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Service Contracts and Risk Retention Groups

PREFACE

Never in history has the non-factory vehicle service contract ("Extended Warranty") industry been in such poor financial shape and poised for a major service contract provider and/or insurer insolvency.

With the service contract industry's loss ratio approximating 185% in 2001 and faced with the prospect of continued losses in the future, many major insurers of vehicle service contracts (those Rated A+ X or higher by A.M. Best) have discontinued offering insurance coverage for extended warranty companies. This pull back by such well-known and financially secure insurers as Travelers Insurance Group has forced many extended warranty companies to move their service contract business to Risk Retention Groups or even "off-shore" reinsurance companies.

Perhaps the biggest challenge to face our industry today is the use of Risk Retention Groups to provide "insurance" coverage for service contract business. The migration by extended warranty companies to Risk Retention Groups can be driven by numerous factors, such as:

1. Lack of insurance coverage available in the market from the major domestic insurers.
2. Ease of establishing a Risk Retention Group - requires filing in only one state and a minimum of capital investment (usually $500,000 or less).
3. Desire by some to avoid regulatory oversight of their service contract insurance and business transactions.
4. The lack of supervision, regulatory audits and oversight requirements for Risk Retention Groups.
5. Get rich scheme - write lots of premiums (service contracts), siphon off the money and don't be around when the Risk Retention Group becomes insolvent.

Risk Retention Groups ("RRG's") are federally chartered and are not required to undergo the scrutiny of insurance regulators in each of the states in which they do business. There is little or no oversight of Risk Retention Groups by any Federal agency and relatively little, if any, checks and balances from state regulators to insure that RRG's comply with sound insurance and/or business practices. There is no "Guaranty Fund" or other safety net for dealers or contract holders in the event a RRG becomes insolvent.

Risk Retention Groups can be established with very little capital ($500,000 or less). Because of their size many RRG's lack the sophisticated staff/professionals (risk managers, actuaries, underwriters, etc.) necessary to ensure that adequate funds are being placed in reserves to pay for future claims. The lack of experienced staff combined with an almost manic desire to grow business has resulted in some RRG's allowing their agents to sell extended service contracts at inadequate and unsafe rates.

Rapid growth in premium has caused several Risk Retention Groups to be faced with the challenge of controlling growth and setting aside adequate reserves for future losses. Typically, a well-managed insurance company will write premiums in any given year not more than two times their "capital and surplus" base (this is a key measurement used by A.M. Best to measure insurer solvency). Many of the Risk Retention Groups that are insuring extended service contracts are so thinly funded and capitalized that the tremendous premium growth is outstripping their ability to properly insure their policies in the event of a shortfall in loss reserves. In fact, we have seen several Risk Retention Groups resort to not reporting insurance premiums by putting the loss funds in a so-called "Trust" account and treating the premiums as "Excess of Loss" or "Off Balance Sheet Funds" and only reporting an "insurance fee" as actual written premium. Risk Retention Groups that don't report the true premium exposure for which they are liable are not only deceiving the selling agent, automobile dealer and general public, they may also be guilty of a criminal offense.

How bad is it? There are several Risk Retention Groups directly at risk for losses on thousands and, in at least two cases, millions of service contracts written at inadequate rates. Some Risk Retention Groups try to disguise their lack of capital and surplus and/or solvency by claiming to have "Reinsurance" coverage. However, on close scrutiny the "Reinsurance" coverage is either non-existent or only a simple excess of loss coverage for a very small part of the Risk Retention Groups' ultimate loss exposure. EXAMPLE: One well known RRG who insures service contracts brags on their web site about having written over $210 million in gross premium. When you examine their audited financials, these funds do not appear and they had less than $1.7 million in capital and surplus at 12/31/01. Their web site would also lead you to believe that all their service contracts are reinsured by a large highly rated reinsurer but when you read the audit information you find there is very little reinsurance coverage.

For those Risk Retention Groups who continue to insure service contracts at inadequate rates, they will continue to have to pay losses on yesterday's contracts with today's premium. Their loss experience will continue to deteriorate and the reversal of cash flow will have a disastrous effect.
Unless a miracle happens in the next twelve months, there will be at least one, and maybe more, major Risk Retention Group insolvency. It is likely that these insolvencies will cause the failure of several large Extended Warranty companies.

