
The

Risk Retention Reporter

Sources of Capital for Risk Retention Groups

A Risk Retention Reporter interview with Andrew Sargeant, President, USA Risk Group of Vermont

RRR: What factors determine the level of capital for risk retention groups?

Sargeant: There are a number of factors to take into account — minimum capital requirements, premium and per occurrence to surplus ratios, as well as some state specific issues. We should also note in this discussion that contributions to surplus are included in these ratios, as well as capital contributions. However, I think we should make the distinction in that capital means ownership. Contributions to surplus do not.

RRR: Do minimum domiciliary state requirements control the amount of capital and surplus?

Sargeant: In states where risk retention groups are formed under captive legislation, the minimum capital has been \$500,000. However, in practical terms, it has been rare for a risk retention group to have capital of less than \$1 million. In fact, Vermont is in the process of changing its minimum to \$1 million. If you take \$1 million as the minimum, then you need to look at the net premiums retained by the risk retention group, as well as the per occurrence retention. Domiciles will want risk retention groups to have a maximum of net premiums written, i.e. gross premiums written less reinsurance, to surplus of 3:1. Therefore, net premiums of \$6 million will require surplus of at least \$2 million. As you would expect, regulators would like to see this ratio closer to 1:1.

RRR: Do regulators require per occurrence retentions?

Sargeant: The next item to consider is the maximum amount retained per occurrence. Although it is not stated in the captive regulations, the regulators use the traditional 10:1 ratio as the rule of thumb. That means a risk retention group retaining \$500,000 per occurrence should look to have \$5 million in capital and surplus. Do you require this on day one? No, but regulators would like to see it demonstrated in the feasibility study that there is a plan to get there. With reinsurers not dropping down the levels they did in the soft market, this is putting a lot of pressure on risk retention group sponsors to come up with higher levels of capital.

RRR: Must requirements of non-domiciliary states also be considered?

Sargeant: The next items to consider are state specific requirements. Although under the Federal Risk Retention Act the domiciliary state has regulatory oversight, some states have unique requirements. For instance, in Pennsylvania, where there has been huge risk retention group activity, a risk retention group writing medical malpractice risks in that state must have surplus of \$1.125 million to access MCare for exposures above \$500,000 per occurrence. Also, in Florida, risk retention groups writing healthcare coverages in that state need at least \$5 million to meet the financial responsibility requirements.

Therefore, there are a number of factors to consider when establishing capital and surplus requirements. Clearly, the regulators want to see as much as possible; however, this is not easy for most sponsors.

RRR: What forms of capital are acceptable?

Sargeant: Although there may be one or two exceptions, capital typically is contributed either by cash or letter of credit. The letters of credit have to be issued by a Federal Reserve Bank with the State Insurance Department as beneficiary. Obviously, the bank needs collateral to support the letter of credit. The minimum capital required by the domicile (or those states with unique requirements) needs to be in place before the risk retention group starts writing business.

RRR: What about subordinated surplus notes?

Sargeant: Some risk retention groups have used these in the past; however I do not think regulators look on these too favorably. They prefer to see cash or letters of credit that are free and unencumbered in any way. However, it does depend on the domicile and the strength of the risk retention group's business plan.

RRR: Is the amount of capital an impediment to start up in many cases?

Sargeant: It depends on the size and affluence of the initial insureds; however in many cases obtaining the required capital is a problem. In many situations, there is an association sponsoring the formation of a risk retention group. In this case, the association will put up surplus through cash or letter of credit. The individual insureds will then pay in capital, usually based on a percentage of premium, to supplement the initial surplus contributed by the association. The

association does not want to have these obligations tied up forever; however, they cannot look to receive any return of surplus until the risk retention group has built up sufficient surplus of its own. For instance, we have a couple of risk retention groups we manage, established in the mid-1990's, that are only now starting to reduce letters of credit they contributed.

In other instances where you have, say 8, large insureds, they should be able to provide the necessary capital. However, if there isn't an association or insureds with deep pockets, then the sponsoring or core group of insureds looking to set up a risk retention group will have to look for outside capital.

