Analysis of Risk Retention Groups – Year-End 2019

Risk Retention Groups Report Surplus Growth Despite Underwriting Losses

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A review of the reported financial results of risk retention groups (RRGs) reveals insurers that continue to collectively provide specialized coverage to their insureds while remaining financially stable. Based on reported financial information, RRGs have a great deal of financial stability and remain committed to maintaining adequate capital to handle losses. It is important to note that ownership of RRGs is restricted to the policyholders of the RRG. This unique ownership structure required of RRGs may be a driving force in their strengthened capital position.

The state in which the RRG is domiciled is responsible for regulating and monitoring that RRG. In 2019, RRGs were domiciled in 20 jurisdictions. Vermont was the state of domicile for 87 RRGs, the most for any jurisdiction. South Carolina was the state of domicile for 36 RRGs, and the District of Columbia for 33 RRGs. Hawaii and Nevada rounded out the top five states of domicile by having 15 RRGs each. The remaining jurisdictions had 10 or fewer RRGs domiciled in their jurisdiction (Exhibit 1).

Balance Sheet Analysis

From year-end 2018 to year-end 2019, cash and invested assets increased 9.3 percent and total admitted assets increased 9.2 percent. Also, RRGs collectively increased policyholders' surplus 12.9 percent. The level of policyholders' surplus becomes increasingly important in times of difficult economic conditions by allowing an insurer to remain solvent when facing uncertainty. This increase represents the addition of nearly $626.3 million to policyholders' surplus. This continues RRGs collectively strengthening balance sheet results. Over the past five years, aggregately RRGs have increased assets and policyholders' surplus while maintaining sufficient liquidity and leverage as well as other balance sheet ratios (Fig. 1).

Fig. 1 - Balance Sheet Results 2015-2019 (in billions)

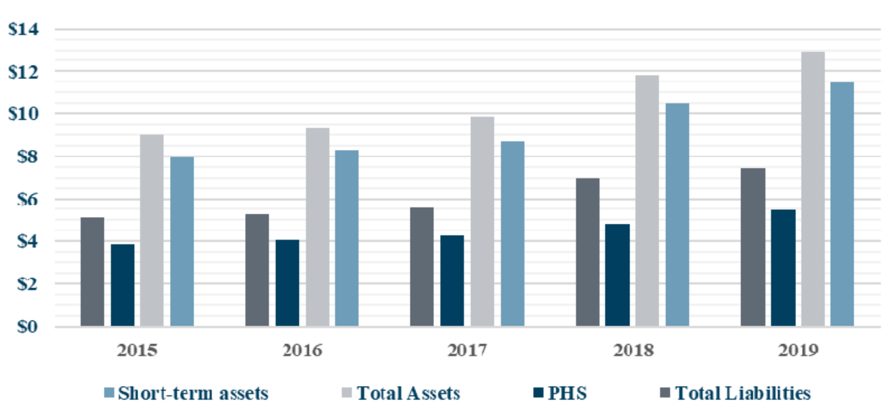

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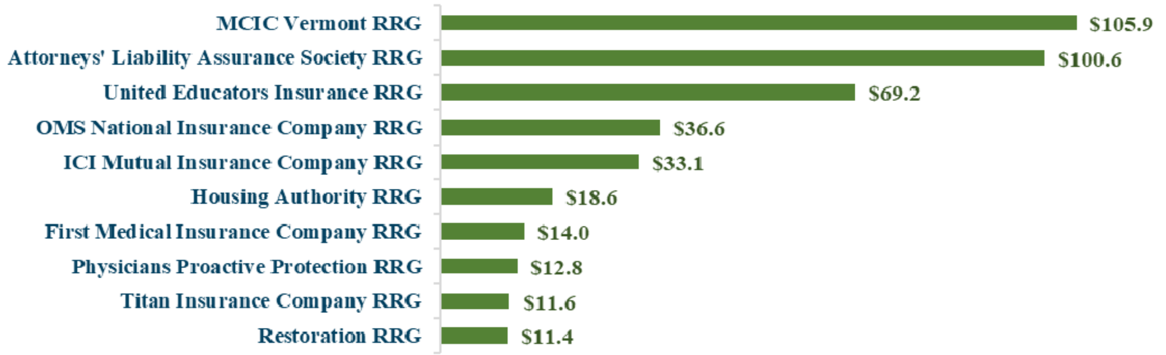
Fig. 2 - 2019 Policyholders' Surplus Growth (in millions)



