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# Risk Retention Reporter

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## Use of Regulation 114 Trusts by Risk Retention Groups

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The recent surge in RRG formations has resulted in a "hunt for capital." The requirements of the 1986 Liability Risk Retention Act that all shareholders of a risk retention group be insureds and all insureds be shareholders, can create a problem with raising initial capital from potential members who do not know if the RRG will (a) get off the ground and (b) offer competitive or market pricing. There have been some innovative structures put in place involving "offshore" or "special purpose" reinsurers where "capital" can be contributed through arms length ceding of reinsurance by the RRG. This reduces the amount of capital needed in the RRG as all captive regulated domiciles base their capitalization requirements on net premium retained and net occurrence limit.

For example, a \$10M program would normally need around \$3.5M in capital on day one. If RRG members and or association raised \$2M, it would be possible for investors, such as agents to contribute the additional \$1.5M in capital to a reinsurance captive and accept a 50% quota share participation, thereby reducing the net premium retained in the RRG to \$5M, which would be acceptable to most regulators. (This example ignores per occurrence retention which can also drive capital requirements)

Obviously, the onshore regulators of the RRG have to be convinced that it is safe, prudent and acceptable for them to allow a substantial part of the premium due the RRG to be ceded to a non-admitted reinsurer. This is where the 114 trust comes in. The 114 trust is method approved by the National Association of Insurance Commissioners for securing those obligations.

### What is a Regulation 114 Trust?

The Regulation 114 trust is a three way investment trust agreement involving a ceding insurance company, i.e. the RRG (the beneficiary), a financial institution, (the trustee), and a non-admitted reinsurer, (the grantor — who is granting the beneficiary control over the ceded premiums.) The governing law is from New York (N. Y. Comp. Codes R. & Regs. tit. 11, Section 126.1 et seq.

(2000) ("Regulation 114"). Under NAIC requirements, the 114 trust must be maintained onshore in an approved financial institution, while the reinsurance captive can be domiciled offshore.

The NAIC does not allow credit for reinsurance ceded to non-admitted reinsurer(s) unless the obligations of the non-admitted reinsurer are secured by a Letter of Credit (LOC) or a Regulation 114 trust. Therefore the 114 trust is the only alternative to providing an LOC unless the ceding company or fronting company is willing to take a potential schedule F penalty against its capital.

### How do 114 Trusts Work?

An RRG, the ceding company, transfers its reinsurance cession to the 114 trust. The funds in the 114 trust cannot be used for any purpose (except for payment of authorized claims) without the approval and consent of the RRG. In the case of an RRG ceding to an unauthorized reinsurer, this allows the state regulator of the RRG to monitor the ceded funds and, in theory, would allow them to control those funds in insolvency.

The trust assets have to be managed and invested in accordance with the terms of the trust documents. This is usually fairly restrictive allowing funds to be invested only in cash, money markets and relatively short term fixed instruments. The fixed income instruments are also subject to NAIC investment requirements. This results in the reinsurer having to adopt a conservative investment policy and accepting a potentially lower rate of return than their investment style may have achieved. This limited investment return has to be weighed against the hoped for underwriting profits from risk participation and, in the case of a broker or agent, the creation of a new market for its client base to generate commissions and or servicing income.

### Advantages of 114 Trusts Over LOCs

The RRG, as the ceding company and party arranging the transfer to the trust, is usually willing to allow the trust to be funded on a monthly cession basis because it knows that, as beneficiary, it is the first

recipient of the funds. The only other alternative for securing an unauthorized reinsurer is an LOC. If the RRG is going to accept an LOC it is going to demand all of it be posted for the benefit of the RRG prior to the inception of the reinsurance contract or will set a very rigorous "step-up" schedule for the LOCs. It is more of a risk to accept LOCs on a step-up basis as there is no guarantee that the step-up will be completed, and some state regulators may require the full year estimated LOC be posted before accepting the non-admitted reinsurer. By accepting a 114 trust the RRG knows the funds are held in a secure NAIC approved financial institution that cannot release the funds for any reason (other than the payment of approved claims) without the consent of the RRG and implied knowledge of the RRG regulators.