PURPOSE

This booklet is designed to make automobile dealers and service contract agents aware:

1. That insurer insolvencies can occur, especially when service contracts are insured through a poorly capitalized Risk Retention Group;
2. That insolvencies hurt the dealer's and agent's business, their customers and impact his/her profitability;
3. What some of the risks are to dealers and agents who sell service contracts insured by thinly capitalized Risk Retention Groups and/or "Offshore" Reinsurers;
4. That there are simple and easy methods to determine which insurers are most likely to become insolvent.

INSOLVENCY DEFINED

Webster's Dictionary defines insolvency as "unable to pay debts." For an "Extended Warranty" company, Risk Retention Group or "Offshore" Reinsurer this normally means that their liabilities exceed their assets. An insurer may be insolvent and still in business - if it can defer paying its debts. A common practice found with insurers who have eventually become insolvent is that they pay claims on contracts or policies sold in prior time periods with premium received from the sale of today's contracts or policies. Deferring debts in this fashion is a short-lived strategy because it compounds eventual losses and when current premium sales level off or drop there are insufficient funds with which to pay losses. Without the infusion of new capital or a major turn to profitability through rate increases, the insurer will almost certainly become insolvent.

INSOLVENCIES OCCUR - HISTORY

From 1985 to 1991, a number of warranty and insurance companies were declared insolvent or placed into conservatorship. In 1989 alone there were more than 15 known warranty company insolvencies including the largest independent service contract provider, General Warranty.

Most of the insolvencies since 1989 pave involved relatively small warranty companies so most agents and dealers have not been worried by the prospect of their warranty or service agreement company becoming insolvent. Additionally, most of these insolvencies were covered by major insurance companies or individual state Guaranty Funds so the loss to dealers and agents was minimal. This will not be the case if any of the thinly funded Risk Retention Groups who insure tens of thousands of service contracts becomes insolvent.

INSOLVENCY - ITS IMPACT ON DEALERS AND AGENTS

Dealers and agents are affected by insolvencies in many ways:

1. When an insurer of service contracts is declared insolvent all in-force insurance policies are cancelled. In the case of a Risk Retention Group there is no "Guaranty Fund" to help cover the losses on service contracts insured by the insolvent company. The dealer, agent and/or warranty company must cover the contract holders' claims or the contract holder is denied the benefits of the service contract that was sold to them by the dealer or agent.
2. Perhaps the most significant impact of an insurer insolvency is on the dealer or agent's customers. There is a loss of confidence in the dealer or agent who placed a client with the warranty company and its insurer and a loss of confidence in the dealer who sells the service contract or extended warranty to the consumer. To a great extent the insured (service contract holder) relies on the dealer or agent for the selection of the warranty provider and the insurer behind the warranty provider. When the insurer becomes insolvent, the consumer holds the dealer responsible and the dealer in turn holds the agent responsible. Many times dealers end up paying for the repairs to their customer's vehicles on which they sold service contracts to avoid adverse publicity and to retain the customers' good will.

THE CAUSE OF INSOLVENCIES

Most insolvencies occur because of insurance or warranty company operating losses. It is common for these operating results to be accompanied by, and to a large degree caused by, inadequate loss reserving.

The impact of insurer insolvencies to the service contract industry is typically underestimated due to the "ripple effect" of driving dealers back to the the manufacturer's warranty programs.

Inadequate Loss Reserves

The most important reason for insurer insolvency has been inadequate loss reserving. Many agents believe warranty or insurance companies are over reserved as a way to avoid paying contingent commissions. While this thinking has great emotional appeal, it is not validated by the facts.

A recent examination of loss reserving for two Risk Retention Groups who claim to insure many thousands of service contracts suggests they are underreserved for losses by millions of dollars. In fact, a careful review of the latest audited financial statements of these two Risk Retention Groups suggests they are not reporting all the premiums and reserves for which they are liable. This leads us to believe that there is the possibility and almost certainty of one or both of these companies becoming insolvent in the near future.

Fraud And Reserves

The variability of loss reserve adequacy (depending on insurance company results) suggests the possibility that loss reserves are set in an arbitrary manner. I believe this is especially true with the Risk Retention Groups who are involved in the warranty business because of coverage volatability and lack of seasoned loss data. These Risk Retention Groups, whose service contract business is under- reserved, are under-reserved because of inadequate technique, lack of data and primarily due to a "cash-flow" mentality that keeps downward pressure on rates, resulting in loss reserve inadequacy. Purposely under-reserving for losses to increase profits for the owners is in my opinion, the same as committing insurance fraud.

