodology, and definitions of rehabilitation, conservation, and liquidation. See appendix IV for a list of the RRGs that have failed.

³¹According to NAIC data, between 1991 and 2003, 21 other RRGs voluntarily dissolved (with all claims paid) and 4 other RRGs combined or merged with other companies.

³²Traditional insurance companies write both property and casualty (that is, liability) insurance, but due to the time-intensive nature of the many tasks involved in this analysis, NAIC could not create a peer group of traditional companies that only wrote commercial liability insurance and were similar in size to RRGs. For example, in 2003 the largest traditional insurer wrote \$32 billion in premiums, whereas the largest RRG wrote \$308 million. See appendix I for more information.

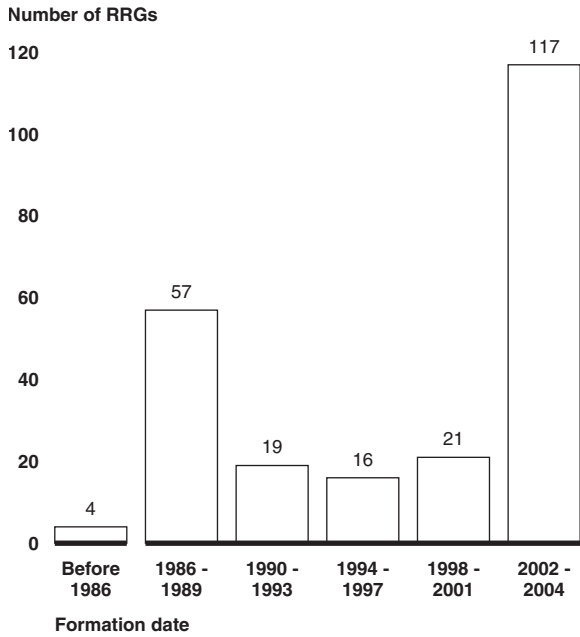
Recent Market Conditions Have Prompted the Creation of Many RRGs, Especially to Provide Medical Malpractice Insurance

In creating RRGs, companies and organizations are generally responding to market conditions. As the availability and affordability of insurance decreased (creating a “hard” market), some insurance buyers sought alternatives to traditional insurance and turned to RRGs.³³ In response, more RRGs formed from 2002 through 2004 than in the previous 15 years (1986–2001). This increase is somewhat similar in magnitude to an increase that occurred in 1986–1989 in response to an earlier hard market for insurance (see fig. 4).³⁴ The 117 RRGs formed from January 1, 2002, through December 31, 2004, represent more than half of all RRGs in operation as of December 31, 2004.

³³During a hard market, insurance prices rise and insurers tend to narrow their coverage, tighten their underwriting standards, and withdraw from certain markets. Soft and hard market cycles in the medical malpractice market tend to be more extreme than in other insurance markets because of the longer time required to resolve medical malpractice claims and other factors, such as changes in investment income and reduced competition, which can exacerbate price fluctuations. See GAO, *Medical Malpractice Insurance: Multiple Factors Have Contributed to Increased Premium Rates*, [GAO-03-702](#) (Washington, D.C.: June 27, 2003).

³⁴According to NAIC, during the mid-1980s, professionals, businesses, nonprofit organizations, and governmental entities experienced significant increases in their liability insurance premiums, while finding it more difficult to obtain coverage. See NAIC, *Cycles and Crises in Property/Casualty Insurance: Cases and Implications for Public Policy* (Kansas City, Mo.: 1991).

Figure 4: Number of RRGs, by Formation Date



Source: GAO analysis of NAIC data.

Note: This figure represents the number of RRGs formed during different periods, regardless of whether they are currently active or not, and includes only those RRGs for which NAIC has data. According to NAIC data, four companies either formed as RRGs or converted to RRGs after the passage of the Product Liability Risk Retention Act of 1981.

More specifically, RRGs established to provide medical malpractice insurance accounted for most of the increase in RRG numbers in 2002–2004.³⁵ Healthcare providers sought 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 have contributed to the high risks of providing medical malpractice insurance.³⁶ From 2002 through 2004, healthcare RRGs accounted for nearly three-fourths of all RRG formations. Further, 105 RRGs were insuring healthcare providers as of the end of 2004, compared with 23 in previous years (see again fig. 2). These RRGs serve a variety of healthcare providers. For example, during 2003, 23 RRGs formed to insure hospitals and their affiliates, 13 formed to insure physician groups, and 11 formed to insure long-term care facilities, including nursing homes and assisted living facilities. However, the dramatic increase in the overall number of RRGs providing medical malpractice insurance may precipitate an increase in the number of RRGs vulnerable to failure. Studies have characterized the medical malpractice insurance industry as volatile because the risks of providing medical malpractice insurance are high.³⁷

³⁵This observation was based on our review of formation statistics provided in the March 2005 *RRR*. In 2002–2004, of the 117 newly formed RRGs, 94 were formed to provide healthcare coverage.

³⁶*GAO-03-702*. Medical malpractice insurance operates much like other types of insurance, with insurers collecting premiums from policyholders (physicians, hospitals, etc.) in exchange for an agreement to defend and pay future claims within the limits set by the policy. Medical malpractice insurance has become less profitable due to higher losses on medical malpractice insurance claims, rising reinsurance rates, long lags between the collection of premiums and the payment of claims, and other factors.

³⁷*GAO-03-702*. We concluded that the medical malpractice insurance market is more volatile than the property-casualty insurance market as a whole because of the length of time involved in resolving medical malpractice claims and the volatility of the claims themselves. Our analysis also showed that annual loss ratios for medical malpractice insurers tended to swing higher or lower than those for property-casualty insurers as a whole, reflecting more extreme changes in insurers' expectations. See also NAIC, *Medical Malpractice Insurance Report: A Study of Market Conditions and Potential Solutions to the Recent Crisis* (Kansas City, Mo.: Sept. 12, 2004). NAIC details statistical evidence supporting the long-term volatility of the medical malpractice market and describes several Conning and Company studies spanning nearly a decade that reported increasing volatility, rapid deterioration in the market, and rapidly deteriorating loss ratios.

Finally, many of the recently formed healthcare-related RRGs are selling insurance in states where medical malpractice insurance rates for physicians have increased the most.³⁸ For example, since April 30, 2002, the Pennsylvania Insurance Department has registered 32 RRGs to write medical malpractice products. In addition, since the beginning of 2003, the Texas Department of Insurance has registered 15 RRGs to write medical malpractice insurance, more than the state had registered in the previous 16 years. Other states where recently formed RRGs were insuring doctors include Illinois and Florida, states that have also experienced large increases in medical malpractice insurance premium rates.

LRRA's Regulatory Preemption Has Resulted in Widely Varying Requirements among States and Limited Confidence in RRG Regulation

LRRA's regulatory preemption has allowed states to set regulatory requirements that differ significantly from those of traditional insurers, and from each other, producing limited confidence among regulators in the regulation of RRGs. Many of the differences arise because some states allow RRGs to be chartered as captive insurance companies, which typically operate under a set of less restrictive rules than traditional insurers. As a result, RRGs generally domicile in those states that permit their formation as captive insurance companies, rather than in the states in which they conduct most of their business. For example, RRGs domiciled as captive insurers usually can start their operations with smaller amounts of capital and surplus than traditional insurance companies, use letters of credit to meet minimum capitalization requirements, or meet fewer reporting requirements. Regulatory requirements for captive RRGs vary among states as well, in part because regulation of RRGs and captives are not subject to uniform, baseline standards, such as the NAIC accreditation standards that define a state's regulatory structure for traditional companies. As one notable example, states do not require RRGs to follow the same accounting principles when preparing their financial reports, making it difficult for some nondomiciliary state regulators, as well as NAIC analysts, to reliably assess the financial condition of RRGs. Regulators responding to our survey also expressed concern about the lack of uniform, baseline standards. Few (eight) indicated that they believed

³⁸GAO-03-702. We examined selected states and determined that, since 1999, medical malpractice insurance rates for physicians in some states increased dramatically for several reasons, including increased losses on insurer medical malpractice claims, decreased insurer investment income, the exit of some insurers from the medical malpractice market (either voluntarily or because of insolvency), and increases in reinsurance rates for medical malpractice insurers.

LRRRA's regulatory safeguards and protections, such as the right to file a suit against an RRG in court, were adequate. Further, some regulators suggested that some domiciliary states were modifying their regulatory requirements and practices to make it easier for RRGs to domicile in their state. We found some evidence to support these concerns based on differences among states in minimum capitalization requirements, willingness to charter RRGs to insure parties that sell extended service contracts to consumers, or willingness to charter RRGs primarily started by service providers, such as management companies, rather than insureds.

Most RRGs Have Domiciled in States That Charter Them as Captives but Have Conducted Most of Their Business in Other States

Regulatory requirements for captive insurers are generally less restrictive than those for traditional insurers and offer RRGs several financial advantages. For example, captive laws generally permit RRGs to form with smaller amounts of required capitalization (capital and surplus), the minimum amount of initial funds an insurer legally must have to be chartered.³⁹ While regulators reported that their states generally require traditional insurance companies to have several millions of dollars in capital and surplus, they often reported that RRGs chartered as captives require no more than \$500,000.⁴⁰ In addition, unlike requirements for traditional insurance companies, the captive laws of the six leading domiciliary states permit RRGs to meet and maintain their minimum capital and surplus requirements in the form of an irrevocable letter of credit (LOC) rather than cash.⁴¹ According to several regulators that charter RRGs as captives, LOCs may provide greater protection to the

³⁹Regulators identified their state's minimum statutory capital and surplus requirements for their traditional and captive insurers in response to our survey.

⁴⁰However, according to the leading domiciliary state regulators, regardless of the statutory minimum requirement, they determine an RRG's actual operating capital and surplus needs based on an assessment of the RRG's proposed business plan and the amount of capitalization necessary to avoid financial difficulties. Also, the statutory minimum for capitalizing new RRGs still may be higher than those for pure captives. For example, for pure captives, Nevada requires \$200,000 and Vermont \$250,000, but for RRGs, Nevada requires \$500,000 and Vermont \$1 million.

⁴¹For an RRG, an LOC 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 LOC could not be canceled or amended without the beneficiary's approval. NAIC reviewed the financial statements of 49 RRGs that commenced business in 2003 and identified 13 that were capitalized with LOCs.

insureds than cash when only the insurance commissioner can access these funds. The insurance commissioner, who would be identified as the beneficiary of the LOC, could present the LOC to the bank and immediately access the cash, but a representative of the RRG could not. However, other state regulators questioned the value of LOCs because they believed cash would be more secure if an RRG were to experience major financial difficulties. One regulator noted that it becomes the regulator's responsibility, on a regular basis, to determine if the RRG is complying with the terms of the LOC. In addition, in response to our survey, most regulators from states that would charter RRGs as captives reported that RRGs would not be required to comply with NAIC's risk-based capital (RBC) requirements.⁴² NAIC applies RBC standards to measure the adequacy of an insurer's capital relative to their risks. Further, RRGs chartered as captives may not be required to comply with the same NAIC financial reporting requirements, such as filing quarterly and annual reports with NAIC, that regulators expect traditional insurance companies to meet.⁴³ For example, while the statutes of all the leading domiciliary states require RRGs chartered as captives to file financial reports annually with their insurance departments, as of July 2004, when we conducted our survey, the statutes of only half the leading domiciliary states—Hawaii,

⁴²Almost all regulators responded that RRGs chartered as traditional companies would have to comply with NAIC's RBC requirements, but only 7 of 19 regulators responded that RRGs chartered as captives would have to comply with these requirements. See appendix II for more information about the survey question and appendix III for more information about RBC requirements.

⁴³LRRA only requires that each RRG submit to the insurance commissioner of each state in which it is doing business a copy of its annual financial statement. 15 U.S.C. § 3902(d)(1)(3). In response to our survey, 14 of 18 regulators indicated that the laws and regulations of their state would require RRGs domiciled in their state to submit the same financial information as traditional insurers to NAIC, but additional discussions with regulators from the six leading domiciliary states suggested that some regulators may have based their responses on their department's practices, rather than the statutes of their state. Arkansas, Montana, Rhode Island, and Utah were the four states that reported that RRGs would not have to submit the same financial information to NAIC as traditional insurers. See the next section for more information on NAIC's accreditation standards and appendix II for more information about the survey question.

South Carolina, and Vermont—explicitly require that these reports also be provided to NAIC on an annual basis.⁴⁴

In addition, when RRGs are chartered as captive insurance companies they may not have to comply with the chartering state’s statutes regulating insurance holding company systems. All 50 states and the District of Columbia substantially have adopted such statutes, based on NAIC’s Model Insurance Holding Company System Regulatory Act.⁴⁵

As in the model act, a state’s insurance holding company statute generally requires insurance companies that are part of holding company systems and doing business in the state to register with the state and annually disclose to the state insurance regulator all the members of that system. Additionally, the act requires that transactions among members of a holding company system be on fair and reasonable terms, and that insurance commissioners be notified of and given the opportunity to review certain proposed transactions, including reinsurance agreements, management agreements, and service contracts. For 2004, NAIC reviewed RRG annual reports and identified 19 RRGs that reported themselves as being affiliated with other companies (for example, their management and reinsurance companies). However, since only two of the six leading domiciliary states, Hawaii, and to some extent South Carolina, actually require RRGs to comply with this act, we do not know whether more RRGs

⁴⁴The District of Columbia has since amended its Risk Retention Act of 1993 (D.C. Law 10-46, D.C. Code §§ 31-4101 et seq.) to require RRGs chartered as captives to file an annual statement with NAIC, on a form prescribed by NAIC. Since its enactment in 1993, the District of Columbia Risk Retention Act has required all RRGs chartered in the District to file a copy of their annual statements with NAIC. According to the District regulator, RRGs chartered as captives were not subject to this requirement prior to the 2004 amendments to the act.

⁴⁵NAIC Model Insurance Holding Company System Regulatory Act (2001). The NAIC model act defines an “insurance holding company system” as consisting of two or more affiliated entities, one or more of which is an insurer. An “affiliate” of an insurer is defined as a person that directly or indirectly controls, is controlled by, or is under common control with the insurer. “Control” over a person is defined as the power to direct management and policies of that person and is presumed to exist if one can vote 10 percent or more of the voting securities of the other person. Some states specifically exempt RRGs from the requirements of their insurance holding company act, and some states give their insurance commissioners discretionary authority to exempt RRGs from the requirements of the act.

could be affiliated with other companies.⁴⁶ The Hawaii regulator said that RRGs should abide by the act's disclosure requirements so that regulators can identify potential conflicts of interests with service providers, such as managers or insurance brokers. Unless an RRG is required to make these disclosures, the regulator would have the added burden of identifying and evaluating the nature of an RRG's affiliations. He added that such disclosures are important because the individual insureds of an RRG, in contrast to the single owner of a pure captive, may not have the ability to control potential conflicts of interest between the insurer and its affiliates. (See the next section of this report for examples of how affiliates of an RRG can have conflicts of interest with the RRG.)

Because of these regulatory advantages, RRGs are more likely to domicile in states that will charter them as captives than in the states where they sell insurance. Figure 5 shows that 18 states could charter RRGs as captives. The figure also shows that most RRGs have chosen to domicile in six states—Arizona, the District of Columbia, Hawaii, Nevada, South Carolina, and Vermont—all of which charter RRGs as captives and market themselves as captive domiciles.⁴⁷ Of these states, Vermont and Hawaii have been chartering RRG as captives for many years, but Arizona, the District of Columbia, Nevada, South Carolina, and five additional states have adopted their captive laws since 1999.⁴⁸ In contrast to an RRG

⁴⁶According to NAIC, the annual statement instructions indicate that companies must identify on the appropriate schedule (that is, Schedule Y) whether they are part of a holding company if the "reporting company is required to file a registration statement under the provisions of the domiciliary state's Insurance Holding Company System Regulatory Act." Thus, if the RRG is not subject to the act, it would not be required to complete Schedule Y, Part I. South Carolina regulators reported that RRGs now are subject to the Insurance Holding Company System Regulatory Act as a result of changes made to their statute in 2004.

⁴⁷The six leading domiciliary states had chartered 88 percent of all RRGs operating as of December 31, 2004. This percentage is an estimate based on data NAIC reported to us in February 2005. NAIC's database may have excluded RRGs that had been chartered but had not yet filed with NAIC. For example, the State of Nebraska reported that it had chartered an RRG in 2002 but this RRG did not appear on NAIC's list of RRGs. In addition, the database included several RRGs that were no longer active as RRGs or were mislabeled as RRGs.

⁴⁸In response to our survey, 18 states reported that they had captive laws under which RRGs could be chartered. Of these, nine reported that they adopted their captive laws between the beginning of 1999 and mid-2004. In addition, according to NAIC data, Vermont chartered its first RRG in 1987, and Hawaii chartered its first RRG in 1988.

chartered as a captive, a true captive insurer generally does not directly conduct insurance transactions outside of its domiciliary state.

Figure 5: Number of RRGs, by Captive or Noncaptive Charter and State of Domicile, as of the End of 2004



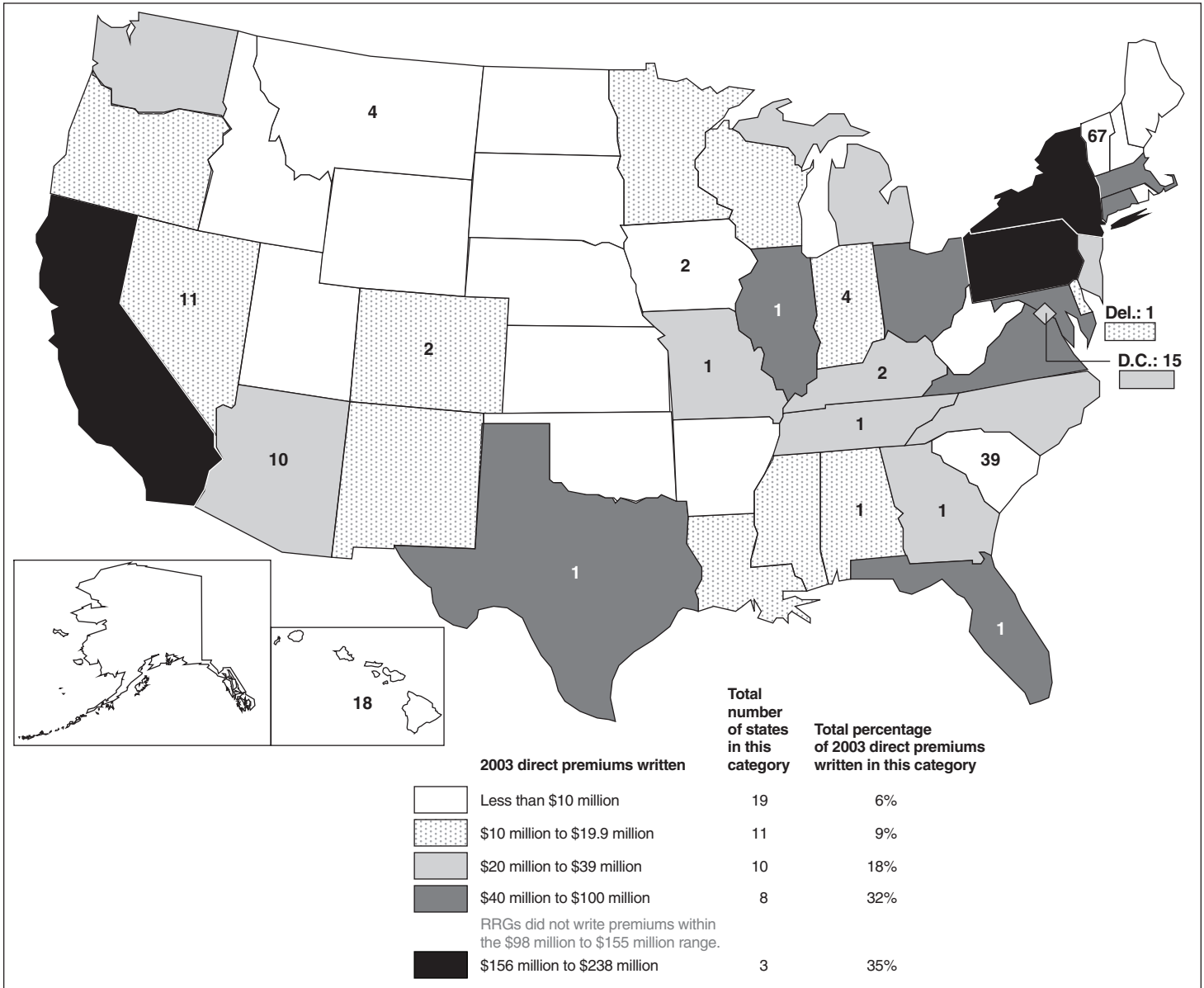
Sources: GAO and NAIC.