Not only are LOCs expensive and difficult to obtain they are considerably more inflexible than the use of a trust. The trust funds are used to settle claims so they are self adjusting in that the balance always represents the ceded premium less commission less paid claims plus investment income. The LOC is posted for the balance of the ceded premium less commissions, and the reinsurer has to negotiate a reduction with the ceding company for paid claims. The trust also allows the reinsurer to work with other insurers and segregate the loss funds appropriately so that more than one insurer can work with the reinsurer and be comfortable its recoverables are protected. The trust, in effect, segregates a program's ceded funds into a controlled account and allows regulators and RRG management to review and monitor the funds available to meet their ceded obligations. In other words the RRG could have multiple 114 trusts from several unauthorized reinsurers, or conversely, the unauthorized reinsurer could accept cessions from more than one RRG by establishing multiple 114 trusts.

### What are the Cost Factors?

The first point to make is that the fees are negotiable and will vary by the size, duration and balance of the assets to be held in the trust. It is also important to deal with a financial institution that knows what these trust instruments are and how they are expected to work. The actual trust wording is also subject to some negotiation and experience with carriers that accept them is another plus. The annual fees range from 0.4% up to 1% of the assets under management. This includes investment management and trustee fees. This would compare to a minimum of 0.3% for a secured LOC up to 1.5% for an unsecured LOC.

### Other Uses of 114 Trusts by RRGs

In some situations, existing RRGs may want to establish a second captive to be used in conjunction with a 114 trust. For example, a medical RRG is admitting a new member to the program that will represent 35% additional premium. The existing members are unsure of

immediately pooling this new risk until they feel comfortable that the new member has adopted the management practices and loss control standards expected of the group members. The proposed solution is to cede 80% quota share of the primary retention to a segregated cell company, thus allowing the new member to still bear a great responsibility for its own losses in the retained layer of the RRG whilst also ensuring there is sufficient risk sharing to allow premium deductibility and pass anti-fronting provisions in some states. The ceded premiums will be held in 114 trusts. The stated long term goal is that the new member will be fully integrated into the RRG in two or three years when the RRG board is comfortable that the member's loss control policies are in place, at which point the use of the segregated cells would be discontinued.

### What Other Concerns Need to be Addressed?

The State regulators will need to be comfortable with the domicile chosen for the second captive. The program will clearly need to benefit the RRG and its members. Using quota share reinsurance between the RRG and the reinsurance captive is the best way to assure this, as the proportional nature of quota share means it is an even sharing in the proceeds, expense and losses, with no possibility of manipulating the reinsurance layers pricing to benefit non-members of the RRG. Dividends from both captives will need to be blessed by the RRG regulator before any distributions take place. In addition, the solvency requirements for the second captive may have to be brought in line with those of the RRG's domiciliary requirements.

### Summary

The use of a second captive secured through a 114 trust can bring more capital and or reinsurance support to the table for RRGs. The regulatory concerns must be addressed to ensure there is no perceived manipulation of the premiums ceded from the RRG and that the second captive is not being enriched at the expense of the members of the RRG.

This can be a win-win situation, allowing related parties, core members of an RRG or investors to bear risk in an alternative market program without breaking the restrictions of the 1986 LRRRA. The 114 trust is critical to ensure the RRG is protected and that the NAIC reporting issues and regulatory comfort levels can be met.

*About the author: Gary Osborne was recently appointed Group President of USA Risk Group. In his new role, Mr. Osborne will become CEO of the group and oversee all domestic and international operations. Mr. Osborne was previously Senior Vice President of USA Risk Group, with his primary responsibility being business development. He joined USA Risk Group in 1995 and has nineteen years experience in the alternative risk market, having held positions in Bermuda, Vermont and Hawaii before joining USA Risk.*

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