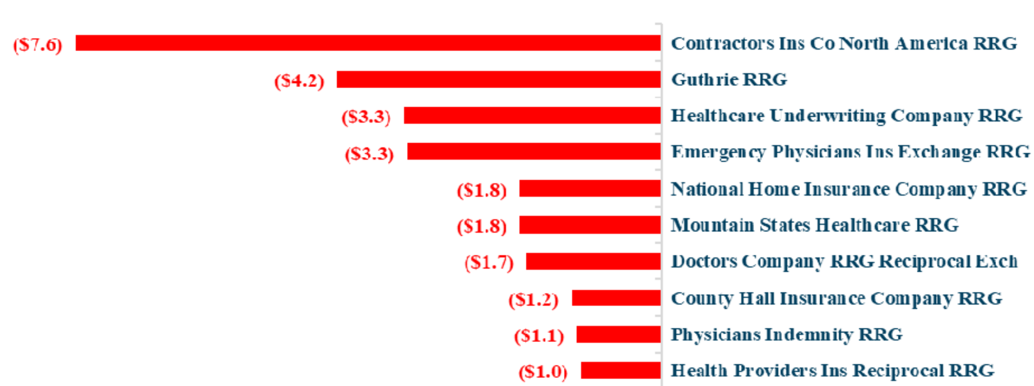
For 2019, 169 RRGs reported policyholders' surplus growth. In examining change in policyholders' surplus in 2019 for individual RRGs, MCIC Vermont (NAIC# 10697) accounted for $105.9 million of policyholders' surplus growth, which was the highest level of growth reported in 2019 (Fig. 2). Most of this surplus growth can be attributed to the company's reported net income and net unrealized capital gains.

Conversely, Contractors Insurance Company of North America (NAIC# 11603) reported the greatest decrease to policyholders' surplus (Fig. 3). The company reported a $7.6 million decrease to policyholders' surplus, which can be mostly attributed to the company's reported net loss. 43 RRGs reported a decrease in policyholders' surplus in 2019.

Liquidity, as measured by cash and invested assets to liabilities, for year-end 2019 was 154 percent. A value more than 100 percent is considered favorable as it indicates that there was more than a dollar of net liquid assets for each dollar of total liabilities. RRGs collectively have reported liquidity results between 150-156 percent at the past five year ends.

In evaluating individual RRGs, Demotech, Inc. prefers companies to report leverage of less than 300 percent. Leverage for all RRGs combined, as measured by total liabilities to policyholders' surplus, for year-end 2019 was 136 percent and indicates a decrease compared to year-end 2018, which is favorable.

Fig. 3 - 2019 Policyholders' Surplus Decrease (in millions)



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The loss and loss adjustment expense reserves (loss reserves) to policyholders' surplus ratio for year-end 2019 was 95 percent and indicates a decrease compared to year-end 2018, when this ratio was 103 percent. The higher the ratio of loss reserves to surplus, the more an insurer's stability is dependent on having and maintaining reserve adequacy.

Regarding RRGs collectively, the ratios pertaining to the balance sheet appear to be appropriate and conservative. These reported results indicate that collectively RRGs remain adequately capitalized and able to remain solvent if faced with adverse economic conditions or increased losses (Exhibit 2).

Income Statement Analysis

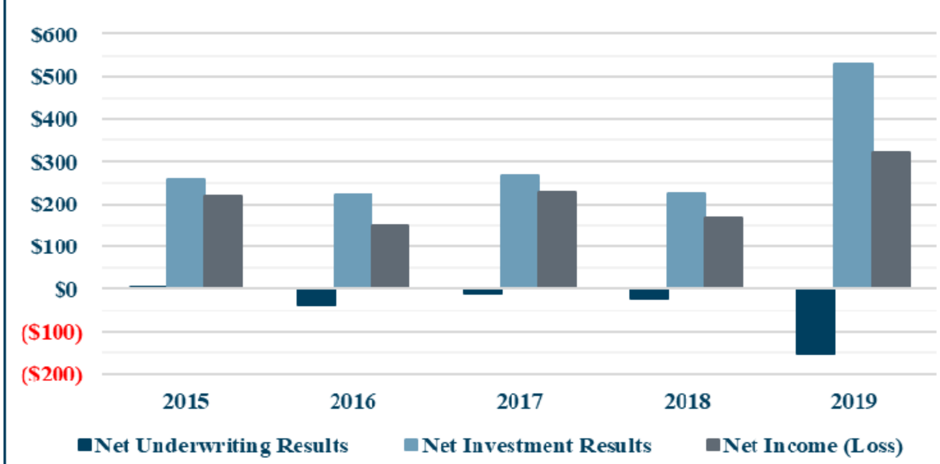
In regards to underwriting results, collectively RRGs were unprofitable in 2019. RRGs reported an aggregate underwriting loss for 2019 of $152.4 million. This is the largest underwriting loss reported for the last five year-ends. 116 RRGs reported an underwriting loss for 2019 compared to 105 RRGs reporting an underwriting gain.