Note: States, with the exception of Maryland, provided us information about their captive laws as part of our survey. We did not independently verify the information provided or whether RRGs domiciled in the state were chartered as captives, although we updated some of the survey results to reflect states that have adopted captive statutes since the time of our survey. In addition, (1) the State of Maine indicated that while it had a captive law, the question of whether or not an RRG could form under it had not been formally considered and (2) the State of Kansas indicated that while it could charter RRGs as captives, its captive law does not explicitly permit RRGs to be chartered as captives.

However, states of domicile are rarely the states in which RRGs sell much, or any, insurance. According to NAIC, 73 of the 115 RRGs active in 2003 did not write any business in their state of domicile, and only 10 wrote more than 30 percent of their business in their state of domicile.⁴⁹ The states in which RRGs wrote most of their business in 2003—Pennsylvania (\$238 million), New York (\$206 million), California (\$156 million), Massachusetts (\$98 million)—did not charter any RRGs. Texas, which chartered only one RRG, had \$87 million in direct written premiums written by RRGs. For more information on the number of RRGs chartered by state and the amount of direct premiums written by RRGs, see figure 6.

⁴⁹“Business” refers to direct written premiums. Direct written premiums equals the total amount of premiums an insurer writes annually on all policies without adjustments for ceding or assuming any portion of these premiums to a reinsurance company.

Figure 6: Number of RRGs Chartered, by State, as of the End of 2004, and Amount of Direct Premiums Written by RRGs, by State, 2003



Sources: GAO and NAIC.

Note: The numbers displayed on some states in the map represent the number of RRGs domiciled in the state. For 2003, RRGs also wrote business in places such as Puerto Rico, Guam, and Canada (less than \$17 million).

Inconsistent Regulation of RRGs Resembles Earlier Regulation of Traditional Insurers, Which Suffered from Lack of Uniform, Baseline Standards

The current regulatory environment for RRGs, characterized by the lack of uniform, baseline standards, offers parallels to the earlier solvency regulation of multistate traditional insurers. Uniformity in solvency regulation for multistate insurers is important, provided the regulation embodies best practices and procedures, because it strengthens the regulatory system across all states and builds trust among regulators. After many insurance companies became insolvent during the 1980s, NAIC and the states recognized the need for uniform, baseline standards, particularly for multistate insurers.⁵⁰ To alleviate this situation, NAIC developed its Financial Regulation Standards and Accreditation Program (accreditation standards) in 1989 and began the voluntary accreditation of most state regulators in the 1990s. Prior to accreditation, states did not uniformly regulate the financial solvency of traditional insurers, and many states lacked confidence in the regulatory standards of other states. By becoming accredited, state regulators demonstrated that they were willing to abide by a common set of solvency standards and practices for the oversight of the multistate insurers chartered by their state. As a result, states currently generally defer to an insurance company's domiciliary state regulator, even though each state retains the authority, through its licensing process, to regulate all traditional insurance companies selling in the state.

⁵⁰See also GAO, *Insurance Regulation Assessment of the National Association of the Insurance Commissioners*, GAO/T-GGD 91-37 (Washington, D.C.: May 22, 1991). We assessed the capability of NAIC to create and maintain an effective national system for solvency regulation. As part of this assessment, we observed that states varied widely in the quality of their solvency regulation, and states did not have consistent solvency laws and regulation.

NAIC's accreditation standards define baseline requirements that states must meet for the regulation of traditional companies in three major areas: First, they include minimum standards for the set of laws and regulations necessary for effective solvency regulation.⁵¹ Second, they set minimum standards for practices and procedures, such as examinations and financial analysis, which regulators routinely should do.⁵² Third, they establish expectations for resource levels and personnel practices, including the amount of education and experience required of professional staff, within an insurance department.⁵³ However, NAIC does not have a similar set of regulatory standards for regulation of RRGs, which also are multistate insurers.

According to NAIC officials, when the accreditation standards originally were developed, relatively few states were domiciling RRGs as captive insurers, and the question of standards for the regulation of captives and RRGs did not materialize until NAIC began its accreditation review of Vermont in 1993. NAIC completely exempted the regulation of captive insurers from the review process but included RRGs because, unlike pure captives, RRGs have many policyholders and write business in multiple states. NAIC's accreditation review of Vermont lasted about 2 years and NAIC and Vermont negotiated an agreement that only part of the accreditation standards applied to RRGs.⁵⁴ As a result of the review, NAIC determined that RRGs were sufficiently different from traditional insurers so that the regulatory standards defining the laws and regulations

⁵¹These accreditation standards also are known as Part A. To meet the requirements of Part A, state legislatures must adopt all of NAIC's 18 model laws and regulations (or versions that are substantially similar) and have authorized the state insurance regulators to implement appropriate regulations.

⁵²Also known as Part B, these accreditation standards cover the three areas considered necessary for effective solvency regulation—financial analysis, financial examinations, and communication with states—and procedures for troubled companies.

⁵³Also known as Part C, the purpose of these accreditation standards is to ensure that state insurance departments have appropriate organizational and personnel practices that encourage professional development, establish minimum educational and experience requirements, and allow the departments to attract and retain qualified personnel.

⁵⁴Accreditation reviews of states vary in length; for example, they could last a few weeks.

necessary for effective solvency regulation should not apply to RRGs.⁵⁵ However, NAIC and Vermont did not develop substitute standards to replace those they deemed inappropriate. Subsequently, other states domiciling RRGs as captives also have been exempt from enforcing the uniform set of laws and regulations deemed necessary for effective solvency regulation under NAIC's accreditation standards. As a result, some states chartering RRGs as captives do not obligate them, for example, to adopt a common set of financial reporting procedures and practices, abide by NAIC's requirements for risk-based capital, or comply with requirements outlined in that state's version of NAIC's Model Insurance Holding Company System Regulatory Act.⁵⁶

In contrast, while NAIC's standards for the qualifications of an insurance department's personnel apply to RRGs, they do not distinguish between the expertise needed to oversee RRGs and traditional insurance companies. Because half of the 18 states that are willing to charter RRGs as captives have adopted captive laws since 1999, few domiciliary state insurance departments have much experience regulating RRGs as captive insurance companies. Further, in response to our 2004 survey, only three states new to chartering captives—Arizona, the District of Columbia, and South Carolina—reported that they have dedicated certain staff to the oversight of captives.⁵⁷ However, the State of Nevada later reported to us that it dedicated staff to the oversight of captives as of June 2005.

The importance of standards that address regulator education and experience can be illustrated by decisions made by state insurance departments or staff relatively new to chartering RRGs. In 1988, Vermont chartered Beverage Retailers Insurance Co. Risk Retention Group (BRICO). Launched and capitalized by an outside entity, BRICO did not

⁵⁵RRGs chartered as captive insurers are exempt from Part A requirements but Vermont and NAIC agreed that the Part B standards regarding practices and procedures, including financial examinations and analysis, should apply to the regulation of RRGs. However, a state's examinations of an RRG would be based on its own laws and regulations rather than the laws and regulations required by the accreditation standards.

⁵⁶For example, according to NAIC's Part A accreditation standards, state statutes, regulations, or practices should require companies to file their annual and quarterly financial statements with NAIC using procedures and practices prescribed by the NAIC *Accounting Practices and Procedures Manual* (for example, use of statutory accounting principles).

⁵⁷Hawaii and Vermont also reported that they have staff specifically dedicated to the oversight of captives.

have a sufficient number of members as evidenced by the need for an outside entity to provide the capital. It failed in 1995 in large part because it wrote far less business than originally projected and suffered from poor underwriting. Further, according to regulators, BRICO began to write business just as the market for its product softened, and traditional licensed insurers began to compete for the business. As a result, the Vermont regulators said that Vermont would not charter RRGs unless they had a sufficient number of insureds at start-up to capitalize the RRG and make its future operations sustainable. More recently, in 2000, shortly after it adopted its captive statutes, South Carolina chartered Commercial Truckers Risk Retention Group Captive Insurance Company. This RRG, which also largely lacked members at inception, failed within a year because it had an inexperienced management team, poor underwriting, and difficulties with its reinsurance company. The regulators later classified their experience with chartering this RRG, particularly the fact that the RRG lacked a management company, as “lessons learned” for their department. Finally, as reported in 2004, the Arizona insurance department inadvertently chartered an RRG that permitted only the brokerage firm that formed and financed the RRG to have any ability to control the RRG through voting rights. The Arizona insurance department explained that they approved the RRG’s charter when the insurance department was operating under an acting administrator and that the department would make every effort to prevent similar mistakes.

According to NAIC officials, RRGs writing insurance in multiple states, like traditional insurers, would benefit from the adoption of uniform, baseline standards for state regulation, and they plan gradually to develop them. NAIC representatives noted that questions about the application of accreditation standards related to RRGs undoubtedly would be raised again because several states new to domiciling RRGs will be subject to accreditation reviews in the next few years.⁵⁸ However, the representatives also noted, that because the NAIC accreditation team can review the oversight of only a few of the many insurance companies chartered by a state, the team might not select an RRG.

⁵⁸NAIC officials provided us examples of states that would be accredited over the next few years, but they also noted that NAIC generally does not publish this information.

Variations in RRG Reporting Requirements Have Impeded Assessments of Their Financial Condition

As discussed previously, states domiciling RRGs as captives are not obligated to require that RRGs meet a common set of financial reporting procedures and practices. Moreover, even among states that charter RRGs as captives, the financial reporting requirements for RRGs vary. Yet, the only requirement under LRRRA for the provision of financial information to nondomiciliary regulators is that RRGs provide annual financial statements to each state in which they operate. Further, since most RRGs sell the majority of their insurance outside their state of domicile, insurance commissioners from nondomiciliary states may have only an RRG's financial reports to determine if an examination may be necessary.⁵⁹ As we have reported in the past, to be of use to regulators, financial reports should be prepared under consistent accounting and reporting rules and provided in a timely manner that results in a fair presentation of the insurer's true financial condition.⁶⁰

One important variation in reporting requirements is the use by RRGs of accounting principles that differ from those used by traditional insurance companies. The statutes of the District of Columbia, Nevada, South Carolina, and Vermont require their RRGs to use GAAP; Hawaii requires RRGs to use statutory accounting principles (SAP); and Arizona permits RRGs to use either.⁶¹ The 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. In general, SAP is designed to meet the needs of insurance regulators, the primary users of insurance financial statements, and stresses the measurement of an insurer's ability to pay claims (remain solvent) in order to protect insureds. In contrast, GAAP provides guidance that businesses follow in preparing their general purpose financial statements, which provide users such as investors and creditors with useful information that allows them to assess a business' ongoing financial performance. However, inconsistent use of accounting methodologies by

⁵⁹LRRRA permits nondomiciliary states to conduct an examination to determine an RRG's financial condition if the insurance commissioner of the state of domicile has not begun or has refused to begin an examination of the RRG. 15 U.S.C. § 3902(a)(1)(E).

⁶⁰GAO/T-GGD-91-37.

⁶¹According to NAIC, 79 of the 115 RRGs active as of the end of 2003 filed financial statements using GAAP while the others filed using SAP. The RRGs that filed their statements using SAP also were domiciled in states besides Hawaii, such as Colorado, Florida, and Indiana.

RRGs could affect the ability of nondomiciliary regulators to determine the financial condition of RRGs, especially since regulators are used to assessing traditional insurers that must file reports using SAP.⁶²

In addition, the statutes of each of the six domiciliary states allow RRGs, like other captive insurers, to modify whichever accounting principles they use by permitting the use of letters of credit (LOC) to meet statutory minimum capitalization requirements. Strictly speaking, neither GAAP nor SAP would permit a company to count an undrawn LOC as an asset because it is only a promise of future payment—the money is neither readily available to meet policyholder obligations nor is it directly in the possession of the company. In addition to allowing LOCs, according to a review of financial statements by NAIC, the leading domiciliary states that require RRGs to file financial statements using GAAP also allow RRGs to modify GAAP by permitting them to recognize surplus notes under capital and surplus. This practice is not ordinarily permitted by GAAP. A company filing under GAAP would recognize a corresponding liability for the surplus note and would not simply add it to the company's capital and surplus.⁶³ See appendix III for more specific information on the differences between SAP and GAAP, including permitted modifications, and how these differences could affect assessments of a company's actual or risk-based capital.

Variations in the use of accounting methods have consequences for nondomiciliary regulators who analyze financial reports submitted by RRGs and illustrate some of the regulatory challenges created by the absence of uniform standards. Most nondomiciliary states responding to our survey of all state regulators indicated that they performed only a limited review of RRG financial statements.⁶⁴ To obtain more specific information about the impact of these differences, we contacted the six

⁶²According to NAIC, some states require a reconciliation of GAAP to SAP in the “note” sections of their financial statements.

⁶³A surplus note is debt that an insurance company owes and that the lender has agreed cannot be repaid without regulatory approval. See appendix III for more information.

⁶⁴In response to our survey, 22 state regulators indicated they gave RRG financial statements less review than they gave for eligible nonadmitted insurers (companies not licensed by a particular state to sell and service insurance policies within that state). In contrast, 21 other regulators indicated they provided RRGs the same level of review, and 5 indicated they provided more review. Our evaluation of the 33 regulators who provided written comments showed that many state reviews were limited.

states—Pennsylvania, California, New York, Massachusetts, Texas, and Illinois—where RRGs collectively wrote almost half of their business in 2003 (see fig. 6). Regulators in Massachusetts and Pennsylvania reported that they did not analyze the financial reports and thus had no opinion about the impact of the accounting differences, but three of the other four states indicated that the differences resulted in additional work. Regulators from California and Texas told us that the use of GAAP, especially when modified, caused difficulties because insurance regulators were more familiar with SAP, which they also believed better addressed solvency concerns than GAAP. The regulator from Illinois noted that RRG annual statements were not marked as being filed based on GAAP and, when staff conducted their financial analyses, they took the time to disregard assets that would not qualify as such under SAP. The Texas regulator reported that, while concerned about the impact of the differences, his department did not have the staffing capability to convert the numbers for each RRG to SAP and, as a result, had to prioritize their efforts.

Further, NAIC staff reported that the use by RRGs of a modified version of GAAP or SAP distorted the analyses they provided to state regulators. One of NAIC's roles is to help states identify potentially troubled insurers operating in their state by analyzing insurer financial reports with computerized tools to identify statistical outliers or other unusual data. In the past, 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.⁶⁵ NAIC uses Financial Analysis Solvency Tools (FAST), such as the ratios produced by the Insurance Regulatory Information System (IRIS) and the Insurer Profile Reports, to achieve these objectives and makes the results available to all regulators through a central database.⁶⁶ However, NAIC analysts reported that differing accounting formats undermined the relative usefulness of these tools because the tools were only designed to analyze data extracted from financial reports based on SAP. Similarly, when

⁶⁵GAO, *Insurance Regulation: The NAIC Accreditation Program Can be Improved*, GAO-01-948 (Washington, D.C.: Aug. 31, 2001).

⁶⁶According to NAIC, it stores IRIS ratios and Insurer Profile Reports, and 10 years of annual and quarterly financial data for more than 4,800 individual insurers in its Financial Data Repository database. Nearly all insurers, except for the smallest ones, submit their annual and quarterly reports to NAIC and their domiciliary regulator. NAIC flags IRIS ratios that are outside the "usual range" for additional regulatory attention. In response to an increased focus on RRGs, NAIC recently made an adjustment to the Insurer Profile Reports to notify the user if any RRG might have filed using GAAP.

we attempted to analyze some aspects of the financial condition of RRGs to compare them with traditional companies, we found that information produced under differing accounting principles diminished the usefulness of the comparison (see app. III).

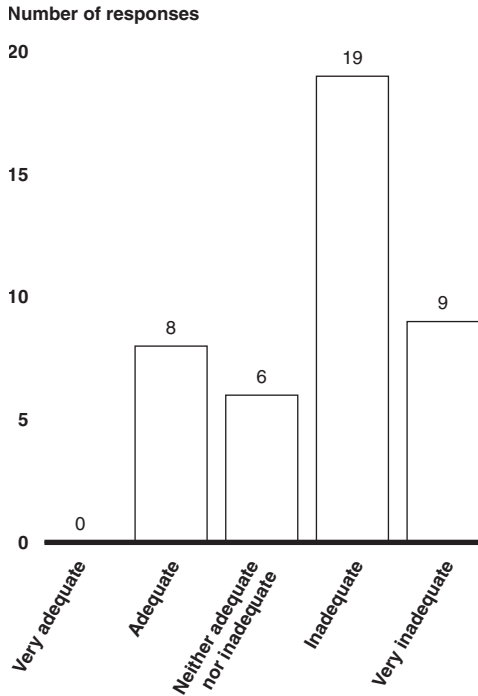
Lack of Uniform, Baseline Regulatory Standards Has Concerned Many Regulators

The lack of uniform, baseline regulatory standards for the oversight of RRGs contributed to the concerns of many state regulators, who did not believe the regulatory safeguards and protections built into LRRRA (such as requiring RRGs to file annual financial statements with regulators and allowing regulators to file suit if they believe the RRG is financially unsound) were adequate.⁶⁷ Only 8 of 42 regulators who responded to our survey question about LRRRA's regulatory protections indicated that they thought the protections were adequate (see fig. 7).⁶⁸ Eleven of the 28 regulators who believed that the protections were inadequate or very inadequate focused on the lack of uniform, regulatory standards or the need for RRGs to meet certain minimum standards—particularly for minimum capital and surplus levels. In addition, 9 of the 28 regulators, especially those from California and New York, commented that they believed state regulators needed additional regulatory authority to supervise the RRGs in their states. While RRGs, like traditional insurers, can sell in any or all states, only the domiciliary regulator has any significant regulatory oversight.

⁶⁷As noted previously, LRRRA requires that RRGs file an initial plan of operation or feasibility study in every state in which it is planning to sell insurance and an annual financial statement with every state in which it is selling insurance. In addition, each nondomiciliary state has the right to (1) request that a domiciliary state examine an RRG, (2) examine the RRG itself if the domiciliary state refuses to do so, and (3) file a suit in a court of "competent jurisdiction" if the state believes that the RRG is in hazardous financial condition.

⁶⁸The states were Delaware, Hawaii, Kansas, Nevada, Ohio, South Dakota, Vermont, and the District of Columbia.

Figure 7: State Regulators' Opinion of the Adequacy of the Regulatory Protections or Safeguards Built into LRRRA



Source: GAO.

Note: In addition, seven regulators responded that they had no opinion on this question, and one regulator did not respond at all.

In addition, the regulators from the six leading domiciliary states—Arizona, the District of Columbia, Hawaii, Nevada, South Carolina, and Vermont—did not agree on the adequacy of LRRRA safeguards. For example, while the regulators from the District of Columbia, Hawaii, Nevada, and Vermont thought the protections adequate, the regulator from South Carolina reported that LRRRA’s safeguards were “neither adequate nor inadequate” because LRRRA delegates the responsibility of establishing safeguards to domiciliary states, which can be either stringent or flexible in establishing safeguards. The other leading domiciliary state—Arizona—had not yet formed an opinion on the adequacy of LRRRA’s provisions. The regulator from Hawaii also noted that the effectiveness of the LRRRA provisions was dependent upon the expertise and resources of the RRG’s domiciliary regulator.

While many regulators did not believe LRRRA's safeguards were adequate, few indicated that they had availed themselves of the tools LRRRA does provide nondomiciliary state regulators. These tools include the ability to request that a domiciliary state undertake a financial examination and the right to petition a court of "competent jurisdiction" for an injunction against an RRG believed to be in a hazardous financial condition. Recent cases involving state regulation of RRGs typically have centered on challenges to nondomiciliary state statutes that affect operations of the RRGs, rather than actions by nondomiciliary states challenging the financial condition of RRGs selling insurance in their states.⁶⁹ Finally, in response to another survey question, nearly half of the regulators said they had concerns that led them to contact domiciliary state regulators during the 24 months preceding our survey, but only five nondomiciliary states indicated that they had ever asked domiciliary states to conduct a financial examination.⁷⁰

However, according to the survey, many state regulators availed themselves of the other regulatory safeguards that LRRRA provides—that RRGs submit to nondomiciliary states feasibility or operational plans before they begin operations in those states and thereafter a copy of the same annual financial statements that the RRG submits to its domiciliary state.⁷¹ Almost all the state regulators indicated that they reviewed these documents to some extent, although almost half of the state regulators indicated that they provided these reports less review than those submitted

⁶⁹Many court cases have involved state financial responsibility statutes that have the effect of precluding RRGs from offering insurance to certain licensed professionals in a particular state, as well as the authority of a state to impose minimum capital and surplus requirement and regulatory fees on RRGs that are chartered in other states. See, e.g., *National Warranty Insurance Co. RRG v. Greenfield*, 214 F.3d 1073 (9th Cir. 2000), *cert. den.*, 531 U.S. 1104 (2001); *Ophthalmic Mutual Ins. Co. v. Musser*, 143 F.3d 1062 (7th Cir. 1998); *Mears Transportation Group v. Florida*, 34 F.3d 1013 (11th Cir. 1994); *National Home Ins. Co. v. King*, 291 F. Supp.2d 518 (E.D. Ky. 2003); *Attorneys' Liability Assur. Society v. Fitzgerald*, 174 F. Supp.2d 619 (W.D. Mich. 2001); *National Risk Retention Assoc. v. Brown*, 927 F. Supp. 195 (1996), *aff'd*, 114 F.3d 1183 (5th Cir. 1997); and *Charter Risk Retention Group v. Rolka et al.*, 796 F. Supp. 154 (M.D. Pa. 1992).

