A Guide to the 1986 Liability Risk Retention Act

A Special Reprint from the Risk Retention Group Directory & Guide

Besieged by pleas from business people and municipalities across the United States who were unable to obtain or afford liability insurance during the mid 1980's, Congress responded by enacting amendments to the 1981 Product Liability Risk Retention Act. The new legislation, known as the Federal Liability Risk Retention Act of 1986 (the Act), created two vehicles by which insurance buyers could more readily avail themselves of liability insurance: risk retention groups (RRGs) and purchasing groups (PGs). Let's compare and contrast these two insurance vehicles.

RRGs and PGs Compared

According to the Act, a risk retention group must form as a liability insurance company under the laws of at least one state. The owners of the risk retention group must also be its insureds. Membership in the risk retention group is limited to persons engaged in similar businesses or activities with respect to the liability to which they are exposed. The Act requires the risk retention group to prepare a feasibility study or plan of operation which includes the coverage, deductibles, coverage limits, rates, and rating classification systems for each line of insurance the group intends to offer. The feasibility study or plan of operation must be filed with the risk retention group's licensing state as well as with every state in which the entity intends to operate.

Unlike a risk retention group, a purchasing group is not an insurance company. Rather, a purchasing group can be any group of persons with similar or related liability risks who form an organization, one of whose purposes is to purchase liability insurance on a group basis. No specific requirements are imposed regarding the legal structure of a purchasing group. In the case of a trade association, a simple resolution of the board authorizing the organization's officers to make arrangements to purchase liability insurance on a group basis would be sufficient to establish the purchasing group.

Like participants in risk retention groups, members of purchasing groups must be in similar or related businesses which expose them to similar liability risks. However, unlike risk retention group participants, purchasing group members need not concern themselves with raising capital or arranging reinsurance. Further, whereas risk retention groups typically must provide quality loss experience, have a minimum number of participants, a minimum premium volume, and the willingness to make a long-term commitment, purchasing groups may find these factors helpful to their formation, but not critical.

From the foregoing, it becomes apparent that purchasing groups are much easier to form. They require no capital contributions, and although loss data is helpful to underwrite the risks, it is not essential. In addition, purchasing groups need not file feasibility studies, but can become operational upon the filing of a notice with their state of domicile and the other states in which the group intends to operate. The notice must state the name and domicile of the purchasing group, the lines and classes the purchasing group intends to buy, and the insurer from which the group intends to buy. While it may take as long as 18 months to form and qualify a risk retention group, a purchasing group can be up and running in approximately 60 days.

The Act requires a risk retention group to file annual financial statements with its chartering state and all other jurisdictions in which it is going to operate. Financial data submitted by the risk retention group must be certified by an independent public accountant and must include 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.

It should be noted that risk retention groups are specifically exempted by the Act from participation in state guaranty funds; if a risk retention group becomes insolvent, insureds and claimants have no protection through such a fund. Similarly, purchasing groups insured by non-admitted carriers are not covered by state guaranty funds.

Regulatory Issues

Over the past 40 years, with few exceptions, Congress has left regulation of the insurance industry to the states, each of which have their own requirements, including licensing laws, "seasoning" requirements, fictitious group laws, restrictions on the ability of insurers to offer to a group special terms regarding rates and coverage, higher tax rates on foreign (out of state) insurers, and countersignature laws.

To help promote the formation and multi-state operation of group liability insurance programs, Congress enacted the Products Liability Risk Retention Act in 1981 and expanded its scope through amendments in 1986. With the advent of the 1986 Risk Retention Act, counter-signature and fictitious group laws which had previously restricted formation of group purchase of liability coverage, were eliminated. Moreover, Congress prohibited discrimination against risk retention and purchasing groups by the states. It was Congressional intent to enable businesses, professionals, nonprofit organizations and governmental agencies to establish self-insurance pools (RRGs) and to purchase liability insurance on a group basis (PGs). On a practical level, preemption of state regulation for risk retention groups provides a particularly effective way for the company to commence operations. Assuming a risk retention group has obtained a license from its chartering state and has raised its capital, it can begin operations in other states almost immediately. The Act requires that a risk retention group which intends to operate in other states file its plan of operation or feasibility study. States are permitted to require that risk retention groups comply with specified state laws, such as unfair claims practices. Moreover, states can bring an action in state or federal court to enjoin a risk retention group if it deems the group to be in hazardous financial condition.

For purchasing groups, preemption of state regulation works differently than for risk retention groups. The Act prohibits states from passing laws that would prohibit formation of purchasing groups. Moreover, the Act makes it unlawful for a state to prohibit an insurer from offering to provide the purchasing group or its members advantages, based on their loss and expense experience, not afforded to other persons with respect to rates, policy form, coverage, or other matters. Because purchasing groups are not risk bearers like risk retention groups, regulation of the purchasing group's insurer is of equal importance to the overall operations and regulation of purchasing groups. As a general rule, admitted insurers of purchasing groups have greater regulatory flexibility, particularly on rate and form requirements, while purchasing groups insured by surplus lines carriers are benefited from placements using non-resident surplus lines brokers.

Continued Growth of Risk Retention

While the "liability" crisis served as the initial motivation for enactment of the 1986 Risk Retention Act, the fundamental advantages derived from risk retention groups and purchasing groups - from both economic and regulatory perspectives - are responsible for their continued growth.

For risk retention groups, major benefits include the ability of members to control their own program; to obtain rate stability over the long-term; to implement effective loss control/risk management programs; to obtain dividends for good loss experience; to have access to reinsurance markets; and to maintain a stable source of liability coverage at affordable rates.

For purchasing groups, major benefits include the ability to negotiate tailor-made coverage at favorable rates with insurers. For insurers, purchasing groups offer the ability to write profitable programs, while also lowering costs and increasing service to insurance buyers. For agents and brokers, purchasing groups offer an ideal way to expand a single-state program into a national program, and also to add value to the group through enhanced loss control and risk management programs.

Growth of the alternative marketplace, of which risk retention groups and purchasing groups are a key part -- is here to stay. Industry experts predict that by the end of 1997, the alternative risk-financing marketplace will comprise 40% or approximately $114 billion of a $285 billion property/casualty commercial market.

Where does risk retention fit into this picture? According to statistics developed by the Risk Retention Reporter - an authoritative monthly journal for the risk retention marketplace that systematically monitors activity of risk retention and purchasing groups - growth of both entities has been steady since passage of the Act. The May 1998 issue of the Risk Retention Reporter cites more than 600 purchasing groups and over 60 risk retention groups. The latest survey published in the October 1997 Risk Retention Reporter found that risk retention group premium for 1996 totaled more than half a billion dollars.

Risk retention is a growing force in the property/casualty marketplace. It provides an alternative risk financing mechanism which, when used responsibly, can serve the needs of the American insurance-buying public.