However, RRGs offset these underwriting losses and collectively reported a net investment gain of $531.4 million and net income of $321.3 million, both the highest reported levels for the last five year-ends (Fig. 4). Looking further back, RRGs have collectively reported annual net income at each year-end since 1996. 158 RRGs reported net income for 2019 compared to 62 RRGs reporting a net loss.

In examining the underwriting results of individual RRGs, MCIC Vermont (NAIC# 10697) reported an underwriting loss of $97 million, the largest underwriting loss in 2019. MCIC Vermont was able to report a net income by recording a net investment gain of $133.8 million, the highest investment gain in 2019. Comparatively, ICI Mutual (NAIC# 11268) reported an underwriting gain of $10.5 million, which was the highest underwriting gain.

The loss ratio for RRGs collectively, as measured by losses and loss adjustment expenses incurred to net premiums earned, at year-end 2019 was 85.5 percent, the highest reported level for the last five year-ends.

Fig. 4 - Profitability Results 2015-2019 (in millions)



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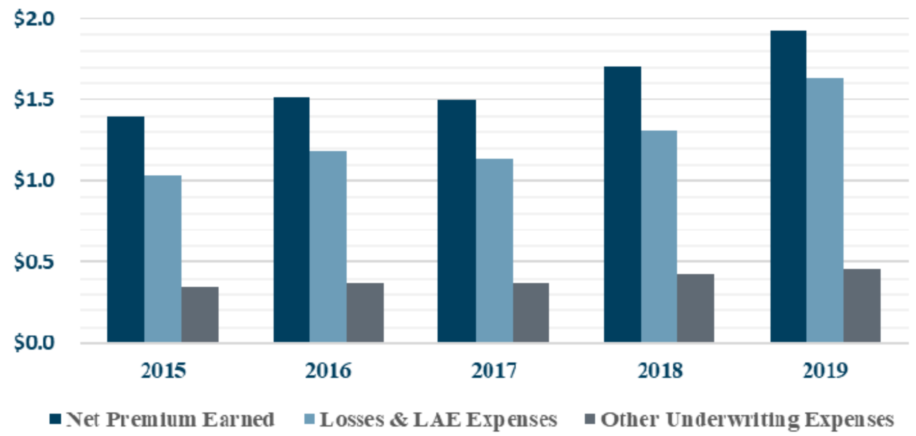
This ratio is a measure of an insurer's underlying profitability on its book of business.

The expense ratio, as measured by other underwriting expenses incurred to net premiums earned, at year-end 2019 was 23.8 percent, the lowest reported level for the last five year-ends. This ratio measurers an insurer's operational efficiency in underwriting its book of business.

Fig. 5 - Premium Earned, Losses & LAE Expenses, Underwriting Expenses 2015-2019 (in billions)



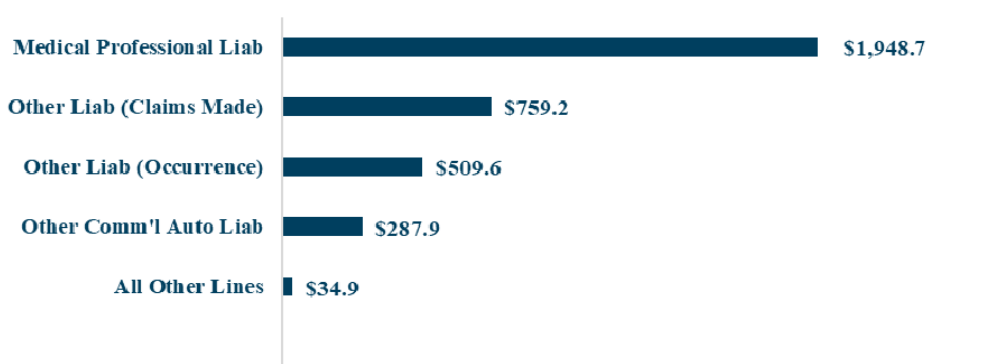
The combined ratio, loss ratio plus expense ratio, at year-end 2019 was 109.3 percent, the highest reported level for the last five year-ends. This ratio measures an insurer's overall underwriting profitability. A combined ratio of less than 100 percent typically indicates an underwriting profit and a ratio of more than 100 percent typically indicates an underwriting loss (Fig. 5).

Despite the underwriting losses, the ratios pertaining to the income statement appear to be appropriate for RRGs collectively (Exhibit 3).

Premium Written Analysis

Since RRGs are restricted to liability coverage, they tend to insure medical providers, product manufacturers, law enforcement officials and contractors, as well as other industries with professional liability. In 2019, 55 percent of RRG direct premium written was reported in Medical Professional Liability (Fig. 6).