⁷⁰These states were Arizona, California, Mississippi, New Mexico, and Texas.

⁷¹15 U.S.C. § 3902(d)(2). In addition, LRRRA requires RRGs to submit a copy of the group's annual financial statement, certified by an independent public accountant and containing a statement of opinion on loss and loss adjustment expense reserves made by a member of the American Academy of Actuaries, or a qualified loss reserve specialist. 15 U.S.C. § 3902(d)(3).

by other nonadmitted insurers.⁷² In addition, nine states indicated that RRGs began to conduct business in their states before supplying them with copies of their plans of operations or feasibility studies, but most indicated that these occurrences were occasional. Similarly, 15 states identified RRGs that failed to provide required financial statements for review, but most of these regulators indicated that the failure to file was an infrequent occurrence.⁷³

Some Evidence Suggests That States Have Set Their Captive Regulatory Standards to Attract RRGs to Domicile in Their States

Some regulators, including those from New York, California, and Texas—states where RRGs collectively wrote about 26 percent of all their business but did not domicile—expressed concerns that domiciliary states were lowering their regulatory standards to attract RRGs to domicile in their states for economic development purposes. They sometimes referred to these practices as the “regulatory race to the bottom.” RRGs, like other captives, can generate revenue for a domiciliary state’s economy when the state taxes RRG insurance premiums or the RRG industry generates jobs in the local economy. The question of whether domiciliary states were competing with one another essentially was moot until about 1999, when more states began adopting captive laws. Until then, Vermont and Hawaii were two of only a few states that were actively chartering RRGs and through 1998 had chartered about 55 percent of all RRGs. However,

⁷²States call insurers that they have not licensed—but which may be licensed in other states—“nonadmitted” insurers or carriers. States have the ability to prohibit unlicensed insurers from selling in their state. However, some states permit nonadmitted insurers to sell coverage that is unavailable from licensed insurers within their borders. This kind of coverage is also known as “surplus lines insurance.” Historically, policyholders bought surplus lines insurance when the insurance coverage they were seeking was unavailable from admitted insurers. See appendix II for more information about how states responded to these questions.

⁷³In addition, for 2003, 10 regulators identified RRGs that had not registered to conduct business in their states, although the RRGs reported to NAIC that they had written premiums in these states. Most of the 10 state regulators identified just a few RRGs as having failed to register and often the states referred to the same RRGs. In addition, while listed as RRGs in the NAIC database, as of 2003 two of the insurance companies no longer wrote insurance as RRGs.

between the beginning of 1999 and the end of 2004, they had chartered only 36 percent of all newly chartered RRGs.⁷⁴

The six leading domiciliary states actively market their competitive advantages on Web sites, at trade conferences, and through relationships established with trade groups. They advertise the advantages of their new or revised captive laws and most describe the laws as “favorable”; for example, by allowing captives to use letters of credit to meet their minimum capitalization requirements. Most of these states also describe their corporate premium tax structure as competitive and may describe their staff as experienced with or committed to captive regulation. Vermont emphasizes that it is the third-largest captive insurance domicile in the world and the number one in the United States, with an insurance department that has more than 20 years of experience in regulating RRGs. South Carolina, which passed its captive legislation in 2000, emphasizes a favorable premium tax structure and the support of its governor and director of insurance for its establishment as a domicile for captives. Arizona describes its state as “business friendly,” highlighting the lack of premium taxes on captive insurers and the “unsurpassed” natural beauty of the state.

However, in addition to general marketing, some evidence exists to support the concern that the leading domiciliary states are modifying policies and procedures to attract RRGs. We identified the following notable differences among the states, some of which reflect the regulatory practices and approaches of each state and others, statute:

⁷⁴These percentages are estimates based on data that NAIC provided. Not all RRGs, such as those domiciled in Bermuda and the Cayman Islands, or even in the United States, report their chartering information to NAIC. In addition, we found two insurance companies that were mislabeled as RRGs.

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- *Willingness to domicile vehicle service contract (VSC) providers:* Several states, including California, New York, and Washington, questioned whether RRGs consisting of VSC providers should even qualify as RRGs and are concerned about states that allow these providers to form RRGs. VSC providers issue extended service contracts for the costs of future repairs to consumers (that is, the general public) who purchase automobiles. Until 2001, almost all of these RRGs were domiciled in Hawaii but after that date, all the new RRGs formed by VSC providers have domiciled in the District of Columbia and South Carolina.⁷⁵ The Hawaii regulator said that the tougher regulations it imposed in 2001 (requiring that RRGs insuring VSC providers annually provide acceptable proof that they were financially capable of meeting VSC claims filed by consumers) dissuaded these providers from domiciling any longer in Hawaii. In addition, one of the leading domiciliary states, Vermont, refuses to domicile any of these RRGs because of the potential risk to consumers. Consumers who purchase these contracts, not just the RRG insureds, can be left without coverage if the RRG insuring the VSC provider's ability to cover VSC claims fails. (We discuss RRGs insuring service contract providers and consequences to insureds and consumers more fully later in this report.)
 - *Statutory minimum capitalization requirements:* Differences in the minimum amount of capital and surplus (capitalization) each insurer must have before starting operations make it easier for smaller RRGs to domicile in certain states and reflect a state's attitude towards attracting RRGs. For example, in 2003, Vermont increased its minimum capitalization amount from \$500,000 to \$1 million—according to regulators, to ensure that only RRGs that are serious prospects, with sufficient capital, apply to be chartered in the state. On the other hand, effective in 2005, the District of Columbia lowered its minimum capitalization amount for a RRG incorporated as a stock insurer (that is, owned by shareholders who hold its capital stock) from \$500,000 to \$400,000 to make it easier for RRGs to charter there.

⁷⁵Since April 1995 Hawaii chartered seven RRGs to insure VSCs, approving the last such charter in December 2000. As of June 2005, only three of these RRGs remained domiciled in Hawaii. Since January 2001, South Carolina has chartered six RRGs to insure VSCs, with the most recent charter approval in April 2002. Since January 2004, the District of Columbia has chartered three RRGs to insure VSCs, with two of these three RRGs in 2005 redomiciling from Hawaii.

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- *Corporate forms:* In 2005, one of the six leading domiciliary states—the District of Columbia—enacted legislation that permits RRGs to form “segregated accounts.” The other leading domiciliary states permit the formation of segregated accounts or “protected cells” for other types of captives but not for their RRGs. According to the District’s statute, a captive insurer, including an RRG, may fund separate accounts for individual RRG members or groups of members with common risks, allowing members to segregate a portion of their risks from the risks of other members of the RRG.⁷⁶ According to the District regulator, RRG members also would be required to contribute capital to a common account that could be used to cover a portion of each member’s risk. The District regulator also noted that the segregated cell concept has never been tested in insolvency; as a result, courts have not yet addressed the concept that the cells are legally separate.
 - *Willingness to charter entrepreneurial RRGs:* RRGs may be formed with only a few members, with the driving force behind the formation being, for example, a service provider, such as the RRG’s management company or a few members. These RRGs are referred to as “entrepreneurial” RRGs because their future success is often contingent on recruiting additional members as insureds. In 2004, South Carolina regulators reported they frequently chartered entrepreneurial RRGs to offset what they described as the “chicken and egg” problem—their belief that it can be difficult for RRGs to recruit new members without having the RRG already in place. Regulators in several other leading domiciliary states have reported they would be willing to charter such RRGs if their operational plans appeared to be sound but few reported having done so. However, regulators in Vermont said that they would not charter entrepreneurial RRGs because they often were created to make a profit for the “entrepreneur,” rather than helping members obtain affordable insurance. (We discuss entrepreneurial RRGs later in the report.)

⁷⁶The core company would still be formed as a stock company, mutual, or a reciprocal. A stock insurer is an incorporated entity with capital stock divided into shares, which is owned by its shareholders. A mutual insurer is an incorporated entity without capital stock, which is owned by its policyholders. A reciprocal, also known as a reciprocal exchange, is an unincorporated aggregation of subscribers (individual members) who insure each other. Reciprocals are administered by an “attorney-in-fact” who, for example, recruits members, pays losses, or exchanges insurance contracts. The District regulator also indicated that the District would never permit a single member of an RRG to have its own account, even though this prohibition is not specifically stated in the District’s statute.

Finally, the redomiciling of three RRGs to two of the leading domiciliary states, while subject to unresolved regulatory actions in their original state of domicile, also provides some credibility to the regulators' assertions of "regulatory arbitrage." In 2004, two RRGs redomiciled to new states while subject to regulatory actions in their original states of domicile. One RRG, which had been operating for several years, redomiciled to a new state before satisfying the terms of a consent order issued by its original domiciliary state and without notifying its original state of domicile.⁷⁷ Although the RRG satisfied the terms of the consent order about 3 months after it redomiciled, the regulator in the original domiciliary state reported that, as provided by LRRRA, once redomiciled, the RRG had no obligation to do so. The second RRG, one that had been recently formed, was issued a cease and desist order by its domiciliary state because the regulators had questions about who actually owned and controlled the RRG. As in the first case, the original domiciliary state regulator told us that this RRG did not advise them that it was going to redomicile and, once redomiciled, was under no legal obligation to satisfy the terms of the cease and desist order. The redomiciling, or rather liquidation, of the third RRG is more difficult to characterize because its original state of domicile (Hawaii) allowed it to transfer some of its assets to a new state of domicile (South Carolina) after issuing a cease and desist order to stop it from selling unauthorized insurance products directly to the general public, thereby violating the provisions of LRRRA.⁷⁸ More specifically, Hawaii allowed the RRG to transfer its losses and related assets for its "authorized" lines of insurance to South Carolina and required the Hawaiian company to maintain a \$1 million irrevocable LOC issued in favor of the insurance commissioner until such time as the "unauthorized" insurance matter was properly resolved. South Carolina permitted the owners of these assets to form a

⁷⁷A cease and desist order is a formal regulatory communication from an insurance department ordering an insurance company to stop certain activities, such as the issuance of new insurance policies.

⁷⁸*Heritage Warranty Mutual Insurance RRG, Inc.*, Hawaii Department of Commerce and Consumer Affairs, Insurance Division, Cease and Desist Order IC-01-003 (March 1, 2001). This order was issued about 2 months after Heritage Warranty Mutual Insurance RRG, Inc., had entered into a consent agreement in which the RRG voluntarily agreed to surrender its license. (The State of Hawaii had earlier charged that the RRG had changed its reinsurance program without approval of the insurance commissioner, as required by law.) According to the Hawaii Department of Insurance, by December 2000, when the consent order was issued, the RRG had already secured preliminary approval from South Carolina to redomicile to that state. Finally, in September 2002, the State of Hawaii liquidated Heritage Warranty Mutual Insurance RRG, Inc., in response to its sale of unauthorized lines of insurance.

new RRG offering a similar line of coverage and use a name virtually identical to its predecessor in Hawaii. Had these RRGs been chartered as traditional insurance companies, they would not have had the ability to continue operating in their original state of domicile after redomiciling in another state without the original state's express consent. Because traditional companies must be licensed in each state in which they operate, the original state of domicile would have retained its authority to enforce regulatory actions.

RRG Failures Have Raised Questions about the Sufficiency of LRRRA Provisions for RRG Ownership, Control, and Governance

Because LRRRA does not comprehensively address how RRGs may be owned, controlled, or governed, RRGs may be operated in ways that do not consistently protect the best interests of their insureds. For example, while self-insurance is generally understood as risking one's own money to cover losses, LRRRA does not specify that RRG members, as owners, make capital contributions beyond their premiums or maintain any degree of control over their governing bodies (such as boards of directors). As a result, in the absence of specific federal requirements and using the latitude LRRRA grants them, some leading domiciliary regulators have not required all RRG insureds to make at least some capital contribution or exercise any control over the RRG. Additionally, some states have allowed management companies or a few individuals to form what are called "entrepreneurial" RRGs. Consequently, some regulators were concerned that RRGs were being chartered primarily for purposes other than self-insurance, such as making a profit for someone other than the collective insureds. Further, LRRRA does not recognize that separate companies typically manage RRGs. Yet, past RRG failures suggest that sometimes management companies have promoted their own interests at the expense of the insureds. Although LRRRA does not address governance issues such as conflicts of interest between management companies and insureds, Congress previously has enacted safeguards to address similar issues in the mutual fund industry. Finally, some of these RRG failures have resulted in thousands of insureds and their claimants losing coverage, some of whom may not have been fully aware that their RRG lacked state insurance insolvency guaranty fund coverage or the consequences of lacking such coverage.

While RRGs Are a Form of Self-Insurance, Not All RRG Insureds Are Equity Owners or Have the Ability to Exercise Control

While RRGs are a form of self-insurance on a group basis, LRRRA does not require that RRG insureds make a capital investment in their RRG and provides each state considerable authority to establish its own rules on how RRGs will be chartered and regulated. Most of the regulators from the leading domiciliary states reported that they require RRGs to be organized so that all insureds make some form of capital contribution but other regulators do not, or make exceptions to their general approach.⁷⁹ Regulators from Vermont and Nevada emphasized that it was important for each member to have “skin in the game,” based on the assumption that members who make a contribution to the RRG’s capital and surplus would have a greater interest in the success of the RRG. The regulator from Nevada added that if regulators permitted members to participate without making a capital contribution, they were defeating the spirit of LRRRA. However, another of the leading domiciliary states, the District of Columbia, does not require insureds to make capital contributions as a condition of charter approval and has permitted several RRGs to be formed accordingly. The District regulator commented that LRRRA does not require such a contribution and that some prospective RRG members may not have the financial ability to make a capital contribution. Further, despite Vermont’s position that RRG members should make a capital contribution, the Vermont regulators said they occasionally waive this requirement under special circumstances; for example, if the RRG was already established and did not need any additional capital. In addition, several of the leading domiciliary states, including Arizona, the District of Columbia, and Nevada, would consider allowing a nonmember to provide an LOC to fund the capitalization of the RRG.

However, as described by several regulators, including those in Hawaii and South Carolina, even when members do contribute capital to the RRG, the amount contributed can vary and be quite small. For instance, an investor with a greater amount of capital, such as a hospital, could initially capitalize an RRG, and expect smaller contributions from members (for example, doctors) with less capital. Or, in an RRG largely owned by one member, additional members might be required only to make a token investment, for example, \$100 or less. As a result, an investment that small

⁷⁹While the statutes of the six leading domiciliary states do not require that RRG members make a minimum capital contribution to the RRG, the regulators in some of these states, as a condition of granting an RRG’s application for a state charter, exercise their discretionary authority to require RRG members to make capital contributions to the RRG.

would be unlikely to motivate members to feel like or behave as “owners” who were “self-insuring” their risks.

LRRA also does not have a requirement that RRG insureds retain control over the management and operation of their RRG. However, as discussed previously, the legislative history indicates that some of the act’s single-state regulatory framework and other key provisions were premised not only on ownership of an RRG being closely tied to the interests of the insureds, but also that the insureds would be highly motivated to ensure proper management of the RRG. Yet, in order to make or direct key decisions about a company’s operations, the insureds would have to be able to influence or participate in the company’s governing body (for example, a board of directors).⁸⁰ A board of directors is the focal point of an insurer’s corporate governance framework and ultimately should be responsible for the performance and conduct of the insurer.⁸¹ Governance is the manner in which the boards of directors and senior management oversee a company, including how they are held accountable for their actions.⁸²

⁸⁰Membership: “[I]t is the committee’s intent that ‘members’ include the equity owners of, or contributors to, the risk retention group, as well as entities affiliated with or related to such owners or contributors. Membership in a risk retention group should be limited to active participants in a risk retention program.” H. Rep. No. 97-190, at 10, *reprinted in* 1981 U.S.C.A.A.N. at 1439; S. Rep. No. 97-172, at 9. Single-state regulation: “Because risk retention groups will be providing insurance coverage only to their own members, and not the public at large, it is believed that regulation by the chartering jurisdiction will be sufficient to provide adequate supervision of these groups.” H. Rep. No. 97-190, at 15 (1981), *reprinted in* 1981 U.S.C.A.A.N. at 1444; S. Rep. No. 97-172, at 13. Reasons for exclusion from guaranty funds: “First, risk retention groups are not full-fledged multi-line insurance companies, but limited operations providing coverage only to member companies, and only for a narrow group of coverages. Second, there will be a strong incentive for risk retention groups to set adequate premiums and establish adequate reserves if each member knows there is no other source of funds (other than its own corporate assets) from which to pay claims.” H. Rep. No. 97-190, at 16 (1981), *reprinted in* 1981 U.S.C.A.A.N. at 1445; S. Rep. No. 97-172, at 15 (1981).

⁸¹Generally speaking, a board of directors is a group of individuals elected by shareholders that represents the owners of a company and oversees the management of the company. RRG members who receive the right to vote through the RRG’s governing instruments (e.g., articles of incorporation, bylaws) may elect some or all of the RRG’s governing body, providing the insureds with a means of influencing corporate policymaking.

⁸²International Association of Insurance Supervisors, *Insurance Core Principles on Corporate Governance* (Basel, Switzerland: 2004).

Most leading state regulators said they expect members of RRGs to exert some control over the RRG by having the ability to vote for directors, even though these rights sometimes vary in proportion to the size of a member's investment in the RRG or by share class.⁸³ Most of the leading state regulators generally define "control" to be the power to direct the management and policies of an RRG as exercised by an RRG's governing body, such as its board of directors. However, regulators from the District of Columbia asserted that they permit RRGs to issue nonvoting shares to their insureds because some members are capable of making a greater financial contribution than others and, in exchange for their investment, will seek greater control over the RRG. The regulators noted that allowing such arrangements increases the availability of insurance and has no adverse effect on the financial solvency of the RRG. Further, the District of Columbia permits nonmembers (that is, noninsureds) to appoint or vote for directors. In addition, we found that even regulators who expect all RRG members to have voting rights (that is, at a minimum a vote for directors) sometimes make exceptions. For example, an RRG domiciled in Vermont was permitted to issue shares that did not allow insureds to vote for members of the RRG's governing body. The Vermont regulators reported that the attorney forming the RRG believed issuing the shares was consistent with the department's position that RRG members should have "voting rights" because under Vermont law all shareholders are guaranteed other minimal voting rights.⁸⁴

⁸³For example, hospitals and doctors, respectively, may be assigned class A and class B shares, with each classification of shareholder entitled to vote for a different number of directors; additionally, a shareholder could be issued nonvoting shares.

⁸⁴Five of the leading domiciliary states—Arizona, the District of Columbia, Hawaii, Nevada, and Vermont—allowed us to review the bylaws and articles of incorporation of their three most recently domiciled RRGs, providing us an opportunity to review a sampling of their chartering practices.

While most regulators affirmed that they expect RRG members to own and control their RRGs, how these expectations are fulfilled is less clear when an organization, such as an association, owns an RRG. Four states—Arizona, District of Columbia, South Carolina, and Vermont—reported that they have chartered RRGs that are owned by a single or multiple organizations, rather than individual persons or businesses.⁸⁵ One of these states—the District of Columbia—permits noninsureds to own the organizations that formed the RRG. However, the District regulator said that while the noninsureds may own the voting or preferred stock of the association, they do not necessarily have an interest in controlling the affairs of the RRG. In addition, Arizona has permitted three risk purchasing groups (RPGs) to own one RRG.⁸⁶ While the three RPGs, organized as domestic corporations in another state, collectively have almost 8,000 policyholders, four individuals, all of whom are reported to be RRG insureds by the Arizona regulator, are the sole owners of all three RPGs.⁸⁷

⁸⁵Nevada regulators did not respond to our question on whether they had chartered RRGs owned by an organization.

⁸⁶RPGs are businesses with similar risk exposures that join to purchase liability insurance as a single entity.

⁸⁷This structure illustrates the ambiguity surrounding LRRAs ownership requirement as contained in 15 U.S.C. § 3902(a)(4)(E). This provision has been interpreted by both the U.S. Department of Commerce and NAIC to require that all insureds have an ownership interest in the RRG. See, U.S. Department of Commerce, *Liability Risk Retention Act of 1986: Implementation Report* (Washington, D.C.: 1987), at 64; and NAIC Model Risk Retention Act (June 1999), § 2.K Drafter's Note. However, LRRAs does not explicitly state that all insureds must own the RRG, and the matter remains open to interpretation. See, e.g., *Attorneys' Liability Assurance Society v. Fitzgerald*, 174 F.Supp.2d 619, 632-34 (W.D. Mich. 2001) noting the ambiguity surrounding the definition of "member" as it relates to LRRAs ownership requirement. According to the Arizona regulator, the three RPGs are the policyholders and owners of the RRG, but the members of the RPGs who are insured by the RRG do not have an ownership interest in the RRG. Therefore, to the extent this Arizona RRG has insureds that do not have an ownership interest in either the RRG or any of the RPGs that own the RRG, this would seem to depart from an interpretation of LRRAs ownership requirement that all insureds must own the RRG. The domiciliary state of the three RPGs identified the number of entities that purchased insurance policies through the three RPGs. However, we do not know if each policyholder obtained their insurance from the Arizona-domiciled RRG or from another insurance company used by the RPG.