RRR: So, it's possible for RRGs to be capitalized by anyone other than the insureds? If so, how does this work?

Sargeant: As with an association sponsored captive, outside investors can provide surplus. However, following the requirements of the LRRRA, as they are not insureds, they cannot be owners and be issued common stock. We have seen a willingness by a variety of parties to provide surplus: agents, third party administrators, hospitals (in respect of non-employed physician programs) etc. In fact, some RRG formations have been driven by agents who have limited markets with which to place business. In cases such as this, the outside investor (agent) will supply cash or arrange for a bank to provide a letter of credit to provide the initial surplus of the capital. As policyholders sign up, they will be asked to contribute capital. In these scenarios, the outside investors usually want to be able to put time limits or other conditions on the return of the surplus they have provided. The bad news for the outside investors is that the regulators look on this as a "gift" to the risk retention group. If the risk retention group is unable to build up sufficient surplus to support its business with the investors' contribution, then that contribution is locked into the risk retention group.

Recently, we have seen a couple of interesting developments, both of which were reported in the Risk Retention Reporter. First, in Florida, a nursing home risk retention group received its initial capitalization from a \$6 million appropriation contained in the state budget. This was unique, not only in that it came from the state, but that it was provided by surplus note that must be repaid over 3 years by capital contributed by the policyholders. Also recently, we saw another nursing home group, domiciled in Vermont, writing Pennsylvania risks, receive its initial capitalization through a \$5 million grant from the Pennsylvania Department of Public Welfare ("DPW"). In this instance, the DPW is not looking to recoup the initial capitalization. The fact that states are willing to help capitalize risk retention groups shows how serious the problems are in the market these days.

RRR: Can RRGs be loaned money by investors who are not insured by the RRG?

Sargeant: Funds loaned by outside investors (or even policyholders) with stipulated repayment terms and inter-

est payments will be treated as liabilities, not capital or surplus, of the risk retention group. However, if investors loan funds to a holding company (with the same owner/insureds as the risk retention group), with the holding company providing the capital and surplus to the risk retention group, the infusion of capital can be treated as surplus and not a liability. There could not be any repayment conditions to this contribution and the holding company would be reliant on dividend payments from the risk retention group to meet its principal and interest obligations. Dividend payments would be subject to regulatory approval, and investors would have to wait for the risk retention group to build up sufficient surplus before paying out dividends.

RRR: What safeguards do these investors have to protect their investment?

Sargeant: An agent or other type of service provider providing the initial capital is doing this not only to provide a market for themselves and existing and new customers, but also to preserve their business. The danger for them is that as they cannot be owners (because they are not insured), then the stockholders, having built up some expertise themselves, can terminate the agreements with these service providers and hold onto the surplus that was provided. In these instances, it is important for the investors to have themselves tied in through rolling multi-year service contracts, as well as have a strong representation on the Board of Directors. This is a fine line as the regulators will want to ensure that the agreements are arms length and that the insureds can terminate their contracts. The agents cannot make the agreements iron-clad or they will not be satisfactory to the regulators. At the moment, we are seeing a lot of camaraderie between insureds who desperately need a market and outside investors who are willing to provide capital.

RRR: This sounds like a hybrid between an agency captive and a risk retention group.

Sargeant: In a way it is. You could take the view that, like agency captives, the agent is looking to reap some of the benefits from profitable underwriting. However, as we know in many areas, i.e. healthcare, nursing homes, trucking, there is a need to provide an alternative market. I think regulators look at the people behind risk retention groups formed in this manner to ensure there is a proper understanding and equity of interest and control between the outside investors and the owner-insureds to make it work.

About the author: Andrew Sargeant has been president of USA Risk Group of Vermont since 1996. The firm, which manages approximately 60 captives, 19 of which are RRGs, has offices in Vermont, South Carolina and the British Virgin Islands. Andy, an English chartered accountant, has worked in the alternative market since 1980.

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