Under-Reserving - - Its Impact On Pricing

Under-Reserving not only artificially inflates the insurer's reported surplus and earnings but, more importantly, influences the price of coverage. If a company was inadequately reserved out of ignorance (as opposed to fraudulent intent) it is likely to under price its product, since reserves are the major component of costs. Thus, the "death spiral" is created where low reserves lead to low prices which in turn lead to both large operating losses and further decreased surplus - enhancing the likelihood of insolvency. This is especially true with thinly capitalized Risk Retention Groups who have tremendous exposure to service contract losses.

Overstatement Of Assets

The second major reason for insolvencies is the overstatement of assets. While insolvencies are almost always triggered by poor operating results, the severity of insolvencies are usually vastly underestimated because financial statements prepared as prescribed by regulatory authorities are only required, on warranty companies, in the state of Florida and Risk Retention Groups only in the state of domicile. When reviewing the strength of a warranty company or Risk Retention Group most agents and dealers are shown unaudited and unreported financial statements, that are often inflated which the agent or dealer has no way to verify. NOTE: Using the previous RRG example, their web site claims to have "over $71,000,000 in assets and capitalization" yet their audited financial statements show only $4,900,000 in assets at 12/31/01. Where did the money go?

CONCLUSION

My own analysis of certain Risk Retention Group financial statements at 12/31/01 leads me to believe that several Risk Retention Groups are, in fact, insolvent. All are still in operation as we approach the end of 2002 and all continue to aggressively solicit business at inadequate rates.

WHERE ARE THE REGULATORS?

Given the poor industry condition you are probably asking yourself "Where are the regulators?" Are they oblivious to the problems? Why have they taken no action to regulate this exploding industry?

There are many explanations for the past inadequacies related to regulating this industry. These range from inadequate staffing levels at Insurance Departments, to laws which give the regulators little or no real authority to regulate or take over a Risk Retention Group when it is in trouble. Florida is the only state that regulates the warranty industry as it does the property/casualty insurance industry. My own view is that state regulators have insufficient authority to regulate independent warranty companies and virtually no authority over Risk Retention Groups. This trend must be reversed promptly if we are to avoid a major insolvency involving many tens of thousands of customers.

Federal law gives state regulators little or no control or authority for oversight or the regulation of Risk Retention Groups. I believe this will change when there is a major

Risk Retention Group insolvency impacting millions of consumers. State regulators and consumers will be calling for Congress to impose closer scrutiny and oversight for Risk Retention Groups.

The large number of past insolvencies, along with the poor shape of the industry today, suggests to me that it would be irresponsible for a dealer or agent to place business with a warranty company that is insured by a Risk Retention Group that does not have adequate reinsurance guarantees.

DEALER/AGENT ACTION LIST

What can dealers and agents do to make sure they know which companies are in a weak financial condition and likely to become insolvent? The following guidelines are suggested:

Review A.M. Best Data

Check the A.M. Best policyholder's ratings of the insurance companies who are insuring the warranty company with which you are doing business. The policyholder's rating does consider historical loss reserve inadequacies, operating performance and numerous other relevant factors. Over the years the policyholder's rating has proven to be fairly reliable. However, they only provide insight into the RELATIVE STRENGTH OF THE COMPANIES. Because A.M. Best rates all companies "on a curve" its system can provide unusually generous ratings.

Even the A.M. Best ratings results do not tell the entire story. There is at least one Risk Retention Group with an "A-" rating that is technically insolvent today. Demand to see the audited financials filed by the Risk Retention Group with the Department of Insurance in the state they are domiciled. Check the capital and surplus listed on their balance sheet, review their assets and available cash and review the amount of direct written premium, less amounts ceded "authorized reinsurers" (reinsurance agreements should also be reviewed), to see that the ratio of net written premium to net worth (capital and surplus) is not more than two times capital and surplus. REMEMBER one of the key solvency measurements is the net premium writings to capital and surplus ratio.

EXAMPLE: Risk Retention Group X has capital and surplus of approximately $7,000,000. A two to one writing ratio would indicate the Risk Retention Group could safely insure $14,000,000 of premium each year.

Compare the $14,000,000 to the amount of premium the Risk Retention Group reported as net written premium. If it's more, further information or explanation should be sought.