Regulators Expressed Concerns That Some RRGs Might Be Operated to Make Money for an Entrepreneur, Rather Than to Provide Self-Insurance

The chartering of an “entrepreneurial” RRG—which regulators generally define as formed by an individual member or a service provider, such as a management company, for the primary purpose of making profits for themselves—has been controversial. According to several regulators, entrepreneurial RRGs are started with a few members and need additional members to remain viable. The leading domiciliary regulators have taken very different positions on entrepreneurial RRGs, based on whether they thought the advantages entrepreneurs could offer (obtaining funding and members) outweighed the potential adverse influence the entrepreneur could have on the RRG. We interviewed regulators from the six leading domiciliary states to obtain their views on entrepreneurial RRGs. In 2004, South Carolina regulators reported they firmly endorsed chartering entrepreneurial RRGs because they believed that already chartered RRGs stand a better chance of attracting members than those in the planning stages.⁸⁸ They cited cases of entrepreneurial RRGs they believe have met the insurance needs of nursing homes and taxicab drivers. However, regulators from Vermont and Hawaii had strong reservations about this practice because they believe the goal of entrepreneurs is to make money for themselves—and that the pursuit of this goal could undermine the financial integrity of the RRG because of the adverse incentives that it creates. Vermont will not charter entrepreneurial RRGs and has discouraged them from obtaining a charter in Vermont by requiring RRGs (before obtaining their charter) to have a critical mass of members capable of financing their own RRG. In addition, the Vermont regulators said they would not permit an entrepreneur, if just a single owner, to form an RRG as a means of using LRRRA’s regulatory preemption to bypass the licensing requirements of the other states in which it planned to operate. Two of the other leading domiciliary states—Arizona and Nevada—were willing to charter entrepreneurial RRGs, providing they believed that the business plans of the RRGs were sound.⁸⁹

Finally, some of the leading state regulators that have experience with chartering entrepreneurial RRGs told us that they recognized that the

⁸⁸In July 2005, South Carolina officials further commented that the state does not oppose licensing entrepreneurial RRGs provided the group has a sound business plan and satisfies other department requirements. The officials noted that they require entrepreneurial RRGs to meet more stringent initial capital and surplus requirements than other RRGs chartered by their state and that they have conducted “target examinations” on several entrepreneurial RRGs to ensure their compliance with the state’s statutes.

⁸⁹According to District regulators, they were not familiar with the term entrepreneurial RRG.

interests of the RRG insureds have to be protected and that they took measures to do so. For example, the regulators from South Carolina said that even if one member largely formed and financed an RRG, they would try to ensure that the member would not dominate the operations. However, they admitted that the member could do so because of his or her significant investment in the RRG. Alternatively, the regulator from Hawaii reported that the state's insurance division, while reluctant to charter entrepreneurial RRGs, would do so if the RRG agreed to submit to the division's oversight conditions. For example, to make sure service providers are not misdirecting money, the division requires entrepreneurial RRGs to submit copies of all vendor contracts. The Hawaii regulator also told us that the insurance division requires all captives to obtain the insurance commissioner's approval prior to making any distributions of principal or interest to holders of surplus notes. However, he concluded that successful oversight ultimately depended on the vigilance of the regulator and the willingness of the RRG to share documentation and submit to close supervision.

LRRA Lacks Governance Standards to Protect RRG Insureds from Management Companies with Potential Conflicts of Interest

LRRA imposes no governance requirements that could help mitigate the risk to RRG insureds from potential abuses by other interests, such as their management companies, should they choose to maximize their profits at the expense of the best interests of the RRG insureds. Governance rules enhance the independence and effectiveness of governing bodies, such as boards of directors, and improve their ability to protect the interests of the company and insureds they serve. Unlike a typical company where the firm's employees operate and manage the firm, an RRG usually is operated by a management company and may have no employees of its own. However, while management companies and other service providers generally provide valuable services to RRGs, the potential for abuse arises if the interests of a management company are not aligned with the interests of the RRG insureds to consistently obtain self-insurance at the most affordable price consistent with long-term solvency.

These inherent conflicts of interest are exemplified in the circumstances surrounding 10 of 16 RRG failures that we examined.⁹⁰ For example, members of the companies that provided management services to Charter

⁹⁰Since 1990, 22 RRGs have failed using NAIC's definition of failure. We examined 16 of the 22 failures. See appendix I for additional information on how we selected RRGs to examine and appendix IV for a list of the failures.

Risk Retention Group Insurance Company (Charter) and Professional Mutual Insurance Company Risk Retention Group (PMIC) also served as officers of the RRGs' boards of directors, which enabled them to make decisions that did not promote the welfare of the RRG insureds. In other instances, such as the failure of Nonprofits Mutual Risk Retention Group, Inc. (Nonprofits), the management company negotiated terms that made it difficult for the RRG to terminate its management contract and place its business elsewhere. Regulators knowledgeable about these and other failures commented that the members, while presumably self-insuring their risks, were probably more interested in satisfying their need for insurance than actually running their own insurance company.

The 2003 failure of three RRGs domiciled in Tennessee—American National Lawyers Insurance Reciprocal Risk Retention Group (ANLIR), Doctors Insurance Reciprocal Risk Retention Group (DIR), and The Reciprocal Alliance Risk Retention Group (TRA)—further illustrates the potential risks and conflicts of interest associated with a management company operating an RRG.⁹¹ In pending litigation, the State of Tennessee's Commissioner of Commerce and Insurance, as receiver for the RRGs, has alleged that the three RRGs had common characteristics, such as (1) being formed by Reciprocal of America (ROA), a Virginia reciprocal insurer, which also served as the RRGs' reinsurance company; (2) having a management company, The Reciprocal Group (TRG), which also served as the management company and attorney-in-fact for ROA; (3) receiving loans from ROA, TRG, and their affiliates; and (4) having officers and directors in common with ROA and TRG.⁹² The receiver has alleged that through the terms of RRGs' governing instruments, such as its bylaws, management agreements with TRG (which prohibited the RRGs from replacing TRG as

⁹¹The failures of the Tennessee RRGs are at the center of pending lawsuits filed by both the Tennessee and Virginia regulators, as receivers, and class action lawsuits filed by insureds of the Tennessee RRGs. See *Flowers v. General Reinsurance Corporation et al.*, No. 04-CV-2078 (W.D. Tenn. filed Feb. 9, 2004); *Gross v. General Reinsurance Corporation et al.*, No. 03-CV-955 (E.D. Va. filed Nov. 12, 2003); *Michael A. Jaynes, P.C. et al. v. General Reinsurance Corporation et al.* No. 04-2479 (W.D. Tenn. filed July 13, 2004); *Fullen et al. v. General Reinsurance Corporation et al.*, No. 03-2195B (W.D. Tenn. filed Apr. 3, 2003); *Herrick et al. v. General Reinsurance Corporation et al.*, No. 03-W-329-N (M.D. Ala. filed Mar. 26, 2003); and *Crenshaw Community Hospital et al. v. General Reinsurance Corporation et al.*, No. 03-M-338-N (M.D. Ala. filed Mar. 28, 2003).

⁹²The Circuit Court for the City of Richmond determined that "ROA and TRG, as attorney-in-fact for ROA, operate as, and comprise a single insurance business enterprise." *Commonwealth of Virginia v. Reciprocal of America, et al.*, No. CH03000135-00 (Final Order Appointing Receiver, Jan. 29, 2003).

their exclusive management company for as long as the loans were outstanding), and the common network of interlocking directors among the companies, TRG effectively controlled the boards of directors of the RRGs in a manner inconsistent with the best interests of the RRGs and their insureds.⁹³ As alleged in the complaint filed by the Tennessee regulator, one such decision involved a reinsurance agreement, in which the RRGs ceded 90-100 percent of their risk to ROA with a commensurate amount of premiums—conditions that according to the regulator effectively prevented the RRGs from ever operating independently or retaining sufficient revenue to pay off their loans with ROA and TRG and thus remove TRG as their management company.⁹⁴ Within days after the Commonwealth of Virginia appointed a receiver for the rehabilitation or liquidation of ROA and TRG, the State of Tennessee took similar actions for the three RRGs domiciled in Tennessee.⁹⁵

The following failures of other RRGs also illustrate behavior suggesting that management companies and affiliated service providers have promoted their own interests at the expense of the RRG insureds:

- According to the Nebraska regulators, Charter failed in 1992 because its managers, driven to achieve goals to maximize their profits, undercharged on insurance rates in an effort to sell more policies. One board officer and a company manager also held controlling interests in third-party service providers, including the one that determined if claims

⁹³In the complaint filed by Tennessee, the regulator alleged that the loans were unsecured, no payments were anticipated, and due dates for the payments were routinely continued. The Tennessee regulator has charged that “despite their independent fiduciary duties to the RRGs and the inherent conflicts of interest presented, TRG management executed agreements between and among ROA and the RRGs without commercially reasonable terms and arms-length negotiation.” *Flowers v. General Reinsurance Corporation, et al.*, No. 04-CV-2078 (W.D. Tenn. filed Feb. 9, 2004), ¶ 44.

⁹⁴*Flowers v. General Reinsurance Corporation, et al.*, No. 04-CV-2078 (W.D. Tenn. filed Feb. 9, 2004), ¶46.

⁹⁵ROA and TRG were placed into receivership on January 29, 2003, when the Circuit Court of the City of Richmond, Virginia, issued its “Final Order Appointing Receiver for Rehabilitation or Liquidation.” The court determined that the receivership was necessary because any further transaction of business would be hazardous to their policyholders and other affected parties; for example, their creditors and the public. The Chancery Court of the State of Tennessee placed the three RRGs—ANLIR, DIR, and TRA—into receivership on January 31, 2003, due to the hazardous financial condition and receivership of ROA, with which the RRGs reinsured substantially all of their business. In June 2003, the Court issued a Final Order of Liquidation for each of the three RRGs.

should be paid. Further, the board officer and a company manager, as well as the RRG, held controlling interests in the RRG's reinsurance company. A Nebraska regulator noted that when a reinsurance company is affiliated with the insurer it is reinsuring: (1) the reinsurer's incentive to encourage the insurer to adequately reserve and underwrite is reduced and (2) the insurer also will be adversely affected by any unprofitable risk it passes to the reinsurer.

- PMIC, which was domiciled in Missouri and formed to provide medical malpractice insurance coverage for its member physicians, was declared insolvent in 1994. The RRG's relationship with the companies that provided its management services undermined the RRG in several ways. The president of PMIC was also the sole owner of Corporate Insurance Consultants (CIC), a company with which PMIC had a marketing service and agency agreement. As described in the RRG's examination reports, the RRG paid CIC exorbitant commissions for services that CIC failed to provide, but allowed CIC to finance collateral loans made by the reinsurance company to CIC. In turn, CIC had a significant ownership stake in the RRG's reinsurance company, which also provided PMIC with all of its personnel. The reinsurer's own hazardous financial condition resulted in the failure of PMIC.
- In the case of Nonprofits, Vermont regulators indicated that essentially the excessive costs of its outsourced management company and outsourced underwriting and claims operations essentially contributed to its 2000 failure. The regulators said that the management company was in a position to exert undue influence over the RRG's operations because the principals of the management company loaned the RRG its start-up capital in the form of irrevocable LOCs. In addition to charging excessive fees, the management company also locked the RRG into a management contract that only allowed the RRG to cancel the contract 1 year before its expiration. If the RRG did not, the contract would automatically renew for another 5 years, a requirement of which the RRG insureds said they were unaware.

Although LRRRA has no provisions that address governance controls, Congress has acted to provide such controls in similar circumstances in another industry. In response to conditions in the mutual fund industry, Congress passed the Investment Company Act of 1940 (1940 Act). The 1940 Act, as implemented by the Securities and Exchange Commission (SEC), establishes a system of checks and balances that includes participation of

independent directors on mutual fund boards, which oversee transactions between the mutual fund and its investment adviser.⁹⁶ A mutual fund's structure and operation, like that of an RRG, differs from that of a traditional corporation. In a typical corporation, the firm's employees operate and manage the firm; the corporation's board of directors, elected by the corporation's stockholders, oversees its operation. Unlike a typical corporation, but similar to many RRGs, a typical mutual fund has no employees and contracts with another party, the investment adviser, to administer the mutual fund's operations.

Recognizing that the "external management" of most mutual funds presents inherent conflicts between the interests of the fund shareholders and those of the fund's investment adviser, as well as potential for abuses of fund shareholders, Congress included several safeguards in the 1940 Act. For example, with some exceptions, the act requires that at least 40 percent of the board of directors of a mutual fund be disinterested (that is, that directors be independent of the fund's investment adviser as well as certain other persons having significant or professional relationships with the fund) to help ensure that the fund is managed in the best interest of its shareholders.⁹⁷ The 1940 Act also regulates the terms of contracts with investment advisers by imposing a maximum contract term and by guaranteeing the board's and the shareholders' ability to terminate an investment adviser contract.⁹⁸ The act also requires that the terms of any

⁹⁶For purposes of this report, the term "mutual fund" refers generally to open-end investment companies required to register with SEC under the 1940 Act.

⁹⁷15 U.S.C. § 80a-10(a). Persons who are not "interested persons" of the fund are referred to as "independent" or "disinterested directors." Section 2(a)(19) of the 1940 Act [codified at 15 U.S.C. § 80a-2(a)(19)] defines an "interested person" of a mutual fund to include any person, partner, or employee of the mutual fund's investment adviser. SEC has authority under the 1940 Act to promulgate rules to address a constantly changing financial services industry environment in which mutual funds and other investment companies operate. While the 1940 Act requires that 40 percent of a fund's directors be independent, SEC has adopted several exemptive rules that permit mutual fund companies to engage in certain transactions that present conflicts of interests and would otherwise be prohibited or restricted under the 1940 Act, if at least 75 percent of the members of the fund's board of directors and the board chair are disinterested persons.

⁹⁸After an initial term of up to 2 years, the investment adviser contract may be renewed "annually" upon the approval of a majority of the mutual fund's independent directors or a majority of the shareholders. 15 U.S.C. § 80a-15(a). The mutual fund's board of directors or its shareholders have the right to terminate the investment adviser contract at any time after providing adequate advance notice (60 days or less) as specified in the contract. 15 U.S.C. § 80a-15(c).

contract with the investment adviser and the renewal of such contract be approved by a majority of directors who are not parties to the contract or otherwise interested persons of the investment adviser. Further, the 1940 Act imposes a fiduciary duty upon the adviser in relation to its level of compensation and provides the fund and its shareholders with the right to sue the adviser should the fees be excessive.⁹⁹ The management controls imposed on mutual fund boards do not supplant state law on duties of “care and loyalty” that oblige directors to act in the best interests of the mutual fund, but enhance a board’s ability to perform its responsibilities consistent with the protection of investors and the purposes of the 1940 Act.

RRG Members May Not Realize They Lack Guaranty Fund Protection

In addition to lacking comprehensive provisions for ownership, control, and governance of RRGs, LRRRA does not mandate that RRGs disclose to their insureds that they lack state insurance insolvency guaranty fund protection. LRRRA’s legislative history indicates that the prohibition on RRGs participating in state guaranty funds (operated to protect insureds when traditional insurers fail) stemmed, in part, from a belief that the lack of protection would help motivate RRG members to manage the RRG prudently. LRRRA does provide nondomiciliary state regulators the authority to mandate the inclusion of a specific disclosure, which informs RRG insureds that they lack guaranty fund coverage, on insurance policies issued to residents of their state (see fig. 8).¹⁰⁰ However, LRRRA does not provide nondomiciliary states with the authority to require the inclusion of this disclaimer in policy applications or marketing materials. For example, of 40 RRGs whose Web sites we were able to identify, only 11 disclosed in their marketing material that RRGs lack guaranty fund protection. In

⁹⁹Section 36(b) of the Investment Company Act [codified at 15 U.S.C. § 80a-35(b)] authorizes excessive fee claims against officers, directors, members of an advisory board, investment advisers, depositors, and principal underwriters if such persons received compensation from the fund. In addition, pursuant to Section 206 of the Investment Advisers Act of 1940, an investment adviser has a fiduciary duty to act in the best interests of a fund it advises. Act of August 22, 1940, c. 686, 54 Stat. 852, § 206 (codified as amended at 15 U.S.C. § 80b-6). Typically, under state common law a fiduciary must act with the same degree of care and skill that a reasonably prudent person would use in connection with his or her affairs. See also [GAO/GGD-00-126](#).

¹⁰⁰15 U.S.C. § 3902(a)(1)(I). In addition to the six domiciliary states, we conducted further research in eight additional states—California, Florida, Illinois, New York, Ohio, Pennsylvania, Tennessee, and Texas—to obtain the perspectives of other states that had domiciled few or no RRGs. These states all required that RRGs operating in their state include the lack of guaranty fund disclosure on their policies.

addition, 11 of the RRGs omitted the words “Risk Retention Group” from their names.¹⁰¹

Figure 8: Permitted Wording of Guaranty Fund Disclosure in LRRRA

<p>NOTICE</p> <p>This policy is issued by your risk retention group. Your risk retention group may not be subject to all of the insurance laws and regulations of your State. State insurance insolvency guaranty funds are not available for your risk retention group.</p>
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Source: LRRRA.

All of the six leading domiciliary states have adopted varying statutory requirements that RRGs domiciled in their states include the disclosure in their policies, regardless of where they operate. The statutes of Hawaii, South Carolina, and the District of Columbia require that the disclosure be printed on applications for insurance, as well as on the front and declaration page of each policy. By requiring that the disclosure be printed on insurance applications, prospective RRG insureds have a better chance of understanding that they lack guaranty fund protection. Regulators in South Carolina, based on their experience with the failure of Commercial Truckers RRG in 2001, also reported that they require insureds, such as those of transportation and trucking RRGs, to place their signature beneath the disclosure. The regulators imposed this additional requirement because they did not believe that some insureds would be as likely to understand the implications of not having guaranty fund coverage as well as other insureds (for example, hospital conglomerates). In contrast, the statutes of Arizona and Vermont require only that the disclosure be printed on the insurance policies. The six leading domiciliary state regulators had mixed views on whether the contents of the disclosure should be enhanced, but none recommended that LRRRA be changed to permit RRGs to have guaranty fund protection.

¹⁰¹LRRRA requires that the name of any RRG should include the phrase “Risk Retention Group.” 15 U.S.C. § 3901(a)(4)(H). We performed our initial search of RRG Web sites in August 2004, based on a listing of 160 RRGs NAIC identified active as of the beginning of June 2004. We updated the results of the initial search in May 2005, for the same group of RRGs.

It is unclear whether RRG insureds who obtain insurance through organizations that own RRGs understand that they will not have guaranty fund coverage. Four states—Arizona, the District of Columbia, South Carolina, and Vermont—indicated that they have chartered RRGs owned by single organizations. When an organization is the insured of the RRG, the organization receives the insurance policy with the disclosure about lack of guaranty fund protection. Whether the organization’s members, who are insured by the RRG, understand that they lack guaranty fund coverage is less clear. The Vermont regulators indicated that members typically are not advised that they lack guaranty fund coverage before they receive the policy. Thus, the regulators recommended that applications for insurance should contain the disclosure as well. The Arizona regulator reported that the insurance applications signed by the insureds of the Arizona-domiciled RRG owned by three RPGs did not contain a disclosure on the lack of guaranty fund coverage, although the policy certificates did. Further, he reported that the practices of RPGs were beyond his department’s jurisdiction and that he does not review them.

Not understanding that RRG insureds are not protected by guaranty funds has serious implications for RRG members and their claimants, who have lost coverage as a result of RRG failures. For example, of the 21 RRGs that have been placed involuntarily in liquidation, 14 either have or had policyholders whose claims remain or are likely to remain partially unpaid (see app. IV).¹⁰² Member reaction to the failure of the three RRGs domiciled in Tennessee further illustrates that the wording and the placement of the disclosure may be inadequate.¹⁰³ In 2003, an insurance regulator from Virginia, a state where many of the RRG insureds resided, reported that he received about 150–200 telephone calls from the insureds of these RRGs and the insureds did not realize they lacked “guaranty fund” coverage, asking instead why they didn’t have “back-up” insurance when their insurance company failed. He explained that the insureds were “shocked” to discover they were members of an RRG, rather than a traditional insurance company and that they had no guaranty fund coverage.

¹⁰²One of the 22 RRGs that “failed” using NAIC’s definition of failure, which includes companies placed into rehabilitation, was not liquidated.

¹⁰³In 1987, the U.S. Department of Commerce concluded that LRRRA’s provision for the guaranty fund notice was insufficient. The department concluded that greater disclosure would be provided if the guaranty fund disclosure would be required on application forms. U.S. Department of Commerce, *Liability Risk Retention Act of 1986: Implementation Report* (Washington, D.C.: 1987).

