
The

Risk Retention Reporter

Corporate Governance Standards for Risk Retention Groups: State Expertise vs. Federal Inexperience Fixing What Is Not Broken

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“Be thankful we’re not getting all the government we’re paying for.” Will Rogers

Among the provisions of the Risk Retention Modernization Act of 2011 (H.R. 2126), that was filed during the First Session of the 112th Congress, is an amendment that would delegate to the Federal Office of Insurance the authority to write corporate governance standards for risk retention groups and purchasing groups. This article contends that a federal role in oversight of corporate governance is not needed, that the Federal Insurance Office is neither chartered nor suited to oversee corporate governance, and that the expertise for overseeing corporate governance of RRGs already resides at the state level.

H.R. 2126 was introduced into Congress primarily as a reaction to the frustration felt by a number of risk retention groups in regard to how non-domiciliary states treat RRGs. If enacted, the resolution would amend the Liability Risk Retention Act of 1986 in three ways: First, it would allow RRGs to write commercial property insurance in addition to the liability insurance already allowed; Second, it would create a dispute resolution system for resolving disputes between a RRG and a state; Third, and the subject of this article, it would permit the Federal Insurance Office to write regulations for corporate governance standards for RRGs. As such, H.R. 2126 would supersede any state law relating to corporate governance standards for risk retention groups and risk purchasing groups.

Corporate governance involves the rules, customs, processes, or laws by which businesses operate and are regulated and controlled. Over the past ten years, corporate governance has become a more prominent issue for corporations. In 2001, when the technology bubble burst with a loss of trillions in capitalization, plus the criminal activity at Enron, WorldCom, and Tyco, the federal government responded with the Sarbanes-Oxley Act of 2002. Last year in response to the 2008 market crises, the federal government passed the Dodd-Frank Wall Street Reform and Consumer Protection Act. Despite the federal government’s recent entrance into corporate

governance, the states, with notably Delaware in the lead, have pioneered the way in developing good governance standards.

Corporate governance is a relatively new area, with its existence partially evolving from court cases issued by the Delaware Court of Chancery and Delaware Supreme Court in the 1980s. Today, corporations permeate our lives in terms of employing us, holding our life savings and investments, and providing a myriad of services and goods. The John L. Weinberg Center for Corporate Governance at the University of Delaware puts it best when it states, “How corporations function is a matter of vital importance not only in our everyday lives, but in the broader sense of how the economy and society at large functions. A healthy and functioning system of corporate governance is a stabilizing influence which attracts and retains investment capital. This capital, in turn, spurs innovation, economic growth, and scientific, medical, and technological advances, and fosters prosperity and well-being.”

In the realm of corporate governance, no jurisdiction is superior to Delaware. The State of Delaware is the domicile of choice for the majority of this nation’s public corporations and legal entities. Today there are over 1.1 million business entities domiciled in the First State. These entities rely upon three pillars of strength. First is the Delaware Corporate Code—the fact that Delaware has the preeminent corporate code is self-evident by the fact that the majority of states have adopted Delaware’s corporate laws as their own. Second and third are the Delaware Court of Chancery and Supreme Court. The former is universally respected as the only court of pure equity in the United States, while the latter has the reputation for issuing consistent rulings. Both issue an impressive number of corporate decisions that set the standard for other state courts to follow when interpreting their own corporate laws.

When Delaware Insurance Commissioner Karen Weldin Stewart formed the captive insurance bureau in 2009, her vision was to weld Delaware’s superior corporate laws with captive insurance. The captive law is

merely a licensing statute built upon the chassis of Delaware corporate and business entity laws. That vision has come to successful fruition with Delaware having grown from 40 captive insurers, when she formed the bureau, to 121 captives, 10 protected cells, and 71 series business units as of November 23, 2011.

H.R. 2126 seeks to supersede Delaware's superior laws with something that is untried and untested, even though Delaware has a worldwide reputation for excellence in corporate governance, policy, and legal decisions. The Federal Insurance Office is a creation of the Dodd-Frank law. In summary, under this law its duties are to collect and analyze information regarding the insurance industry; assist the Financial Stability Oversight Council (FSOC) in identifying any systemically risky insurers; represent the federal government in international discussions relating to insurance regulation; and coordinate federal efforts to negotiate international agreements relating to insurance regulation. The Federal Insurance Office's authority is solely advisory since the Dodd-Frank law does not grant this office any regulatory powers, nor does Dodd-Frank grant the Federal Insurance Office authority to promulgate regulations.

A misconception among some in the insurance industry is that the director of the Federal Insurance Office is a presidential appointee. The director is a senior executive service position, in effect a career civil servant, in the federal civil service. This is a unique characteristic never seen before in the arena of insurance regulation—unlike state insurance commissioners, directors, or superintendents, who are either elected or appointed. This type of position is not required to be filled by a Presidential appointment and with the advice and consent of the Senate. The fact that the director is a career civil servant, and that many who have a career Senior Executive Service stay in that position for many years, means that the Director's tenure will likely far outlast the majority of insurance commissioners currently serving.

Over time I expect the Federal Insurance Office to develop an expertise in insurance within the scope of duties permitted under Dodd-Frank. However, an expertise in insurance does not equate to an expertise in corporate governance. The Federal Insurance Office cannot be as responsive to recognizing changes in corporate law and governance as the Delaware courts and legislature, because they do not have nearly the same level of expertise that these Delaware governmental bodies do.

A significant drawback with having the Federal Insurance Office write corporate governance standards is that doing so does not comport with its mission. Dodd-Frank tasked the Federal Insurance Office with duties that are not remotely related to writing corporate governance standards for RRGs. Consider that the director of the Federal Insurance Office assists the FSOC in identifying insurers that are a systemic risk for this nation's financial system. The FSOC monitors and ensures the stability of our nation's financial system and is charged with identifying threats to the financial stability of the United States. It is not difficult to figure out that no single RRG qualifies as a systemic risk, nor would the failure of a RRG threaten the U.S.'s financial stability. Today there are about 250 RRGs in the United States with less than \$3 billion in combined admitted assets. This amount of assets spread out over 250 entities does not qualify as a systemic risk.

The Federal Insurance Office also represents the federal government in international discussions about insurance regulation. Although some of these discussions may indirectly affect RRGs, the reality is that RRGs do not write coverage beyond the borders of the United States, and RRGs would not have a direct interest in these discussions. In light of the important tasks assigned to it by Dodd-Frank, the Federal Insurance Office has more important duties than to take the time to write corporate governance standards for RRGs, which in terms of premium comprise less than one percent of the total property casualty market.

Instead of allowing the Federal Office of Insurance to draft corporate governance rules for RRGs, it is better to leave this task to the states. The states have an existing body of corporate law. In Delaware the legislature drafts corporate laws with the intent that these laws be flexible. The Delaware courts understand this intent and apply these laws with the mission to bridle the type of activity that is not consistent with the corporate laws. The result is a consistent and predictable system unmatched by any state and impossible to match by the federal government.

Steve Kinion is the Director of the Bureau for Captive and Financial Insurance Products for the Delaware Department of Insurance. Since becoming director in July 2009, Delaware has grown from 40 to 121 captive insurers. Steve represents Delaware on both the NAIC's RRG task force and working group. He began his insurance career with the Oklahoma Insurance Department. He is also a lieutenant colonel in the U.S. Army Reserve.

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