FORC QUARTERLY JOURNAL
OF
INSURANCE LAW AND REGULATION

Fall 1997 September 20, 1997 Vol. IX, Edition III

THE ARIZONA LIFE AND DISABILITY REINSURER: A RISK ASSUMPTION VEHICLE FOR THE HEALTH CARE INDUSTRY

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There is a unique type of insurer that is permitted to hold a Certificate of Authority in the State of Arizona. This type of entity is known as a domestic life and disability reinsurer. Essentially, an Arizona domestic life and disability reinsurer is a corporation that is incorporated in Arizona and limited to accepting life or health insurance ceded from any domestic or foreign insurer.[(1)] In the past, the unique Arizona reinsurer has principally been used in the credit life and disability insurance area. Such reinsurers have frequently been established by auto dealers, consumer lending companies and others directly involved in the sale of consumer products where a credit life or disability policy is commonly a part of such transaction. Such reinsurers have also been established by major life insurers as a means through which key agents of the company could participate in the ownership of a class of stock in the reinsurer and any dividend that would be paid due to the profitability of the business produced by such agents and reinsured into the Arizona company. The agents would benefit from the quality of the business reinsured from the direct writing life insurer to the reinsurer which would be attributable to their own efforts.

Arizona currently licenses approximately 400 domestic life and disability reinsurers. Recently, this type of entity has received substantial interest from various health care providers and institutions. The Arizona reinsurer is seen as a way that the providers can participate in a risk-bearing strategy, together with providing clear incentives for the health care professionals and institutions in a managed care setting. The proliferation of these type of health care related life and disability reinsurers addresses regulatory concerns regarding the appropriateness of independent practice associations (IPAs), preferred provider organizations (PPOs), physician hospital organizations (PHOS) and the like undertaking to bear risk without previously being licensed as an insurer. It also provides a vehicle by which health maintenance organizations (HMOs), vision plans, dental plans and other service providers can participate in the potential for underwriting profit with respect to those parts of the health program that require a fully insured participant.

Under this scenario, a direct writing insurer would front the particular coverage that *may* be required, i.e. a point of service product, and then reinsure same to the reinsurer owned by the health care service provider. The diversity of possibilities that the Arizona reinsurer provides in this context mirrors the growth in the type of health care options available to the consumer in the late 1990s.

To form an Arizona reinsurer, one needs to maintain a minimum paid-in capital of at least $100,000[(2)] and an initial free surplus of at least $50, 000.[(3)] Thereafter, the surplus can be reduced by 50% to $25,000 once the company obtains its Certificate of Authority. Again, the Articles of Incorporation limit the corporation to reinsuring life and disability-type risks.[(4)] The Articles also require that there be a Board of Directors of not less than five nor more than fifteen, together with identifying the time of the annual meeting, the principal place of business, the limitation on the corporation's indebtedness and the extent to which the stock of the corporation shall be liable to assessment.[(5)] Arizona requires that a $100,000 statutory deposit be established representing either cash or acceptable government securities, i.e. treasury bills.[(6)]

Importantly, A.R.S. 20-260 provides an overall limit on the amount of risk on any one subject of insurance to an amount not exceeding 10% of the insurer's policyholder surplus. The policyholder surplus, representing the capital and surplus of the company, determines the amount of risk under the Reinsurance Agreement with the fronting carrier that can be assumed. For example, if the Arizona reinsurer possessed a capital and surplus of $250,000, it could reinsure a portion of the risk not to example, if the Arizona reinsurer possessed a capital and surplus of $250,000, it could reinsure a portion of the risk not to exceed $25,000 per risk. A.R.S. 20-260 does exclude group life and group or blanket disability policies from the 10% risk limitation section; however, the Department as a general rule applies an analysis based upon risk-based capital requirements, together with examining the maximum amount of exposure that may exist for an individual under a group policy in applying the 10% risk limitation. In practice, the Arizona reinsurer either retrocedes back to the fronting carrier the excess risk or enters into another reinsurance arrangement with a different reinsurer to cede off the excess exposure.

Apart from the 10% risk limitation rule, there are other sections of the Arizona Insurance Code that are relevant to such an entity. There are no premium taxes paid by the Arizona reinsurers;[(7)] however, the annual fees required of such an entity at the time of the filing of the Annual Statement are approximately $3,600. The Arizona reinsurer is subject to examination once every five years, which differs from the examination requirement for a full direct writing insurer which is once every three years.[(8)] Such a company also is exempt from filing its Annual Statement with the National Association of Insurance Commissioners.[(9)] Last, Arizona permits a hardship exemption from the audited statement requirement to the extent that the reinsurer has not assumed gross premiums of more than $5 million and is not otherwise required to file an audited financial report.[(10)]

While the Arizona reinsurer maintains some clear advantages from the standpoint of bearing less of a regulatory burden than other regulated insurance companies, it is important to realize that the Department does view this entity as a fully licensed insurance company and subject to the general regulation of the Department relating to same. From a practical standpoint, the fact that the company is a reinsurer that can only operate in connection with an appropriate Reinsurance Agreement with a domestic or foreign life or health insurer, provides the Arizona regulators with a comfort level that the consumer should be fully protected based upon the obligations of the direct writing carrier. Accordingly, the level of regulatory attention is generally less than that typically given to the direct writing insurer.

In summary, the Arizona reinsurer provides a unique and potentially financially rewarding vehicle for providers, institutions and health-related entities to gain control over their plan coverages and participate in a legally acceptable fashion in a risk-bearing relationship. With the growth of the health care industry across the country, the Arizona reinsurer provides an underwriting mechanism that can facilitate the operations and interests of a wide range of health care plans and programs. In many ways, this type of insurance entity provides a key structure consistent with the regulatory compliance requirements of the health care industry to continue to offer managed care solutions.