According to the regulator, they commented, “Who reads their insurance policies?” Regulators in Tennessee also noted that insureds of the RRGs, including attorneys, hospitals, and physicians did not appear to understand the implications of self-insuring their risks and the lack of guaranty fund coverage. In 2004, the State of Tennessee estimated that the potential financial losses from these failures to the 50,000 or so hospitals, doctors, and attorneys that were members of the Tennessee RRGs could exceed \$200 million, once the amount of unpaid claims were fully known.¹⁰⁴

Other regulators, including those in Missouri, in response to our survey, and New York, in an interview, also expressed concern that some RRG members might not fully understand the implications of a lack of guaranty fund protection and were not the “sophisticated” consumers that they believe may have been presumed by LRRRA. In addition, in response to our survey, regulators from other states including New Mexico and Florida expressed specific concerns about third-party claimants whose claims could go unpaid when an RRG failed and the insured refused or was unable to pay claims. The Florida regulator noted that the promoters of the RRG could accentuate the “cost savings” aspect of the RRG at the expense of explaining the insured’s potential future liability in the form of unpaid claims due to the absence of guaranty funds should the RRG fail. In addition, regulators who thought that protections in LRRRA were inadequate, such as those in Wyoming, Virginia, and Wisconsin, tended to view lack of guaranty fund protection as a primary reason for developing and implementing more uniform regulatory standards or providing nondomiciliary states greater regulatory authority over RRGs.

Lack of Guaranty Fund Protection Also Has Consequences for Consumers Who Purchase Extended Service Contracts

Lack of guaranty fund protection also can have unique consequences for consumers who purchase extended service contracts from service contract providers. Service contract providers form RRGs to insure their ability to pay claims on extended service contracts—a form of insurance also known as contractual liability insurance—and sell these contracts to consumers.¹⁰⁵ In exchange for the payment (sometimes substantial) made by the consumer, the service contract provider commits to performing services—

¹⁰⁴Tennessee Department of Commerce and Insurance media release, dated February 9, 2004. In addition, see appendix IV for more recent information on expected losses.

¹⁰⁵Contractual liability insurance is liability assumed under any contract or agreement. Extended service contracts are also known as “extended warranties.”

for example, paying for repairs to an automobile. Service contract providers may be required to set aside some portion of the money paid by consumers in a funded “reserve account” to pay resulting claims and may have to buy insurance (for example, from the RRG they have joined) to guarantee their ability to pay claims.¹⁰⁶ However, potential problems result from the perception of consumers that what they have purchased is insurance, since the service contract provider pays for repairs or other service, when in fact it is not.¹⁰⁷ Only the service contract provider purchases insurance, the consumer signs a contract for services.

The failure of several RRGs, including HOW Insurance Company RRG (HOW) in 1994 and National Warranty RRG in 2003, underscores the consequences that failures of RRGs that insure service contract providers can have on consumers:

- In 1994, the Commonwealth of Virginia liquidated HOW and placed its assets in receivership. This RRG insured the ability of home builders to fulfill contractual obligations incurred by selling extended service contracts to home buyers. While settled out of court, the Commonwealth of Virginia asserted that the homeowners who purchased the contracts against defects in their homes had been misled into believing that they were entitled to first-party insurance benefits—that is, payment of claims.¹⁰⁸ A Virginia regulator said that while his department received few calls from the actual insureds (that is, the home builders) at the time of failure, they received many calls from home owners who had obtained extended service contracts when they purchased their home and thought they were insured directly by the RRG.

¹⁰⁶The amount placed in the account by the service contract provider may or may not be based on actuarial standards that provide some assurance that the account would be sufficient.

¹⁰⁷Responses to our survey indicated that only eight states regulate vehicle service contracts as insurance in their states although others reported that they did so under certain conditions. However, we did not perform any additional audit work to compare how the regulation of vehicle service contracts as an insurance product could differ from the regulation of other insurance products in these states. Moreover, our survey only addressed the regulation of vehicle service contracts, not other types of service contracts.

¹⁰⁸See *Foster v. Spies et al.*, No. 3:95-CV-832 (E.D. Va. filed Oct. 10, 1995).

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- In 2003, National Warranty Insurance RRG failed, leaving behind thousands of customers with largely worthless vehicle service contracts (VSCs). This RRG, domiciled in the Cayman Islands, insured the ability of service contract providers to honor contractual liabilities for automobile repairs. Before its failure, National Warranty insured at least 600,000 VSCs worth tens of millions of dollars. In 2003, the liquidators of National Warranty estimated that losses could range from \$58 to \$74 million.¹⁰⁹ National Warranty's failure also raised the question of whether RRGs were insuring consumers directly, which LRRRA prohibits—for example, because the laws of many states, including Texas, require that the insurance company become directly responsible for unpaid claims in the event a service contract provider failed to honor its contract.¹¹⁰

The failure of National Warranty also raised the question of whether RRGs should insure service contract providers at all because of the potential direct damage to consumers. Several regulators, including those in California, Wisconsin, and Washington, went even further. In response to our survey, they opined that LRRRA should be amended to preclude RRGs from offering “contractual liability” insurance because such policies cover a vehicle service contract provider’s financial obligations to consumers.¹¹¹ At a minimum, regulators from New York and California, in separate interviews, recommended that consumers who purchase extended service contracts insured by RRGs at least be notified in writing that the contracts they purchase were not insurance and would not qualify for state guaranty fund coverage.

¹⁰⁹The loss estimates, from June 2003, and the number of contracts insured, from March 2004, are based on the most recent loss estimates made available by the liquidators of National Warranty.

¹¹⁰In response to our survey, 17 states reported that in the event a service contract provider fails to pay or provide service on a vehicle service contract claim within a certain number of days after proof of loss has been filed, the contract holder is entitled to make a claim directly against the insurance company. For example, the Texas code provides that if a service covered under a service contract is not provided to a service contract holder not later than the sixtieth day after the date of proof of loss, the insurer shall pay the covered amount directly to the service contract holder or provide the required service. Tx. Occ. Code § 304.152(a)(2).

¹¹¹The regulators provided these opinions in response to our question on whether LRRRA should be amended or clarified. In addition, one other state—Texas—recommended that Congress clarify whether RRGs should be permitted to offer contractual liability insurance.

Conclusions

In establishing RRGs, Congress intended to alleviate a shortage of affordable commercial liability insurance by enabling commercial entities to create their own insurance companies to self-insure their risks on a group basis. RRGs, as an industry, according to most state insurance regulators, have fulfilled this vision—and the intent of LRRRA—by increasing the availability and affordability of insurance for members that experienced difficulty in obtaining coverage. While constituting only a small portion of the total liability insurance market, RRGs have had a consistent presence in this market over the years. However, the number of RRGs has increased dramatically in recent years in response to recent shortages of liability insurance. While we were unable to evaluate the merits of individual RRGs, both state regulators and advocates of the RRG industry provided specific examples of how they believe RRGs have addressed shortages of insurance in the marketplace. This ability is best illustrated by the high number of RRGs chartered over the past 3 years to provide medical malpractice insurance, a product which for traditional insurers historically has been subject to high or unpredictable losses with resulting failures.

However, the regulation of RRGs by a single state, in combination with the recent increase in the number of states new to domiciling RRGs, the increase in the number of RRGs offering medical malpractice insurance, and a wide variance in regulatory practices, has increased the potential for future solvency risks. As a result, RRG members and their claimants could benefit from greater regulatory consistency. Insurance regulators have recognized the value of having a consistent set of regulatory laws, regulations, practices, and expertise through the successful implementation of NAIC's accreditation program for state regulators of multistate insurance companies. Vermont and NAIC negotiated the relaxation of significant parts of the accreditation standards for RRGs because it was unclear how the standards, designed for traditional companies, applied to RRGs. However, this agreement allowed states chartering RRGs as captives considerable latitude in their regulatory practices, even though most RRGs were multistate insurers, raising the concerns of nondomiciliary states. With more RRGs than ever before and with a larger number of states competing to charter them, regulators, working through NAIC, could develop a set of comprehensive, uniform, baseline standards for RRGs that would provide a level of consistency that would strengthen RRGs and their ability to meet the intent of LRRRA. While the regulatory structure applicable to RRGs need not be identical to that used for traditional insurance companies, uniform, baseline regulatory

standards could create a more transparent and protective regulatory environment, enhancing the financial strength of RRGs and increasing the trust and confidence of nondomiciliary state regulators. These standards could include such elements as the use of a consistent accounting method, disclosing relationships with affiliated businesses as specified by NAIC's Model Insurance Holding Company System Regulatory Act, and the qualifications and number of staff that insurance departments must have available to charter RRGs. These standards could reflect the regulatory best practices of the more experienced RRG regulators and address the concerns of the states where RRGs conduct the majority of their business. Further, such standards could reduce the likelihood that RRGs would practice regulatory arbitrage, seeking departments with the most relaxed standards. While it may not be essential for RRGs to follow all the same rules that traditional insurers follow, it is difficult to understand why all RRGs and their regulators, irrespective of where they are domiciled, should not conform to a core set of regulatory requirements. Developing and implementing such standards would strengthen the foundation of LRRAs' flexible framework for the formation of RRGs.

LRRAs' provisions for the ownership, control, and governance of RRGs may not be sufficient to protect the best interests of the insureds. While acknowledging that LRRAs have worked well to promote the formation of RRGs in the absence of uniform, baseline standards, this same flexibility has left some RRG insureds vulnerable to misgovernance. In particular, how RRGs are capitalized is central to concerns of experienced regulators about the chartering of entrepreneurial RRGs because a few insureds or service providers, such as management companies, that provide the initial capital also may retain control over the RRG to benefit their personal interests. Further, RRGs, like mutual fund companies, depend on management companies to manage their affairs, but RRGs lack the federal protections Congress and SEC have afforded mutual fund companies. As evidenced by the circumstances surrounding many RRG failures, the interests of management companies inherently may conflict with the fundamental interests of RRGs—that is, obtaining stable and affordable insurance. Moreover, these management companies may have the means to promote their own interests if they exercise effective control over an RRG's board of directors. While RRGs may need to hire a management company to handle their day-to-day operations, principles drawn from legislation such as the Investment Company Act of 1940 would strongly suggest that an RRG's board of directors would have a substantial number of independent directors to control policy decisions. In addition, these standards would strongly suggest that RRGs retain certain rights when

negotiating the terms of a management contract. Yet, LRRRA has no provisions that establish the insureds' authority over management. Without these protections, RRG insureds and their third-party claimants are uniquely vulnerable to abuse because they are not afforded the oversight of a multistate regulatory environment or the benefits of guaranty fund coverage. Nevertheless, we do not believe that RRGs should be afforded the protection of guaranty funds. Providing such coverage could further reduce any incentives insureds might have to participate in the governance of their RRG and at the same time allow them access to funds supplied by insurance companies that do not benefit from the regulatory preemption. On the other hand, RRG insureds have a right to be adequately informed about the risks they could incur before they purchase an insurance policy. Further, consumers who purchase extended service contracts (which take on the appearance of insurance) from RRG insureds likewise have a right to be informed about these risks. The numerous comments that regulators received from consumers affected by RRG failures illustrate how profoundly uninformed the consumers were.

Finally, while opportunities exist to enhance the safeguards in LRRRA, we note again the affirmation provided by most regulators responding to our survey—that RRGs have increased the availability and affordability of insurance. That these assertions often came from regulators who also had concerns about the adequacy of LRRRA's regulatory safeguards underscores the successful track record of RRGs as a self-insurance mechanism for niche groups. However, as the RRG industry has matured, and recently expanded, so have questions from regulators about the ability of RRGs to safely insure the risks of their members. These questions emerge, especially in light of recent failures, because RRGs can have thousands of members and operations in multiple states. Thus, in some cases, RRGs can take on the appearance of a traditional insurance company—however, without the back-up oversight provided traditional insurers by other state regulators or the protection of guaranty funds. This is especially problematic because RRGs chartered under captive regulations differ from other captives—RRGs benefit from the regulatory preemption that allows multistate operation with single-state regulation. Further, we find it difficult to believe that members of RRGs with thousands of members view themselves as “owners” prepared to undertake the due diligence presumed by Congress when establishing RRGs as a self-insurance mechanism. Because there is no federal regulator for this federally created entity, all regulators, in both domiciliary and nondomiciliary states, must look to whatever language LRRRA provides when seeking additional guidance on protecting the residents of their state. Thus, the mandated development

and implementation of uniform, baseline standards for the regulation of RRGs, and the establishment of governance protections, could make the success of RRGs more likely.

Recommendations for Executive Action

In the absence of a federal regulator to ensure that members of RRGs, which are federally established but state-regulated insurance companies, and their claimants are afforded the benefits of a more consistent regulatory environment, we recommend that the states, acting through NAIC, develop and implement broad-based, uniform, baseline standards for the regulation of RRGs. These standards should include, but not be limited to, filing financial reports on a regular basis using a uniform accounting method, meeting NAIC's risk-based capital standards, and complying with the Model Insurance Holding Company System Regulatory Act as adopted by the domiciliary state. The states should also consider standards for laws, regulatory processes and procedures, and personnel that are similar in scope to the accreditation standards for traditional insurers.

Matters for Congressional Consideration

To assist NAIC and the states in developing and implementing uniform, baseline standards for the regulation of RRGs, Congress may wish to consider the following two actions:

- Setting a date by which NAIC and the state insurance commissioners must develop an initial set of uniform, baseline standards for the regulation of RRGs.
- After that date, making LRRRA's regulatory preemption applicable only to those RRGs domiciled in states that have adopted NAIC's baseline standards for the regulation of RRGs.

To strengthen the single-state regulatory framework for RRGs and better protect RRG members and their claimants, while at the same time continuing to facilitate the formation and efficient operation of RRGs, Congress also may wish to consider strengthening LRRRA in the following three ways:

- Requiring that insureds of the RRG qualify as owners of the RRG by making a financial contribution to the capital and surplus of the RRG, above and beyond their premium.

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- Requiring that all of the insureds, and only the insureds, have the right to nominate and elect members of the RRG’s governing body.
 - Establishing minimum governance requirements to better secure the operation of RRGs for the benefit of their insureds and safeguard assets for the ultimate purpose of paying claims. These requirements should be similar in objective to those provided by the Investment Company Act of 1940, as implemented by SEC; that is, to manage conflicts of interest that are likely to arise when RRGs are managed by or obtain services from a management company, or its affiliates, to protect the interests of the insureds. Amendments to LRRRA could
 - require that a majority of an RRG’s board of directors consist of “independent” directors (that is, not be associated with the management company or its affiliates) and require that certain decisions presenting the most serious potential conflicts, such as approving the management contract, be approved by a majority of the independent directors;
 - provide safeguards for negotiating the terms of the management contract— for example, by requiring periodic renewal of management contracts by a majority of the RRG’s independent directors, or a majority of the RRG’s insureds, and guaranteeing the right of a majority of the independent directors or a majority of the insureds to unilaterally terminate management contracts upon reasonable notice; and
 - impose a fiduciary duty upon the management company to act in the best interests of the insureds, especially with respect to compensation for its services.

To better educate RRG members, including the insureds of organizations that are sole owners of an RRG, about the potential consequences of self-insuring their risks, and to extend the benefits of this information to consumers who purchase extended service contracts from RRG members, Congress may wish to consider the following two actions:

- Expand the wording of the current disclosure to more explicitly describe the consequences of not having state guaranty fund protection should an RRG fail, and requiring that RRGs print the disclosure prominently on policy applications, the policy itself, and marketing materials, including those posted on the Internet. These requirements

also would apply to insureds who obtain their insurance through organizations that may own an RRG; and

- Develop a modified version of the disclosure for consumers who purchase extended service contracts from providers that form RRGs to insure their ability to meet these contractual obligations. The disclosure would be printed prominently on the extended service contract application, as well as on the contract itself.

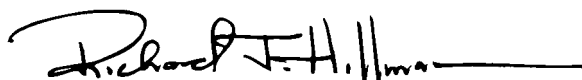
Agency Comments and Our Evaluation

We requested comments on a draft of this report from the President of the National Association of Insurance Commissioners or her designee. The Executive Vice President and CEO of NAIC said that the report was "...well thought out and well documented," and provided "...a clear picture of how states are undertaking their responsibilities with regard to regulation of risk retention groups." She further stated that our report "...explored the issues that are pertinent to the protection of risk retention group members and the third-party claimants that are affected by the coverage provided by the risk retention groups." NAIC expressed agreement with our conclusions and recommendations. NAIC also provided technical comments on the report that were incorporated as appropriate.

As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to other interested Members of Congress, congressional committees, and the Executive Vice President of NAIC and the 56 state and other governmental entities that are members of NAIC. We also will make copies available to others upon request. In addition, this report will be available at no charge on GAO's Web site at <http://www.gao.gov>.

If you or your staff have any questions on this report, please contact me at (202) 512-8678 or hillmanr@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 major contributions to this report are listed in appendix VI.

Sincerely yours,

A handwritten signature in black ink that reads "Richard J. Hillman" followed by a horizontal line extending to the right.

Richard J. Hillman
Managing Director, Financial Markets and
Community Investment

Objectives, Scope, and Methodology

Our objectives were to (1) examine the effect risk retention groups (RRG) have had on the availability and affordability of commercial liability insurance; (2) assess whether any significant regulatory problems have resulted from the Liability Risk Retention Act's (LRRRA) partial preemption of state insurance laws; and (3) evaluate the sufficiency of LRRRA's ownership, control, and governance provisions in protecting the interests of RRG insureds. We conducted our review from November 2003 through July 2005 in accordance with generally accepted government auditing standards.

Effects on Availability and Affordability of Commercial Liability Insurance

Overall, we used surveys, interviews, and other methods to determine if RRGs have increased the availability and affordability of commercial liability insurance. First, we surveyed regulators in all 50 states and the District of Columbia. The survey asked regulators to respond to questions about regulatory requirements for RRGs domiciled in their state, their experiences with RRGs operating in their state, and their opinions about the impact of LRRRA. We pretested this survey with five state regulators, made minor modifications, and conducted data collection during July 2004. We e-mailed the survey as a Microsoft Word attachment and received completed surveys from the District of Columbia and all the states except Maryland. Then, to obtain more specific information about how regulators viewed the usefulness of RRGs, we interviewed insurance regulators from 14 different states that we selected based on several characteristics that would capture the range of experiences regulators have had with RRGs. In addition, we interviewed representatives from eight RRGs serving different business areas and reviewed documentation they provided describing their operations and how they served their members.¹ Second, we asked the National Association of Insurance Commissioners (NAIC) to calculate the overall market share of RRGs in the commercial liability insurance market as of the end of 2003. We used 2003 data for all financial analyses because it constituted the most complete data set available at the time of our analysis. Using its Financial Data Repository, a database containing annual and quarterly financial reports and data submitted by most U.S. domestic insurers, NAIC compared the total amount of gross premiums written by RRGs with the total amount of gross premiums generated by the sale of

¹The business areas were environmental, government and institutions, healthcare, manufacturing and commerce, professional services, and property development.

commercial liability insurance by all insurers.² For the market share analysis, as well as for our analysis of gross premiums written by RRGs, we only included the 115 RRGs that wrote premiums during 2003. NAIC officials reported that while they perform their own consistency checks on this data, state regulators were responsible for validating the accuracy and reliability of the data for insurance companies domiciled in their state. We conducted tests for missing data, outliers, and consistency of trends in reporting and we found these data to be sufficiently reliable for the purposes of this report. Third, to determine the number of RRGs that states have chartered since 1981, we obtained data from NAIC that documented the incorporation and commencement of business dates for each RRG and identified the operating status of each RRG—for example, whether it was actively selling insurance or had voluntarily dissolved. Finally, to determine which business sectors RRGs were serving and the total amount of gross premiums written in each sector, we obtained information from a trade journal—the *Risk Retention Reporter*—because NAIC does not collect this information by business sector.