Another quick test would be how many service contracts the Risk Retention Group insures each year. If you assume the average reserve for losses on service contract business is $500 then the Risk Retention Group cited above could safely insure 28,000 service contracts per year or 2,333 service contracts per month. If you know the Risk Retention Group writes more than these amounts you should demand an explanation of why this information was not disclosed in their audit report. Don't be fooled by off-handed explanations about "off-balance" sheet "Trust" accounts. The Risk Retention Group has liability for loses that exceed the loss reserves whether held in "Trust" or not and MUST disclose this information to their auditors and regulators. Failure to disclose this information is improper and we believe illegal.

IN MY JUDGMENT, ANY AGENT OR DEALER WHO DOES BUSINESS WITH A WARRANTY COMPANY THAT IS INSURED BY A RISK RETENTION GROUP OR OTHER INSURER THAT DOES NOT HAVE A STRONG CAPITAL AND SURPLUS BASE IS TAKING UNNECESSARY RISKS.

If their service agreement program is insured by a Risk Retention Group, the agent and/or dealer should carefully review the financial information concerning the insurer and any reinsurance agreements the Risk Retention Group might have to cover excess losses to be sure they have enough capital and surplus to stay in business and pay claims in the event they have under reserved for losses.

OTHER INDICATIONS OF TROUBLE

In addition to the A.M. Best policyholders information, there are some other indications that may help dealers and agents isolate companies with potential solvency problems.

Complaint Ratios

Over the years those companies with the highest complaint ratios (published in many states) tended to be the companies in the worst financial condition. High complaints frequently result from efforts to conserve cash, by intentionally paying losses slowly, delaying the repayment of unearned premiums or cutting back staff.

Premium Finance Companies - Refusals To Finance Premium

Finance companies such as GMAC and FMC and Banks are fairly sophisticated. If they become concerned about a company's ability to return its unearned premium, they may stop doing business with that company.

ALTERNATIVE SOLUTIONS

A number of agents with whom I have spoken have indicated that while it may be easy to understand which companies are likely to go broke, it can create a real hardship for the agency if it is not able to offer the low-price products of companies (insurers) which do not have adequate loss reserves or reinsurance. These agents fear the potential dealer will do business with another agent at the lower rate so they think they also have to offer the lowest priced product or they will lose the business. While I can understand their point, I am not sympathetic. Doing business with a warranty company or Risk Retention Group that may have solvency concerns can endanger the agent’s own solvency as well as that of the automobile dealer(s) whom they are pledged to protect.

A solution for dealing with this problem may be for the agent to advise the dealer of the differences in a low cost Risk Retention Group insured product and the warranty program insured by a financially strong, highly rated insurance carrier and review the financial strength, coverage issues and complaint ratios with the dealer. This strikes me as a particularly effective way to deal with the issue and many agents have indicated to me that this invariably results in the dealer choosing the higher premium but stronger company.

As the following quote indicates, doing business with weak companies may provide short term benefits but can have serious long-term consequences.

“Many agents and dealers who dealt with the insolvency of Reliance Insurance Company (“Reliance”) are still trying to get their problems worked out”. If a large (billions of dollars), heavily regulated insurer like Reliance can have solvency problems, think what can happen at a thinly funded Risk Retention Group which has virtually no regulatory oversight.

SUMMARY

I believe the next three years will be the toughest in the history of the warranty industry with many insolvencies, especially among Risk Retention Groups. As the manufacturers’ coverage on new vehicles expires, the Risk Retention Groups who insure these service contracts become at risk. Regulators are without regulatory authority and unable to prevent large insolvencies until after the fact.

In less than fifteen minutes you can make easy checks which will point out which companies may have trouble. The "other indicators of trouble" may provide even more substance to an agent’s or dealer’s doubts.

It is a frightening thought but if these insolvencies take place at the predicted rate, we will be moving closer to the manufacturer monopolizing the extended warranty industry. Agents and dealers have an opportunity to diminish the severity of company insolvencies and at the same time improve their own financial positions by refusing to do business with such weak companies.

ABOUT THE AUTHOR

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We use the terminology "warranty" or "extended warranty" interchangeably with the terminology "extended service agreements", variations of the terminology "extended service contracts", and the abbreviation "ESC" throughout this website. The information contained within this web site is intended to provide you with general information.