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Risk Retention Groups: Reasons to be Wary

On June 5, 2015, the president of a Delaware-based risk retention group (RRG) pled guilty to numerous criminal charges, including aggravated identity theft, falsifying statements to an insurance regulator, obstruction of justice, and wire fraud. The RRG provided liquor, excess, and general liability coverage to entertainment-industry clients in several states. From 2008 to 2012, It collected more than $100 million in premiums from over 3,000 policyholders.[i]

Another licensed agent pled guilty to 96 felony counts in 2015. The charges included denial of benefits, forgery, and grand theft. Among many schemes, this agent established a risk retention group for workers' compensation, registering it in Florida and collecting more than $280,000 in premiums.[ii]

In November of that year, a construction risk retention group was charged with breach of contract in Montana, having failed to pay defense and settlement costs for an insured. The risk retention group was found liable for $192,500—the amount of the settlement—as well as the insured's defense expenses.[iii]

While fraud can come in many forms—and there are certainly examples of it involving traditional carriers—it's no coincidence that these high-profile cases involve risk retention groups. The way these entities are formed, designed and regulated makes them particularly subject to fraud—and insurance agents placing risks on behalf of business customers are right to be wary of them.

What Are Risk Retention Groups?

In the 1970s, liability insurance in the United States was in crisis. General liability premiums skyrocketed in the face of rapidly rising claims—and insurers severely limited and even eliminated coverage for some types of liability as a cost-saving measure. The medical community was hit especially hard, with medical malpractice premiums soaring due to an increased number of lawsuits against doctors—and hefty awards for plaintiffs.

In this environment, it was very difficult for some businesses and professionals to get coverage to operate legally. It was either far too expensive or not available at all. To resolve this problem, Congress first passed the Product Liability Risk Retention Act, in 1981, and then the Liability Risk Retention Act in 1986.

The first piece of legislation allowed individuals and organizations in the same industry to gather together and essentially self-insure. They did it through Risk Retention Groups (RRGs), or member-owned entities that spread risk for the whole group among all members.

Originally, RRGs could only provide product liability insurance. However, the 1986 legislation allowed them to offer other products including errors and omissions, commercial, and professional liability.[iv]

What Makes RRG's a Risky Bet?

Today, insurance agents can place challenging risks with RRGs as well as traditional markets. These entities often look and behave like traditional insurance companies—but there are differences that make placing business with them significantly riskier.

They are not well regulated. Traditional insurance companies must meet regulatory requirements in all states in which they do business. For the most part, RRGs are only required to follow regulatory requirements in the state where they are domiciled—even if they operate in other states as well.

Naturally, many RRGs choose to be domiciled in the states with the least regulations. This creates a host of opportunities for abuse.

The Government Accountability Office stated its concern over this situation in 2005. According to its report, "Some regulators, including those from New York, California, and Texas—states where RRGs collectively wrote about 26 percent of all their business
but did not domicile—expressed concerns that domiciliary states were lowering their regulatory standards to attract RRGs to domicile in their states for economic development purposes."[v]

There is no support from the state guaranty fund. Every state has an insolvency guaranty fund that will pay outstanding claims if an insurance company folds, ensuring its customers do not get left exposed. RRGs are not covered by this, however. When RRG entities go bankrupt, the customers often have little recourse.

Some states require their RRGs to inform customers of this, in twelve-point font, on their application forms, certificates, and policy documents. Not all do, however.[vi]

E&O policies don't cover RRGs. Many insurance agents don't realize that most errors and omissions policies will not cover them if they make a mistake when placing business with an RRG. This leaves the insurance agent just as exposed as the customer.

It's difficult to determine financial stability. The only sure way to assess an RRG's financials is to look at its balance sheets. And that's easier said than done. Most RRGs will release only P&L documents that do not give a full picture of their financial performance. When audited financial reports are released, they can also be difficult to read for those without specialized expertise.

They are less financially stable by nature. It's not unusual for the industry to speak of RRGs as though they were just another type of insurance company—but in fact, the nature of RRGs does make them less financially viable than traditional markets.

Often, RRGs attract customers by charging premiums significantly lower than those charged for comparable programs offered by traditional insurers. But traditional insurers don't just set their rates arbitrarily—premiums are based on years of accumulated data and careful calibration of risk. When RRGs set their premiums significantly below market rates, they set themselves up for insolvency.

Another reason RRGs are less financial stable involves the nature of the organizations themselves. RRGs are designed as a vehicle for businesses and individuals in specific industries to band together and insure themselves. Most RRGs only offer specific types of coverage to customers in a single industry. Traditional insurers are much more diverse, making them more robust and less subject to fluctuations in various insurance sectors.

RRG Success Stories

Despite the intrinsic challenges with risk retention groups, there have been a number of success stories. A few examples include:

Caring Communities. This organization provides coverage for nonprofit senior housing organizations and facilities. It has been in business since 2002; part of its success may be attributable to its intense focus on spreading risk management practices that prevent injury and protect resident health and safety. It has been remarkably financially stable; in 2015, it reported issuing $47.9 million in dividends to its members over the past ten years.[vii]

OrthoForum Insurance Company. This RRG provides coverage for orthopedic practices. While many RRGs are established fairly quickly, this one is unusual in that its leadership committee performed two years of due diligence before it was formed. The RRG currently covers 20 orthopedic practice owners and over 950 physicians and mid-level insureds.[viii]

Not all RRGs are risky bets. Doing business with RRGs can sometimes be beneficial, both for insurance agents and the clients they serve. However, it's important to be careful in choosing which organizations to work with, and to be wary of low premium prices that seem too good to be true.

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Notes

[i] Donlon, Rosalie L. *Maryland Insurance Executive Pleads Guilty in Insurance Fraud Scheme.* Property Casualty 360, June 6, 2015.

[ii]"California Insurance Agent Arrested in Chicago Faces 96 Felony Charges." California Department of Insurance, March 20, 2015.

[iii] "Judge: Insurer Breached Duty to Defend, is Liable for $192,500 Defects Settlement." *Lexis Legal News,* November 9, 2015.

[iv]"Risk Retention Groups: A Basic Overview." *Captive Insurance News*, April 12, 2017.

[v]"Risk Retention Groups: Common Regulatory Standards and Greater Member Protections are Needed." United States Government Accountability Office Report to the Chairman, Committee on Financial Services House of Representatives, August 2005.

[vi]"Risk Retention and Purchasing Group Handbook." National Association of Insurance Commissioners (NAIC), 2013.

[vii]"Caring Communities RRG: A Financial Success Story." Captive.com, May 6, 2016.

[viii]Towle, Anne Marie; Fahey, Dr. Mark; Brewster, Patricia. "Captive & RRG Success Stories." SCCIA 16th Annual Executive Educational Conference, September 22, 2015. Presentation. http://c.ymcdn.com/sites/www.sccia.org/resource/resmgr/Docs/PDF_Materials/Captive__RRG_Success_Stories.pdf

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