Failure Analysis

We also requested that NAIC analyze their annual reporting data to calculate the “failure” rate for RRGs and compare it with that of traditional property and casualty insurance companies from 1987 through 2003. In response, NAIC calculated annual “failure” rates for each type of insurer, comparing the number of insurers that “failed” each year with the total number of active insurers that year. The analysis began with calendar year 1987 because it was the first full year following the passage of LRRRA. NAIC classified an insurance company as having failed if a state regulator reported to NAIC that the state had placed the insurer in a receivership for the purpose of conserving, rehabilitating, or liquidating the insurance

²Gross premiums are the total direct premiums written by the insurer and assumed by other carriers.

company.³ Since NAIC officials classified an insurance company subject to any one of these actions as having failed, the failure date for each insurance company reflects the date on which a state first took regulatory action. We independently verified the status of each RRG that NAIC classified as failed by cross-checking the current status of each RRG with information from two additional sources— state insurance departments’ responses to our survey, with follow-up interviews as necessary, and the *Risk Retention Group Directory and Guide*.⁴ To determine if the differences in annual failure rates of the RRGs and traditional companies were statistically significant, NAIC performed a paired T-test. They concluded that the average annual RRG failure rates were higher than those for traditional property and casualty insurers.⁵ We also obtained a similar statistically significant result when testing for the difference across the 18-year period for RRGs and traditional insurers active in a given year. We recognize that, although these tests indicated statistically significantly different failure rates, the comparison between these insurer groups is less than optimal because the comparison group included all property and casualty insurers, which do not constitute a true “peer group” for RRGs. First, RRGs are only permitted to write commercial liability insurance, but NAIC estimated that

³Conservation, rehabilitation, and liquidation are regulatory actions a state insurance commissioner can take in response to concerns about the condition of an insurance company. A state places an insurance company in conservation when the management is deemed unable to administer the company in a proper fashion, usually because of concerns about insolvency. The scope of conservation under current state law can vary from seizure of certain assets to the supervision of an insurer’s operations, with or without a court order, and could include an order of rehabilitation. Rehabilitation generally involves the transfer of all operational authority from an insurer’s management to a receiver with the objective of initiating a rehabilitation plan to return the company to sound financial and operational condition. An insurance company not deemed susceptible to a successful conservation or rehabilitation may be placed in liquidation. The liquidation process ordinarily would include the seizure, marshalling, and liquidation of the company’s assets, a determination of the company’s liabilities, and the distribution of the assets of the insurance company to claimants with approved claims. Each time states take one of these, or other, regulatory actions, they are supposed to notify NAIC of these actions so NAIC can store this information in its Financial Data Repository.

⁴*Risk Retention Group Directory and Guide*, ed. Karen Cutts, J.D. (Insurance Communications, Pasadena Calif.: 2004).

⁵A paired T-test is used to make multiple paired comparisons (in the same or many subjects), over a number of years, to determine if the average difference between these paired comparisons is larger than would be expected by chance.

only 34 percent of insurers exclusively wrote liability insurance.⁶ Further, NAIC's peer group included traditional insurers writing both commercial and personal insurance. Second, we noted that the paired T-test comparison is more sensitive to any single RRG failing than any failure of a traditional insurer because of the relatively small number of RRGs. Finally, most RRGs are substantially smaller in size (that is, in terms of premiums written) than many insurance companies and may have different characteristics than larger insurance companies. Given the data available to NAIC, it would have been a difficult and time-consuming task to individually identify and separate those property and casualty insurers with similar profiles for comparison with RRGs.

Selection of Regulators for Interviews

In choosing which regulators to interview, we first selected regulators from the six states that had domiciled the highest number of active RRGs as of June 30, 2004, including two with extensive regulatory experience and four new to chartering RRGs. The six leading domiciliary states were Arizona, the District of Columbia, Hawaii, Nevada, South Carolina, and Vermont. Second, we selected regulators from eight additional states, including four that had domiciled just a few RRGs and four that had domiciled no RRGs. For states that had domiciled just a few or no RRGs, we identified and selected those where RRGs, as of the end of 2003, were selling some of the highest amounts of insurance. Finally, we also considered geographic dispersion in selecting states across the United States. In total, we selected 14 regulators (see table 1 for additional information).

⁶According to NAIC, estimates based on its analysis of 2004 filings indicate that 9 percent of insurers wrote only property lines of insurance, 34 percent wrote only liability lines of insurance, 9 percent wrote neither property or liability insurance, and 48 percent wrote either property or liability insurance combined with another line of insurance (for example, property and liability). NAIC explained that its conducting such an analysis for each year included in the failure analysis would be both time-intensive and complex—for example, because companies sometimes changes the lines of business they write from year to year.

**Appendix I
Objectives, Scope, and Methodology**

Table 1: Characteristics of States We Interviewed, Based on Years of Regulatory Experience and Number of RRGs Domiciled

Characteristics of states	State	Number of active domiciled RRGs, as of June 30, 2004	Year first RRG was formed	Amount of insurance written by RRGs in the state, as of Dec. 31, 2003
High number of RRGs and years of experience domiciling RRGs	Vermont	63	1987	N/A ^a
	Hawaii	17	1988	N/A
High number of RRGs and new to domiciling RRGs	South Carolina	36	2001	N/A
	District of Columbia	12	2003	N/A
	Nevada	8	2001	N/A
	Arizona	6	2003 (for RRGs formed under captive law) ^b	N/A
Limited number of domiciled RRGs ^c	Florida	1	1987	\$46 million
	Illinois	1	1980	\$74 million
	Texas	1	1984	\$87 million
	Tennessee	1	1987	\$38 million
No RRGs domiciled	California	0	N/A ^a	\$156 million
	New York	0	N/A	\$206 million
	Ohio	0	N/A	\$45 million
	Pennsylvania	0	N/A	\$238 million

Source: NAIC.

^aIn the “Amount of Insurance Written” column, we use N/A to mean “not applicable” because we did not use “amount of insurance written in each state” as a criterion for selecting states that had domiciled the highest amount of RRGs. “Amount of insurance written” is based on direct written premiums as of December 31, 2003, the most recent annual data available at the time we selected states for interview. In the “Year First RRG Was Formed” column, we used N/A to mean “not applicable” because the four states had not domiciled any RRGs.

^bArizona chartered three RRGs between 1987 and 1989, but they dissolved by 1995. Arizona began chartering RRGs under its captive law in 2003.

^cFlorida, Illinois, Texas, and Tennessee had chartered other RRGs in the past, although each state had only one active as of mid-2004. According to NAIC’s data, California, New York, and Ohio never chartered an RRG.

Effects of Partial Preemption of State Insurance Laws

To determine if any significant regulatory problems have resulted from LRRAs’ partial preemption of state insurance laws, as part of our survey we asked regulators to evaluate the adequacy of LRRAs’ protections, describe how they reviewed RRG financial reports, and report whether their state had ever asked a domiciliary state to conduct an examination. To obtain an in-depth understanding of how state regulators viewed the adequacy of LRRAs’ regulatory protections and identify specific problems, if any, we interviewed regulators from each of our selected 14 states. We made visits

to the insurance departments of five of the six leading domiciliary states—Arizona, the District of Columbia, Hawaii, South Carolina, and Vermont—and five additional states—Nebraska, New York, Tennessee, Texas, and Virginia. To assess the regulatory framework for regulating RRGs in the six leading domiciliary states (the five we visited plus Nevada), we also reviewed state statutes and obtained from regulators detailed descriptions of their departments' practices for chartering and regulating RRGs. To determine how the RRG regulatory framework created in these states compared with that of traditional insurers, we identified key components of NAIC's accreditation program for traditional insurance companies, based on documentation provided by NAIC and our past reports. Finally, our survey also included questions about RRGs consisting of businesses that issued vehicle service contracts (VSC) to consumers because this type of arrangement is associated with two failed RRGs.

In reviewing how RRGs file financial reports, we assessed how the use or modification of two sets of accounting standards, generally accepted accounting principles (GAAP) and statutory accounting principles (SAP), could affect the ability of NAIC and regulators to analyze the reports. For the year 2003, we also obtained from NAIC the names of RRGs that used GAAP to file their financial reports and those that used SAP. To obtain an understanding of differences between these accounting principles, we obtained documentation from NAIC that identified key differences and specific examples of how each could affect an RRG's balance sheet. We relied on NAIC for explanations of SAP because NAIC sets standards for the use of this accounting method as part of its accreditation program. The purpose of the accreditation program is to make monitoring and regulating the solvency of multistate insurance companies more effective by ensuring that states adhere to basic recommended practices for an effective state regulatory department. Specifically, NAIC developed the *Accounting Practices and Procedures Manual*, a comprehensive guide on SAP, for insurance departments, insurers, and auditors to use. To better understand GAAP and its requirements, we reviewed concept statements from the Financial Accounting Standards Board (FASB), which is the designated private-sector organization that establishes standards for financial accounting and reporting. We also consulted with our accounting experts to better understand how GAAP affected the presentation of financial results.

Sufficiency of LRRRA Provisions in Protecting RRG Insureds

To determine if LRRRA's ownership, control, and governance requirements adequately protect the interests of RRG insureds, we analyzed the statute to identify provisions relevant to these issues. In addition, we reviewed the insurance statutes of the six leading domiciliary states—Arizona, the District of Columbia, Hawaii, Nevada, South Carolina, and Vermont—related to the chartering of RRGs to determine if those states imposed any statutory requirements on RRGs with respect to ownership, control, or governance of RRGs. To identify additional expectations that state insurance departments might have set for the ownership, control, or governance of RRGs, we interviewed regulators from the six leading domiciliary states and reviewed the chartering documents, such as articles of incorporation and bylaws, of RRGs recently chartered in five of those states. One state insurance department, South Carolina, would not provide us access to these documents although we were able to obtain articles of incorporation from the Office of the South Carolina Secretary of State. In addition, we looked at past failures (and the public documentation that accompanies failures) to assess whether factors related to the ownership, control, and governance of RRGs played a role, or were alleged to have played a role, in the failures, particularly with respect to inherent conflicts of interest between the RRG and its management company or managers. To identify these factors, we first selected 16 of the 22 failures to review, choosing the more recent failures from a variety of states. As available for each failure, we reviewed relevant documentation, such as examination reports, liquidation petitions and orders, court filings (for example, judgments, if relevant), and interviewed knowledgeable state officials. Because some of the failures were more than 5 years old, the amount of information we could collect about a few of the failures was more limited than for others. In the case of National Warranty RRG, we reviewed publicly available information as supplied by the liquidator of National Warranty on its Web site; we also interviewed insurance regulators in Nebraska where National Warranty's offices were located and reviewed court documents. We used these alternative methods of obtaining information because National Warranty RRG's liquidators would not supply us any additional information. To determine how frequently RRGs include the lack of guaranty fund disclosure on their Web sites and if they use the words "risk retention group" in their name, we searched the Internet to identify how many RRGs had Web sites as of August 2004, based on a listing of 160 RRGs NAIC identified as active as of the beginning of June 2004. When we identified Web sites, we noted whether the words "risk retention group" or the acronym "RRG" appeared in the RRG's name and reviewed the entire site for the lack of guaranty fund disclosure. We updated the results of our initial search in May 2005, using the original group of RRGs.

Survey of State Regulators on Risk Retention Groups



Introduction

The Liability Risk Retention Act of 1986 permits risk retention groups (RRGs) to offer most types of commercial liability insurance. RRGs are unique because unlike most insurance companies, they are regulated only by the state that chartered them and are largely exempt from the oversight of the states in which they operate. At the request of Chairman Michael G. Oxley, Chairman of House Financial Services, we are conducting a review of RRGs to determine how they have met the insurance needs of businesses and whether the exemption of RRGs from most state regulations, other than those of the state in which they are domiciled, has resulted in any regulatory concerns.

We believe that you can make an important contribution to this study, and ask that you respond to this survey so we can provide the most complete information about RRGs to Congress. The survey should take about 90 *minutes* to complete, although additional time may be required if your state has chartered several RRGs. Please note that attached to the e-mail that transmitted this survey is a file that identifies all the RRGs operating in your state, as of year-end 2003. You will need to review this list in order to answer questions 23 and 24.

As indicated in the survey, we would like you to provide us information about insurance statutes and regulations that apply to RRGs chartered in your state. For the regulations only, we are requesting that you provide a hyperlink to the regulation, but you are also welcome to send us a copy of the regulation attached to the e-mail message that contains your completed survey instrument. Please complete the survey in MS-Word and return it via e-mail to GAOrgSurvey@gao.gov -- no later than *July 23, 2004*.

If you have any questions about the **content** of this questionnaire, please contact:

Matthew Poynton, Analyst/Intern
e-mail: poyntonm@gao.gov
Phone: (202) 512-6099

Sonja Bensen, Senior Analyst
e-mail: bensens@gao.gov
Phone: (202) 512-9806

If you encounter any **technical** difficulties please contact:

William R. Chatlos
Phone: (202) 512-7607
e-mail: chatlosw@gao.gov

NOTE: The number of states responding to an item is generally printed left of the response. No responses are provided in this Appendix when the answers are too diverse to summarize or present briefly.

**Appendix II
Survey of State Regulators on Risk Retention
Groups**

Definitions of acronyms and terms used in this questionnaire

Risk Retention Group (RRG): An RRG is a group of members with similar risks that join to create an insurance company to self-insure their risks. The Liability Risk Retention Act permits RRGs to provide commercial liability insurance and largely exempts them from regulatory oversight other than that performed by their chartering state.

State of Domicile: The state that charters an RRG and is responsible for performing regulatory oversight, including examinations. ("State" includes the District of Columbia, and for RRGs chartered before 1985, Bermuda and the Cayman Islands.)

Host state: Any state in which an RRG operates but is not chartered.

Vehicle Service Contract: A vehicle service contract, purchased by consumers when they buy cars, is for maintaining and repairing an automobile beyond its manufacturer's warranty coverage.

INSTRUCTIONS:

1. Please use your mouse to navigate throughout the survey by clicking on the field or check box you wish to answer or filling in the requested field [].
2. To select a check box, simply click or double click on the center of the box.
3. To change or deselect a response, simply click on the check box and the 'X' should disappear.
4. Consult with others as needed to complete any section.
5. After each section, there is a place for you to make comments.

Part I: Contact Information About the Person Completing the Survey

1. What is the name of your State Insurance Commissioner?

49 of 50 State Commissioners; plus Washington, DC responded

2. Please provide the name, title, phone number, and email address of the person completing the survey so we might contact them if there are questions.

Name: [] Title: []
Phone: [] E-Mail: []

Appendix II
Survey of State Regulators on Risk Retention
Groups

Part II: Requirements for Domiciling RRGs in Your State

In Part II (Questions 3-12), we are asking about the role of your state as a “domiciliary” state for RRGs, the state responsible for chartering and regulating an RRG. This information is important, even if your state has not actually chartered an RRG, because the laws and regulations for domiciling RRGs vary from state to state. In contrast, Section III contains questions pertaining to RRGs operating but not domiciled in your state.

In addition, in some states RRGs can be chartered under more than one set of laws. When responding to the questions below, please respond for each law under which a RRG could be chartered, even if a RRG or you the regulator would prefer a RRG be chartered under one law (e.g., a captive law) rather than another (e.g., traditional insurance company law).

3. In your state, under which of the following domiciliary laws and/or regulations would RRGs be chartered, if domiciled and chartered in your state? *(Check all that apply.)*

- 45 Traditional insurance law and/or regulations
16 Captive law and/or regulations; with or without specific provisions for RRGs
7 Other (Specify): [_____]

4. If your state has a captive law and/or regulations, please provide the following information:

- 27 Not applicable, we do not use a captive law and/or regulations *(Skip to Question #5.)*
- a. Year captive law enacted: []]
b. Year regulations created: []]
c. Citation for Statute: []]
d. Citation for regulations *(Please include website link below.)*
 website link: []]
e. Does this law/regulation permit RRGs to be chartered as a captive?.
 No Yes

5. If your state uses its traditional insurance law to charter RRGs, please provide the following information:

- 4 Not applicable, we do not use traditional laws and/or regulations to charter RRGs. *(Skip to Question #6.)*
- a. Citation for statute under which RRGs are chartered: []]
b. Citation for regulations *(Please include website link below.)*
 website link: []]

**Appendix II
Survey of State Regulators on Risk Retention
Groups**

6. In your state, what are the minimum initial capital and/or surplus requirements for a RRG domiciled in your state under any of the following laws/regulations that are applicable?

Type of Law/Regulation	Not Applicable (RRGs Cannot Be Chartered Under These Statutes or Regulations in this State)	Minimum Initial Capital and/or Surplus Requirements Applicable to RRGs
a. Traditional Insurance Laws/Regs	3	\$[]
b. Captive Insurance Laws/Regs	21	\$[]
c. Other (Specify): []	19	\$[]

7. In your state, under which of the following laws and/or regulations would RRGs domiciled in your state be required to comply with the National Association of Insurance Commissioners' (NAIC) risk-based capital requirements?

Type of Law/Regulation	Not Applicable (RRGs Cannot Be Chartered Under These Statutes or Regulations in this State)	Yes	No
a. Traditional Insurance Laws/Regs	3	44	2
b. Captive Insurance Laws/Regs	19	7	12
c. Other (Specify): []	19	3	2

8. In your state, under which of the following laws and/or regulations would RRGs domiciled in your state be required to submit the same financial information as traditional insurance companies to the NAIC?

Type of Law/Regulation	Not Applicable (RRGs Cannot Be Chartered Under These Statutes or Regulations in this State)	Yes	No*
a. Traditional Insurance Laws/Regs	3	45	0
b. Captive Insurance Laws/Regs	20	14	4
c. Other (Specify): []	20	4	0

*If you indicated that your state does not require RRGs to file financial information with NAIC, please explain: [_____]

**Appendix II
Survey of State Regulators on Risk Retention
Groups**

9. How many RRGs have *ever* domiciled in your state?

Number of domiciled RRGs: [] *(If this number is greater than "0", please complete Appendix A.)*

26 = 0 RRGs

17 = 1 – 5 RRGs

7 = 6+ RRGs

10. Does your state have staff who are *exclusively* dedicated to overseeing matters related to captives and/or RRGs domiciled in your state?

42 No (Skip to Q12.)

7 Yes

11. If you answered "Yes" to Question 10, about how many full-time-equivalent (FTE) staff are currently dedicated to working with captives and RRGs domiciled in your state?

Total number of FTEs working with captives and RRGs: []

12. If you have any comments related to this section, please write them here: [_____]

Part III: Your Role as a Host State Regulator For RRGs Operating in Your State But Domiciled in Another State

In Part III (Questions 13–24), we are asking about the role of your state as a "host state" regulator. A host state is one in which RRGs operate but are not domiciled. The 1986 Liability Risk Retention Act limits the amount of oversight that "host state" regulators can perform over RRGs operating but not domiciled in their states. *This section pertains only to requirements for RRGs operating but not domiciled in your state.*

A. Submission of Operational Plans or Feasibility Studies to Host State Regulators

The Liability Risk Retention Act, 15 U.S.C. §3902, requires that each RRG submit to the insurance commissioner of each state in which it intends to do business, a **copy of a plan of operation or a feasibility study** which includes the coverages, deductibles, coverage limits, rates and rating classification systems for each line of insurance the group intends to offer, and a **copy of any revisions** to such plan or study.

Appendix II
Survey of State Regulators on Risk Retention
Groups

B. Submission of Annual Financial Statements to Host State Regulators

The Risk Retention Act, 15 U.S.C. §3902, requires that each RRG submit to the insurance commissioner of each State in which it is doing business, **a copy of the group's annual financial statement** submitted to the State in which the group is chartered as an insurance company, which statement shall be certified by an independent public accountant and contain a statement of opinion on loss and loss adjustment expense reserves made by a member of the American Academy of Actuaries, or a qualified loss reserve specialist.

19. What steps, if any, does your state routinely take to ensure that RRGs operating but not domiciled in your state submit *annual financial statements*?

7 None; No steps are routinely taken

The following steps are routinely taken (*Describe*): [_____]

20. To the best of your knowledge, has any RRG operating in your state ever failed to provide copies of its *annual financial statement* to your state insurance department?

35 No

15 Yes → (*If yes, please explain how often*): [_____]

21. Since host states have limited authority over RRGs operating in their states, to what extent do you review *these annual financial statements* compared to those of *eligible non-admitted insurers* (i.e., surplus line insurers)?

22 Less review than eligible non-admitted insurers

21 About the same review as eligible non-admitted insurers

5 More review than eligible non-admitted insurers

Please briefly describe the review you conduct: [_____]

22. If you have any comments related to this section, please write them here: [_____]

Appendix II
Survey of State Regulators on Risk Retention
Groups

C. Identification of RRGs Operating in Your State

INSTRUCTIONS: The e-mail inviting you to respond to this survey contained two attachments: (1) the survey itself, including Appendix A and (2) **Appendix B—a list of all RRGs that reported financial data to NAIC for 2003.** The RRGs appearing first in Appendix B identified themselves to NAIC as writing premiums in your state during 2003 and those appearing second did not. To respond to the questions below, please compare the list of RRGs in Appendix B that reported to NAIC that they wrote premiums in your state in 2003 with your internal records.

23. To the best of your knowledge, were all of the RRGs reporting to NAIC that they wrote premiums in your state in 2003, also registered to conduct business in your state in 2003?

- 36 Yes
10 No -- If "No", please indicate:

The names of RRGs that wrote premiums in your state but were not registered in your state: [_____]

- 3 Not sure -- Some RRGs may have written premiums in our state without first registering with our department but we are double-checking NAIC's information directly with the RRGs in question. *(Request: Please let GAO know if you identify RRGs that operated but were not registered in your state in 2003, even if you have already submitted your survey.)*

24. Based on a review of your internal records, did you identify any RRGs that wrote premiums in your state in 2003 but were not listed on NAIC's list?

- 30 No
10 Yes -- If "Yes", please indicate:

The names of RRGs that wrote premiums in your state in 2003 but were not included on NAIC's list as writing premiums in your state in 2003:

- 8 do not know—our state does not track whether registered RRGs wrote premiums in our state.

Appendix II
Survey of State Regulators on Risk Retention
Groups

31. Please identify each request your state has made, including the name of the RRG, the date of request, the domiciliary state to which you made the request, and a brief explanation of the circumstances.

Name of RRG	Date of Request	Domiciliary State	Explanation of Circumstances
[]	[]	[]	[]
[]	[]	[]	[]

32. Did the domiciliary state comply with your state's request(s)?

- 2 Yes
 2 No (Please provide further explanation): [____]
 2 Do not know

33. Do you have any additional comments on questions 25 through 32? [____]

34. For the record, does your State believe RRGs have *expanded the availability and affordability of commercial liability insurance* for groups that would otherwise have had difficulty in obtaining coverage?

- 33 Yes
 3 No
 12 No Opinion

Please offer any comments on your response: [____]

35. For the record, what is your State's opinion as to whether the Risk Retention Act should be *expanded to permit RRGs to provide property insurance*?

- 31 No, the Act should not be expanded
 8 Yes, the Act should be expanded
 10 No opinion

Please offer any comments on your response: [____]

Appendix II
Survey of State Regulators on Risk Retention
Groups

36. In your opinion, how adequate or inadequate are the regulatory protections or safeguards built into the Risk Retention Act? (Check one.)

- 0 Very adequate
- 8 Adequate
- 6 Neither adequate nor inadequate
- 19 Inadequate
- 9 Very inadequate
- 7 No opinion or don't know

Please offer any comments on your response: [_____]

37. Does your state have an opinion as to whether the Risk Retention Act should be clarified or amended in any way?

- 21 No opinion
- 1 No → If "No", please explain your response: [_____]
- 27 Yes → If "Yes", please describe the desired changes: [_____]

(Continue on next page.)

Appendix II
Survey of State Regulators on Risk Retention
Groups

Part IV. Regulation of Vehicle Service Contracts

Part IV (Questions 38-48) is about vehicle service contracts (VSCs). An increasing number of risk retention groups have been established to insure VSC obligors. These obligors—whether auto dealers or third party administrators—issue VSCs to consumers. Because of this trend, and the recent failure of National Warranty RRG, we are seeking a limited amount of information on how states regulate insurance companies that insure obligors who issue VSCs.

INSTRUCTIONS: Please complete Questions 38 to 47. If VSCs are regulated in another office, please ask for assistance. If someone other than the person identified in question 2 answered these questions, please provide the appropriate contact information.

38. Please provide the name, title, office and phone number of the person who completed this part of the survey unless the name is the same as shown in question 2:

Name: [] Title: []
Office: [] Phone: []

39. Are vehicle service contracts (VSCs) regulated as insurance in your state?

- 28 No
8 Yes
13 Yes, but under certain conditions (Specify conditions):
Citation for statute: []
Citation for regulation: [] website link: []

40. Has your state adopted the NAIC Service Contracts model law?

- 35 No
11 Somewhat – please explain: []
4 Yes

41. Does your state permit third-party administrators, rather than just auto dealers, to issue VSCs?

- 7 No
38 Yes
Citation for statute/regulation: []

Appendix II
Survey of State Regulators on Risk Retention
Groups

42. Do any of your state agencies license obligors—whether auto dealers or third-party administrators—before obligors can issue vehicle service contracts in your state?

- 25 No
21 Yes

Name of the state agency: []

43. Which of the following requirements, if any, does your state require of obligors before they issue VSCs in your state? (*Check all that apply.*)

- 28 Insure VSCs under a reimbursement or other insurance policy
13 Maintain a funded reserve account for its obligations
16 Place in trust with the commissioner a financial security deposit (e.g., a surety bond)
13 Maintain a net worth of \$100 million or another amount:
(If checked, identify amount: [])
18 Other, please describe []

44. If obligors in your state purchase insurance for their VSCs, does your state require that in the event the obligor fails to perform, *the insurer issuing the policy must either pay on behalf of the obligor any sums the obligor is legally obligated to pay, or provide any service which the obligor is legally obligated to provide?*

- 19 No (Skip to Question 46)
23 Yes
4 Yes, but under certain conditions
Citation for statute/regulation: []

45. If you answered “yes” to question 44, does that mean that the insurer is required to pay 100 percent of the loss (i.e., first dollar coverage) or does the insurer’s risk not attach until some deductible amount is met, such as a loss in excess of the obligor’s reserves?

- 2 No
18 Yes
4 Yes, but under certain conditions
Please explain: []

Appendix II
Survey of State Regulators on Risk Retention
Groups

46. Does your state require that in the event an obligor fails to pay or provide service on a VSC claim within a certain number of days (e.g., 60) after proof of loss has been filed, the contract holder is entitled to make a claim directly against the insurance company?

- 27 No
17 Yes
2 Yes, but under certain conditions
Citation for statute/regulation: []

47. Are VSCs covered by your guarantee fund?

- 43 No
1 Yes
2 Yes, but under certain conditions
Citation for statute/regulation: []

48. If you have any other comments about RRGs, or other insurance companies, insuring vehicle service contracts, please provide them here: [_____]

Have you completed Appendix A and/or Appendix B?

*(Please save this document as an MSWord document,
then attach it to an email and send it to GAORrgSurvey@gao.gov)*

Thank you for your assistance.

**Appendix II
Survey of State Regulators on Risk Retention
Groups**

Appendix A: Identification of RRGs Domiciled in Your State

For each RRG that your state has chartered since 1981, please provide the following information:
(Duplicate the table as many times as needed to complete for all RRG domiciled in your state.)

Note: You may also choose to send this information as a separate attachment.

Name of RRG	Date of Charter	Date Started Business	Type of Insured Business	NAIC Status Code (See below)	If INACTIVE, Date Stopped Business
[]			[]	[]	
[]			[]	[]	
[]			[]	[]	
[]			[]	[]	
[]			[]	[]	
[]			[]	[]	
[]			[]	[]	
[]			[]	[]	
[]			[]	[]	
[]			[]	[]	

- NAIC Status codes:
- 1—Active—No regulatory action in process
 - 2—Not Used
 - 3—Inactive—Merged or combined into another company
 - 4—In rehabilitation, permanent or temporary receivership
 - 5—Voluntarily out of business
 - 6—Being liquidated or has been liquidated
 - 7—Inactive—Estate has closed
 - 8—Inactive—Charter is inactive

Selected Differences between Statutory and Generally Accepted Accounting Principles as They Relate to Financial Reporting for RRGs

On an annual basis, traditional insurance companies, as well as risk retention groups (RRG), file various financial data, such as financial statements and actuarial opinions, with their respective state regulatory agencies and the National Association of Insurance Commissioners (NAIC). More specifically, RRGs—although subject to the regulation of one state (their domiciliary state)—can and do sell insurance in multiple states and are required to provide their financial statements to each state in which they sell insurance. Unless exempted by the state of domicile, RRGs generally file their financial statements with NAIC as well. Additionally, although insurance companies generally are required to file their financial statements based on statutory accounting principles (SAP), captive insurance companies (a category that in many states includes RRGs) are generally permitted, and in some cases required, to use generally accepted accounting principles (GAAP), the accounting and reporting principles generally used by private-sector (nongovernmental) entities.¹ Thus, while some RRGs report their financial information using SAP, others report using GAAP or variations of GAAP and SAP.

However, the use or modification of two different sets of accounting principles can lead to different interpretations of an RRG's financial condition. For example, differences in the GAAP or SAP treatment of assets and acquisition costs can significantly change the reported levels of total assets, capital, and surplus. Because regulators, particularly those in nondomiciliary states, predicate their review and analysis of insurance companies' financial statements on SAP reporting, the differing accounting methods that RRGs may use could complicate analyses of their financial condition. For instance, based on whatever accounting basis is filed with them, the different levels of surplus reported under GAAP, or SAP, or modifications of each, can change radically the ratios NAIC uses to analyze the financial condition of insurers—undercutting the usefulness of the analyses. Similarly, the accounting differences also affect calculations for NAIC's risk-based capital standards and may produce significantly different results. For example, an RRG could appear to have maintained capital adequacy under GAAP but would require regulatory action or control if the calculations were based on SAP.

¹Captive insurance companies are companies that are formed and owned by a single company or association to self-insure the risks of the parent organization. According to NAIC, 79 of the 115 RRGs active as of the end of 2003 filed financial statements using GAAP while the others filed using SAP.

Differences in Accounting Principles Produce Different Financial Statements

Differences in the two sets of accounting principles reflect the different purposes for which each was developed and may produce different financial pictures of the same entity. GAAP (for nongovernmental entities) provides guidance that businesses follow in preparing their general purpose financial statements, which provide users such as investors and creditors with a variety of useful information for assessing a business's financial performance. GAAP stresses measurement of a business's earnings from period to period and the matching of revenue and expenses to the periods in which they are incurred. In addition, these financial statements provide information to help investors, creditors, and others to assess the amounts, timing, and uncertainty of future earnings from the business. SAP is designed to meet the needs of insurance regulators, who are the primary users of insurers' financial statements, and stresses the measurement of an insurer's ability to pay claims—to protect policyholders from an insurer becoming insolvent (that is, not having sufficient financial resources to pay claims).²

Additionally, while RRGs may be permitted to report their financial condition using either GAAP or SAP, some regulators permit RRGs to report using nonstandard variants of both sets of accounting principles—to which we refer as modified GAAP and modified SAP. The use of variants further constrains the ability of NAIC and nondomiciliary state analysts to (1) understand the financial condition of the RRGs selling insurance to citizens of their state and (2) compare the financial condition of RRGs with that of traditional insurers writing similar lines of insurance. In some cases, RRGs are permitted to count letters of credit (LOC) as assets as a matter of permitted practice under modified versions of GAAP and SAP,

²Each state conducts financial oversight of the companies operating in its jurisdictions to help ensure that policyholders and claimants receive the requisite benefits from the policies sold. In recognition of these special concerns and responsibilities, statutes, regulations, and practices combine to establish statutory accounting principles. Statutory accounting principles have historically been those practices or procedures prescribed or permitted by an insurer's domiciliary state. NAIC has standardized and incorporated these principles in its *Accounting Practices and Procedures* manuals (which provide a comprehensive guide of statutory principles), *Annual Statement Instructions*, and *Financial Condition Examiners Handbook*.

Appendix III
Selected Differences between Statutory and
Generally Accepted Accounting Principles as
They Relate to Financial Reporting for RRGs

although neither accounting method traditionally permits this practice.³ Further, regulators in some states have allowed RRGs filing under GAAP to modify their financial statements and count surplus notes as assets and add to surplus, another practice which GAAP typically does not allow.⁴

According to NAIC, the key differences between GAAP and SAP as they relate to financial reporting of RRGs are the treatment of acquisition costs and assets, differences that affect the total amount of surplus an RRG reports on the balance sheet. This is important because surplus represents the amount of assets over and above liabilities available for an insurer to meet future obligations to its policyholders. Consequently, the interpretation of an RRG's financial condition can vary based on the set of accounting principles used to produce the RRG's balance sheet.

Acquisition Costs

According to NAIC, GAAP and SAP differ most in their treatment of acquisition costs, which represent expenditures associated with selling insurance such as the commissions, state premium taxes, underwriting, and issuance costs that an insurer pays to acquire business. Under GAAP, firms defer and capitalize these costs as an asset on the balance sheet, then report them as expenses over the life of the insurance policies. This accounting treatment seeks to match the expenses incurred with the related income from policy premiums that will be received over time. Under SAP, firms "expense" all acquisition costs in the year they are incurred because these expenses do not represent assets that are available to pay future policyholder obligations. As illustrated in figure 9, the different accounting treatments of acquisition costs have a direct impact on the firm's balance sheet. Under GAAP, a firm would defer acquisition costs and have a higher level of assets, capital, and surplus than that same firm would have if reporting under SAP. Under SAP, these acquisition costs would be fully charged in the period in which they are incurred, thereby reducing assets, capital, and surplus.

³A letter of credit is a financial guaranty issued by a bank or financial institution that permits the party to which it is issued to draw funds from the bank if necessary. In the case of RRGs, LOCs generally are drawn if a commissioner of insurance needs to take over the RRG and use the LOC to pay all outstanding claims.

⁴A surplus note is debt that an insurance company owes and that the lender has agreed cannot be repaid without regulatory approval.

Appendix III
Selected Differences between Statutory and
Generally Accepted Accounting Principles as
They Relate to Financial Reporting for RRGs

Figure 9: The Effect of Differences in Accounting for Acquisition Costs on Assets, Capital, and Surplus, GAAP Compared with SAP

Account category	Current financials (GAAP)	Adjustments	SAP
Cash and invested assets	\$2,129,981		\$2,129,981
Uncollected premiums	674		674
Other	0		0
Aggregate write-ins ^a :			
LOCs	0		0
Other	0		0
Fixed and other assets	0		0
Deferred acquisition costs ^b	318,132	(318,132)	0
Prepaid expenses ^c	0		0
Total assets	2,448,787		2,130,655
Reserves	37,807		37,807
Other	1,727,324		1,727,324
Total liabilities	1,765,131		1,765,131
Capital and surplus	683,656	(318,132)	365,524
Total liabilities and capital and surplus	\$2,448,787		\$2,130,655

Source: NAIC.

^aAn aggregate write-in is an item that is included in the balance sheet but for which there is no preprinted or established line item.

^bDeferred acquisition costs are a balance sheet item only under GAAP or modified versions of GAAP. SAP does not allow for the deferral of acquisition costs.

^cPrepaid expenses are payments made for goods and services in advance of the date they will be received.

Assets

GAAP and SAP also treat some assets differently. Under GAAP, assets are generally a firm’s property, both tangible and intangible, and claims against others that may be applied to cover the firm’s liabilities. SAP uses a more restrictive definition of assets, focusing only on assets that are available to pay current and future policyholder obligations—key information for regulators. As a result, some assets that are included on a GAAP balance sheet are excluded or “nonadmitted” under SAP. Examples of nonadmitted assets include equipment, furniture, supplies, prepaid expenses (such as prepayments on maintenance agreements), and trade names or other intangibles.

Appendix III
Selected Differences between Statutory and
Generally Accepted Accounting Principles as
They Relate to Financial Reporting for RRGs

Some RRGs also modify GAAP to count undrawn LOCs as assets. More specifically, the six leading domiciliary states for RRGs—Arizona, the District of Columbia, Hawaii, Nevada, South Carolina, and Vermont—allow RRGs to count undrawn LOCs as assets, thus increasing their reported assets, capital, and surplus, even though undrawn LOCs are not recognized as an asset under GAAP or SAP. For example, in 2002–2003, state regulators permitted about one-third of RRGs actively writing insurance to count undrawn LOCs as assets and supplement their reported capital.⁵

Figure 10 illustrates the impact of different asset treatments for undrawn LOCs. In this example, the RRG had a \$1.5 million LOC that was counted as an asset under a modified version of GAAP but was not counted as an asset under a traditional use of SAP.⁶ In addition, the RRG treated \$363,750 in prepaid expenses as an asset, which it would not be able to do under SAP. Under a modified version of GAAP, the RRG's total assets would be \$17,914,359 instead of \$16,050,609 under a traditional use of SAP, a difference of \$1,863,750.

⁵According to NAIC data, 37 of 115 RRGs were allowed to admit an LOC as an asset during either 2002 or 2003.

⁶However, had the RRG used a modified version of SAP, the \$1.5 million could have been counted as an asset as well.

Appendix III
Selected Differences between Statutory and
Generally Accepted Accounting Principles as
They Relate to Financial Reporting for RRGs

Figure 10: Impact of Counting an LOC and Prepaid Expenses as Assets on the Balance Sheet, Modified GAAP Compared with SAP

Account category	Current financials (Modified GAAP)	Adjustments	SAP ^a
Cash and invested assets	\$6,485,210		\$6,485,210
Uncollected premiums	914,011		914,011
Other	946,778		946,778
Aggregate write-ins ^b :			
LOCs	1,500,000	(1,500,000)	0
Other	7,704,610		7,704,610
Fixed and other assets	0		0
Deferred acquisition costs ^c	0		0
Prepaid expenses ^d	363,750	(363,750)	0
Total assets	17,914,359		16,050,609
Reserves	10,452,990		10,452,990
Other	4,799,971		4,799,971
Total liabilities	15,252,961		15,252,961
Capital and surplus	2,661,398	(1,863,750)	797,648
Total liabilities and capital and surplus	\$17,914,359		\$16,050,609

Source: NAIC.

^aIn some states, RRGs file under SAP, but can admit an LOC as an asset as a matter of permitted practice. This example assumes that such permitted practices are not present.

^bAn aggregate write-in is an item that is included in the balance sheet but for which there is no preprinted or established line item.

^cDeferred acquisition costs are a balance sheet item only under GAAP or modified versions of GAAP. SAP does not allow for the deferral of acquisition costs.

^dPrepaid expenses are payments made for goods and services in advance of the date they will be received.

Figure 11 illustrates different treatments of acquisition costs and assets, using a modified version of GAAP and a traditional version of SAP. In this example, under a modified version of GAAP, undrawn LOCs (\$2.2 million), acquisition costs (\$361,238), and prepaid expenses (\$15,724) are valued as an additional \$2,576,962 in assets with a corresponding increase in capital and surplus. The overall impact of treating each of these items as assets under a modified version of GAAP is significant because the RRG reported a total of \$2,603,656 in capital and surplus, whereas it would report only \$26,694 under a traditional use of SAP. Under traditional GAAP, capital and

Appendix III
Selected Differences between Statutory and
Generally Accepted Accounting Principles as
They Relate to Financial Reporting for RRGs

surplus would be reported as \$403,656 (\$2,603,656 minus the \$2,200,000 undrawn LOC).

Figure 11: Impact of Counting Acquisition Costs, LOCs, and Prepaid Expenses as Assets on the Balance Sheet, Modified GAAP Compared with SAP

Account category	Current financials (Modified GAAP)	Adjustments	SAP ^a
Cash and invested assets	\$4,558,039		\$4,558,039
Uncollected premiums	465,999		465,999
Other	409,775		409,775
Aggregate write-ins ^b :			
LOCs	2,200,000	(2,200,000)	0
Other	519,233		519,233
Fixed and other assets	0		0
Deferred acquisition costs ^c	361,238	(361,238)	0
Prepaid expenses ^d	15,724	(15,724)	0
Total assets	8,530,008		5,953,046
Reserves	3,814,446		3,814,446
Other	2,111,906		2,111,906
Total liabilities	5,926,352		5,926,352
Capital and surplus	2,603,656	(2,576,962)	26,694
Total liabilities and capital and surplus	\$8,530,008		\$5,953,046

Source: NAIC.

^aIn some states, RRGs file under SAP, but can admit an LOC as an asset as a matter of permitted practice. This example assumes that such permitted practices are not present.

^bAn aggregate write-in is an item that is included in the balance sheet but for which there is no preprinted or established line item.

^cDeferred acquisition costs are a balance sheet item only under GAAP or modified versions of GAAP. SAP does not allow for the deferral of acquisition costs.

^dPrepaid expenses are payments made for goods and services in advance of the date they will be received.

Additionally, the two accounting principles treat surplus notes differently. Although SAP restricts certain assets, it permits (with regulatory approval) the admission of surplus notes as a separate component of statutory surplus, which GAAP does not. When an insurance company issues a surplus note, it is in effect making a promise to repay a loan, but one that the lender has agreed cannot be repaid without regulatory approval. Both SAP and GAAP recognize the proceeds of the loan as an asset to the extent they have been borrowed but not expended (are still available). However, since the insurer cannot repay the debt without approval, the regulator knows that the proceeds of the loan are available to pay claims, if necessary. Thus, under SAP, with its emphasis on the ability of an insurer to pay claims, the proceeds are added to capital and surplus rather than recognizing a corresponding liability to repay the debt. GAAP, on the other hand, requires companies issuing surplus notes to recognize a liability for the proceeds of the loan, rather than adding to capital and surplus since the insurer still has to repay the debt. However, according to NAIC data, four state regulators have allowed RRGs to modify GAAP and report surplus notes as part of capital and surplus during either 2002 or 2003. A total of 10 RRGs between the four states modified GAAP in this manner and were able to increase their reported level of capital and surplus.⁷

Other Differences

Finally, in addition to the differences between GAAP and SAP already discussed, and as they have been modified by RRGs, other differences between the two accounting methods include the treatment of investments, goodwill (for example, an intangible asset such as a company's reputation), and deferred income taxes. According to NAIC, while these differences may affect a company's financial statement, they generally do not have as great an impact as the differences in the treatment of acquisition costs and assets.

The Different Results under Each Permitted Accounting Method Can Affect Analysis of an RRG's Financial Condition

Use or modification of GAAP and the modification of SAP can also affect the ability of NAIC and regulators to evaluate the financial condition of some RRGs. Although subject to the regulation of one state (their domiciliary state), RRGs can and do sell insurance in multiple states and are required to provide financial statements to each state in which they sell insurance. In almost all cases, RRGs also provide financial statements to NAIC for analysis and review.

⁷The value of the surplus notes for the 10 RRGs ranged from \$25,000 to \$3 million.

Appendix III
Selected Differences between Statutory and
Generally Accepted Accounting Principles as
They Relate to Financial Reporting for RRGs

NAIC uses financial ratios and risk-based capital standards to evaluate the financial condition of insurance companies and provides this information to state regulators in an effort to help them better target their regulatory efforts.⁸ NAIC calculates the ratios using the data from the financial statements as they are filed by the companies. However, since both the formulas and the benchmarks for the financial ratios are based on SAP, the ratio information may not be meaningful to NAIC or the state regulators if the benchmarks are compared with the ratios derived from financial information based on a standard or modified version of GAAP, or a modified version of SAP. Further, the use of GAAP, modified GAAP, or modified SAP could make risk-based capital standards less meaningful because these standards also are based on SAP. (We discuss accounting differences in relation to risk-based capital standards in more detail at the end of this appendix.)

To illustrate how the use of two different accounting methods can impede an assessment of an RRG's financial condition, we selected two financial ratios that NAIC commonly uses to analyze the financial condition of insurers—net premiums written to policyholders' surplus (NPW:PS) and reserves to policyholders' surplus. Using SAP, NAIC has established a "usual range" or benchmark for these financial indicators from studies of the ratios for companies that became insolvent or experienced financial difficulties in recent years. As part of its review process, NAIC compares insurers' ratios with these benchmarks. We selected these two ratios because of the emphasis regulators place on insurance companies having an adequate amount of surplus to meet claims and because policyholders' surplus is affected by the different accounting treatments used by RRGs.⁹

⁸NAIC collects information on insurance companies through the annual and quarterly financial reports that insurance companies file and conducts analyses using financial ratios to identify companies that are likely to have financial difficulties. An NAIC database generates key ratio results, which cover indicators of financial condition such as profitability and liquidity, and serve as tools to determine the level of regulatory attention required for a particular insurer.

⁹While the different accounting treatments affect these two ratios, they would not necessarily affect all of the analyses performed by NAIC.

Appendix III
Selected Differences between Statutory and
Generally Accepted Accounting Principles as
They Relate to Financial Reporting for RRGs

Net Premiums Written to
Policyholders' Surplus Ratio

The NPW:PS ratio is one of the 12 ratios in NAIC's Insurance Regulatory Information System (IRIS) and measures the adequacy of a company's ability to pay unanticipated future claims on that portion of its risk that it has not reinsured.¹⁰ The higher the NPW:PS ratio, which is typically expressed as a percentage, the more risk a company bears in relation to the policyholders' surplus available to absorb unanticipated claims. In other words, the higher the NPW:PS, the more likely an insurance company could experience difficulty paying unanticipated claims. Since surplus, as reflected by the availability of assets to pay claims, is a key component of the ratio, the use of GAAP, modified GAAP, or modified SAP instead of SAP may affect the results substantially.

As shown in figure 12, each of the three RRGs has a lower NPW:PS ratio when the ratio is calculated using balance sheet information based on a modified version of GAAP than when the same ratio is based on SAP. In other words, under modified GAAP, each of these three RRGs would appear to have a greater capability to pay unanticipated claims than under SAP. However, one RRG (RRG from figure 9) is below the NAIC benchmark regardless of which accounting method is used.

¹⁰IRIS is part of NAIC's Financial Analysis Solvency Tools (FAST), a collection of analytical tools designed to provide state insurance departments with information to better screen and analyze the financial condition of insurance companies operating in their respective states.

**Appendix III
Selected Differences between Statutory and
Generally Accepted Accounting Principles as
They Relate to Financial Reporting for RRGs**

Figure 12: Differences in the Calculation of Net Premiums Written to Policyholders' Surplus Ratio, Modified GAAP Compared with SAP

		Dollars		NPW:PS ratio	
		Net premiums written (NPW)	Policyholders' surplus (PS)		
RRG from figure 9	Modified GAAP (current financials)	968,030	683,656	142% ○	NAIC benchmark
	SAP (converted with adjustments)	968,030	365,524	265% ○	
	NAIC benchmark				
RRG from figure 10	Modified GAAP (current financials)	9,314,922	2,661,398	350% ○	NAIC benchmark
	SAP (converted with adjustments)	9,314,922	797,648	1,168% ○	
	NAIC benchmark				
RRG from figure 11	Modified GAAP (current financials)	3,058,107	2,603,656	117% ○	NAIC benchmark
	SAP (converted with adjustments)	3,058,107	26,694	11,456% ○	
	NAIC benchmark				

- NPW:PS Ratio**
- Modified GAAP
 - SAP
 - | NAIC (benchmark)

Source: NAIC.

Note: In some states, RRGs file under SAP, but can admit an LOC as an asset as a matter of permitted practice. This example assumes that such permitted practices are not present.

Some of the higher NPW:PS ratios under SAP could provide a basis for regulatory concern. NAIC considers NPW:PS ratios of 300 percent or less as “acceptable” or “usual.” However, according to NAIC staff, companies that primarily provide liability insurance generally should maintain lower NPW:PS ratios than insurers with other lines of business because estimating potential losses for liability insurance is more difficult than estimating potential losses for other types of insurance. Since RRGs only can provide liability insurance, NAIC staff believe a value above 200 percent (in conjunction with other factors) could warrant further regulatory attention. Using this lower benchmark, two RRGs (from figures

Appendix III
Selected Differences between Statutory and
Generally Accepted Accounting Principles as
They Relate to Financial Reporting for RRGs

9 and 11) meet the benchmark criteria under modified GAAP, but all three RRGs fail to meet the benchmark under SAP. Thus, an analysis of an RRG's financial condition as reported under modified GAAP could be misleading, particularly when compared with other insurers that report under SAP.

**Reserves to Policyholders'
Surplus Ratio**

The reserves to policyholders' surplus ratio is one of NAIC's Financial Analysis Solvency Tools ratios and represents a company's loss and loss adjustment expense reserves in relation to policyholders' surplus.¹¹ This ratio, which is typically expressed as a percentage, provides a measure of how much risk each dollar of surplus supports and an insurer's ability to pay claims, because if reserves were inadequate, the insurer would have to pay claims from surplus. The higher the ratio, the more an insurer's ability to pay claims is dependent upon having and maintaining reserve adequacy. Again, surplus is a key component of the ratio and the use of GAAP, modified GAAP, or modified SAP rather than SAP could affect the ratio.

As shown in figure 13, each of the three RRGs has higher reserves to policyholders' surplus ratios when the calculations are derived from balance sheet numbers based on SAP rather than modified GAAP. Under the modified version of GAAP, each of the three RRGs reports higher levels of surplus and consequently less risk being supported by each dollar of surplus (a lower ratio) compared with SAP.

¹¹A company's loss reserves represent the estimated liability for outstanding insurance claims or losses that have occurred but have not been reported as of a given evaluation date. Loss adjustment expenses are the expenses incurred in investigating and settling such claims or losses and insurers also establish reserves for these expenses. The sum of the two reserves represents the total reserves for unpaid losses and the expenses incurred in investigating and settling them.

**Appendix III
Selected Differences between Statutory and
Generally Accepted Accounting Principles as
They Relate to Financial Reporting for RRGs**

Figure 13: Differences in the Calculation of Reserves to Policyholders' Surplus Ratio, Modified GAAP Compared with SAP

		Dollars		R:PS ratio	
		Reserves (R)	Policyholders' surplus (PS)		
RRG from figure 9	Modified GAAP (current financials)	37,807	683,656	6% ○	
	SAP (converted with adjustments)	37,807	365,524	10% ○	
	NAIC benchmark				
RRG from figure 10	Modified GAAP (current financials)	10,452,990	2,661,398	393% ○	
	SAP (converted with adjustments)	10,452,990	797,648	1,310% ○	
	NAIC benchmark				
RRG from figure 11	Modified GAAP (current financials)	3,814,446	2,603,656	147% ○	
	SAP (converted with adjustments)	3,814,446	26,694	14,290% ○	
	NAIC benchmark				

R:PS Ratio

- Modified GAAP
- SAP
- | NAIC (benchmark)

Source: NAIC.

Note: In some states, RRGs file under SAP, but can count an LOC as an asset as a matter of permitted practice. This example assumes that such permitted practices are not present.

Higher reserves to policyholders' surplus ratios could provide a basis for regulatory concerns. According to NAIC, ratios of 200 percent or less are considered "acceptable" or "usual" for RRGs. However, although the RRG from figure 11 meets NAIC's benchmark under modified GAAP, it significantly exceeds NAIC's benchmark when the ratio is calculated based on SAP—a condition that could warrant further regulatory attention.

Risk-Based Capital

NAIC applies risk-based capital standards to insurers in order to measure their capital adequacy relative to their risks. Monitoring capital levels with other financial analyses helps regulators identify financial weaknesses. However, since risk-based capital standards are based on SAP, numbers used to calculate capital adequacy that are derived from any other

accounting basis (GAAP, modified GAAP, or modified SAP) could distort the application of the standards and make resulting assessments less meaningful.

NAIC uses a formula that incorporates various risks to calculate an “authorized control level” of capital, which is used as a point of reference. The authorized control level is essentially the point at which a state insurance commissioner has legal grounds to rehabilitate (that is, assume control of the company and its assets and administer it with the goal of reforming and revitalizing it) or liquidate the company to avoid insolvency. NAIC establishes four levels of company and regulatory action that depend on a company’s total adjusted capital (TAC) in relation to its authorized control level, with more severe action required as TAC decreases. They are

- *Company action level.* If an insurer’s TAC falls below the company action level, which is 200 percent of the authorized control level, the insurer must file a plan with the insurance commissioner that explains its financial condition and how it proposes to correct the capital deficiency.
- *Regulatory action level.* If an insurer’s TAC falls below the regulatory action level, which is 150 percent of its authorized control level, the insurance commissioner must examine the insurer and, if necessary, institute corrective action.
- *Authorized control level.* If an insurer’s TAC falls below its authorized control level, the insurance commissioner has the legal grounds to rehabilitate or liquidate the company.
- *Mandatory control level.* If an insurer’s TAC falls below the mandatory control level, which is 70 percent of its authorized control level, the insurance commissioner must seize the company.

Because the differences between GAAP and SAP, as well as the modification of both accounting bases, affect an RRG’s capital, the differences also affect the TAC calculation for an RRG, and when compared to the control levels, could lead an analyst to draw different conclusions about the level of regulatory intervention needed. For example, in table 2, we place the three RRGs that we have been using as examples in the action categories that would result from calculating each TAC under the two accounting methods or their variants. The accounting methods used have no effect in terms of regulator action for the first RRG

**Appendix III
 Selected Differences between Statutory and
 Generally Accepted Accounting Principles as
 They Relate to Financial Reporting for RRGs**

(because the RRG maintained a TAC level of more than 200 percent of the authorized control level). The other two RRGs change to categories that require more severe actions.

Table 2: Differences in Regulatory Actions When Calculating Risk-Based Capital for Three RRGs, Modified GAAP Compared with SAP

	Current financials (modified GAAP)	With adjustments converting to SAP
RRG from figure 9	No action required	No action required
RRG from figure 10	Regulatory action level	Mandatory control level
RRG from figure 11	No action required	Mandatory control level

Source: GAO analysis of NAIC data.

Note: In some states, RRGs file under SAP, but can admit an LOC as an asset as a matter of permitted practice. This example assumes that such permitted practices are not present.

Liquidated Risk Retention Groups (RRG), from 1990 through 2003

Name of RRG and state of domicile	Date business commenced and type of coverage provided ^a	Liquidation status		Amount of claims paid on each dollar of loss and overall loss, as measured in dollars ^b	
		Start date	Open/ closed	Closed liquidations	Open liquidations (estimates)
National Warranty Insurance RRG (Cayman Islands)	1984 Contractual liability insurance arising from extended service contracts	2003 August	Open		As of 2003, the liquidators reported that losses could reach about \$74 million. The liquidators have not updated their loss estimate since 2003.
Doctors Insurance Reciprocal, RRG (DIR) (Tenn.)	1990 Medical malpractice for physicians	2003 June	Open		As of May 2005, timely claims against the RRG numbered 1,990 but it is not known what percentage of approved claims will be paid. ^c
American National Lawyers Insurance Reciprocal RRG (ANLIR) (Tenn.)	1993 Malpractice for lawyers	2003 June	Open		As of May 2005, timely claims against the RRG numbered 2,420 but it is not known what percentage of approved claims will be paid. ^d
The Reciprocal Alliance, RRG (TRA) (Tenn.)	1995 Malpractice for healthcare liability providers, including institutions, such as hospitals, and individuals, such as doctors	2003 June	Open		As of May 2005, timely claims against the RRG numbered 2,150, but it is not known what percentage of approved claims will be paid. ^e
Heritage Warranty Mutual Insurance, RRG, Inc. (Hawaii)	1999 Contractual liability insurance arising from extended service contracts for the cost of automobile repairs	2002 September	Open		As of July 2005, the liquidation was expected to be closed within a few months. No claims have been paid yet for the unauthorized insurance.

**Appendix IV
Liquidated Risk Retention Groups (RRG),
from 1990 through 2003**

(Continued From Previous Page)

Name of RRG and state of domicile	Date business commenced and type of coverage provided ^a	Liquidation status		Amount of claims paid on each dollar of loss and overall loss, as measured in dollars ^b	
		Start date	Open/ closed	Closed liquidations	Open liquidations (estimates)
Commercial Truckers RRG Captive Insurance Company (S.C.)	2001 February Commercial truckers liability	2001 September	Open		As of May 2005, the receivership estimated that the RRG had about 350 outstanding claims, valued at about \$6 million. The receiver expected to pay claims at 50 cents on the dollar.
Nonprofits Mutual RRG, Inc. (Vt.)	1991 Liability insurance for nonprofit service providers	2000 June	Open		As of July 2005, the overall estimated loss was undetermined. Claims are being paid at 86 cents on the dollar.
Osteopathic Mutual Insurance Company RRG, Inc. (Tenn.)	1986 Medical malpractice for osteopathic physicians	1996 December	1998 March	The RRG's business was assumed by another insurance company, pursuant to an approved plan of rehabilitation.	
Beverage Retailers Insurance Company RRG (Vt.)	1988 Liability for licensed alcoholic beverage retailers	1995 July	Open		As of July 2005, the overall loss estimate was about \$1.5 million. Claims have been paid at 82.5 cents on the dollar.
North American Physicians Insurance RRG (Ariz.)	1989 Medical malpractice for cosmetic, plastic, and reconstructive surgeons	1995 January	Open		As of April 2005, the overall loss was estimated at \$4.2 million with about 260 claims filed. Distribution to date is 32 cents on the dollar and may increase to 42 cents on the dollar.
U.S. Physicians Mutual RRG (Mo.)	1989 Medical malpractice for orthopedic surgeons	1994 February	Open (but expected to close soon)		As of June 2005, claims were expected to be paid at 63 cents on the dollar. ^f

**Appendix IV
Liquidated Risk Retention Groups (RRG),
from 1990 through 2003**

(Continued From Previous Page)

Name of RRG and state of domicile	Date business commenced and type of coverage provided ^a	Liquidation status		Amount of claims paid on each dollar of loss and overall loss, as measured in dollars ^b	
		Start date	Open/ closed	Closed liquidations	Open liquidations (estimates)
Professional Mutual Insurance Company RRG (Mo.)	1987 Medical malpractice to physicians	1994 April	Open but expected to close soon		Claims paid in full.
National Dental Mutual Insurance Co., a RRG (Colo.)	1987 Malpractice insurance for dentists	1997 April	Open		As of June 2005, the claims were expected to be paid in full.
HOW Insurance Company, A RRG (Va.)	1981 Contractual liability insurance arising from extended service contracts for the cost of home repairs	1994 October	Open		The claims have been paid in full, and the receivership is expected to close in a few years.
Transportation American Group, Inc., an Insurance RRG (Hawaii)	1992 Commercial automobile liability insurance for taxicab drivers	1994 July	Closed 2000 February	Claims paid in full.	
Charter RRG Insurance Company (Neb.)	1987 Automobile and garage liability insurance to persons engaged in the automobile rental industry	1992 December	Closed 1997 December	The overall loss was about \$6 million, and claims were paid at 75 cents on the dollar.	
United Physicians Insurance, RRG (Tenn.)	1989 Medical malpractice insurance for physicians	1992 July	Closed 2005 July	The loss was estimated at \$5 million, and claims were paid at 65 cents on the dollar.	
Physicians National RRG (La.)	1987 Medical malpractice	1991 November	Open		As of July 2005, claims were being paid at 50 cents on the dollar and will pay an estimated additional 7 cents at closing. The overall estimated loss is about \$27 million.

**Appendix IV
Liquidated Risk Retention Groups (RRG),
from 1990 through 2003**

(Continued From Previous Page)

Name of RRG and state of domicile	Date business commenced and type of coverage provided ^a	Liquidation status		Amount of claims paid on each dollar of loss and overall loss, as measured in dollars ^b	
		Start date	Open/ closed	Closed liquidations	Open liquidations (estimates)
National Auto Mutual Insurance Co., a RRG (N. Mex.)	1989 Commercial auto liability insurance	1991 August	Open		Payments have been made at 60 cents on the dollar, with a possible final distribution of 4 cents on the dollar.
Petroleum Marketers Mutual Insurance Company, A RRG (Tenn.)	1988 Liability insurance for the environmental clean-up of underground storage tanks	1990 May	Open		Liquidated claims have been paid in full, and money has been reserved to pay the estimated amount of unliquidated claims (as they become payable).
Rent Rite Advantage Services, Inc., a RRG (N. Mex.)	1987 Commercial vehicle liability insurance for rental cars	1990 March	Closed	The overall loss estimate is \$945,000, and claims were paid at 61 cents on the dollar.	

Sources: NAIC, state regulators, liquidators, and public documents.

Note: This table provides information about the 21 RRGs that have been liquidated. RRGs that have been liquidated meet NAIC's definition of "failure." Using NAIC's definition of failure, one other RRG can be categorized as failed because it was placed into receivership. However, because this RRG was not liquidated, we have not included it in our table.

^aFor the date on which each RRG commenced business we obtained data for most RRGs from NAIC.

^bThe information contained in this table is based on information we obtained from state regulators or liquidators. However, these sources were not always able to provide us the same types of information.

^cAccording to a Tennessee official, as of December 31, 2004, DIR had approximately \$5 million in assets and \$115 million in liabilities in expected losses for policy claims.

^dAccording to a Tennessee official, as of December 31, 2004, ANLIR had approximately \$6 million in assets and \$91 million in liabilities in expected losses for policy claims.

^eAccording to a Tennessee official, as of December 31, 2004, TRA had approximately \$17 million in assets and \$61 million in liabilities in expected losses for policy claims.

^fAs of July 2005, no estimate of the overall losses was available.

Comments from the National Association of Insurance Commissioners



NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

July 21, 2005

EXECUTIVE HEADQUARTERS
2301 MCGEE STREET
SUITE 800
KANSAS CITY, MO
64108-2662
VOICE 816-842-3600
FAX 816-783-8175

Richard J. Hillman, Director
Financial Markets and Community Investment
Government Accountability Office
441 G. Street N.W.
Washington, DC 20548

RE: GAO Report on Risk Retention Groups

Dear Mr. Hillman:

GOVERNMENT RELATIONS
HALL OF THE STATES
444 NORTH CAPITOL ST NW
SUITE 701
WASHINGTON DC
20001-1509
VOICE 202-624-7790
FAX 202-624-8579

The National Association of Insurance Commissioners (NAIC) appreciates this opportunity to review the GAO draft report on Risk Retention Groups. As you know, the NAIC is a voluntary organization of the chief insurance regulatory officials of the 50 states, the District of Columbia and five U.S. territories. The association's overriding objective is to assist state insurance regulators in protecting consumers and helping maintain the financial stability of the insurance industry by offering financial, actuarial, legal, computer, research, market conduct and economic expertise. Formed in 1871, it is the oldest association of state officials.

SECURITIES VALUATION OFFICE

48 WALL STREET
6TH FLOOR
NEW YORK NY
10005-2906
VOICE 212-398-9000
FAX 212-382-4207

Several members of the NAIC staff and Director L. Tim Wagner in his capacity as chair of the NAIC's Property and Casualty Insurance Committee reviewed the draft report and a consensus opinion among them was that the report was well thought out and well documented. The research methods employed were solid and the results obtained were carefully interpreted to obtain a clear picture of how states are undertaking their responsibilities with regard to regulation of risk retention groups. It explored the issues that are pertinent to the protection of risk retention group members and the third party claimants that are affected by the coverage provided by the risk retention groups.

Overall, the reviewers believed that the report was materially accurate. The reviewers agree with the recommendations contained in the report for Congress and for insurance regulators. Attached to this letter are several editorial suggestions and clarifications that we believe would improve the final document.

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Thanks again for all your hard work in making government accountable to the public that it serves.

Sincerely,

Catherine J. Weatherford
Executive Vice President & CEO

GAO Contact and Staff Acknowledgments

GAO Contact

Richard J. Hillman (202) 512-8678

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