Fig. 6 - 2019 Direct Premium Written by Line of Business (in millions)



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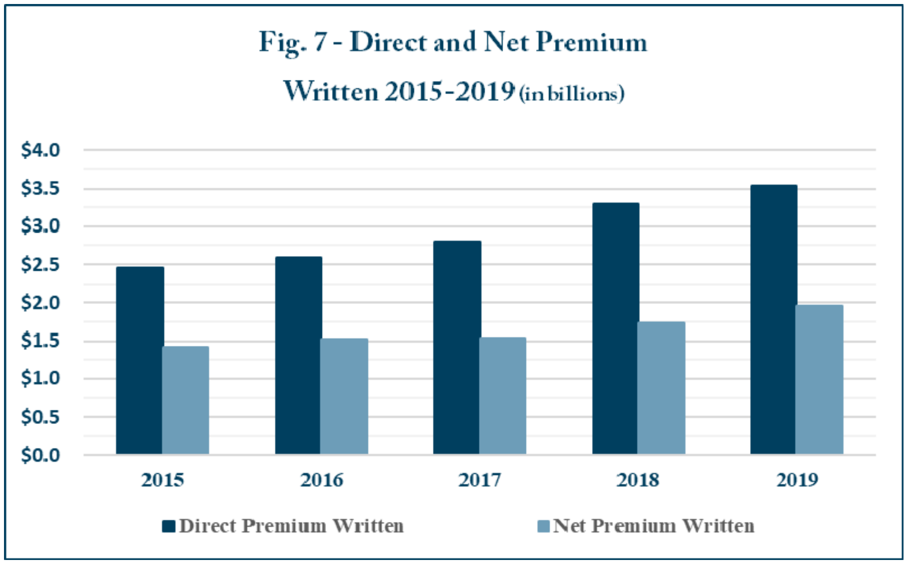
RRGs reported premium for nine different lines of business in 2019 (Exhibit 4).

RRGs collectively reported $3.5 billion of direct premium written for 2019, an increase of 7.5 percent over 2018. RRGs reported nearly $2 billion of net premium written for 2019, an increase of 13.2 percent over 2018 (Fig. 7).

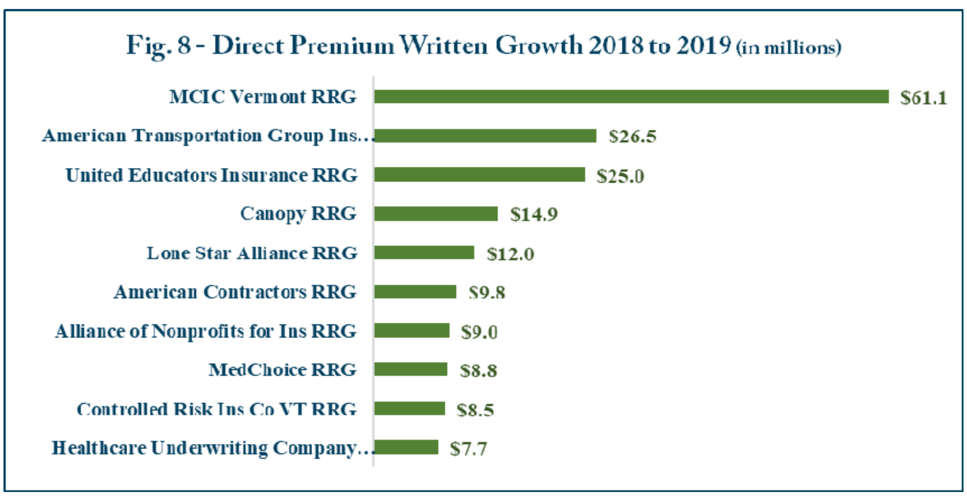


The direct premium written to policyholders' surplus ratio for RRGs collectively for 2019 was 64.7 percent. The net premium written to policyholders' surplus ratio for RRGs for 2019 was 35.8

An insurer's direct premium written to surplus ratio is indicative of its policyholders' surplus leverage on a direct basis, without consideration for the effect of reinsurance. An insurer's net premium written to surplus ratio is indicative of its policyholders' surplus leverage on a net basis. An insurer relying heavily on reinsurance will have a large disparity in these two ratios.

A direct premium written to surplus ratio in excess of 600 percent would subject an individual RRG to greater scrutiny during the financial review process. Likewise, a net premium written to surplus ratio greater than 300 percent would subject an individual RRG to greater scrutiny. In certain cases, premium to surplus ratios in excess of those listed would be deemed appropriate if the RRG had demonstrated that a contributing factor to the higher ratio is relative improvement in rate adequacy.

In regards to RRGs collectively, the ratios pertaining to premium written appear to be conservative.



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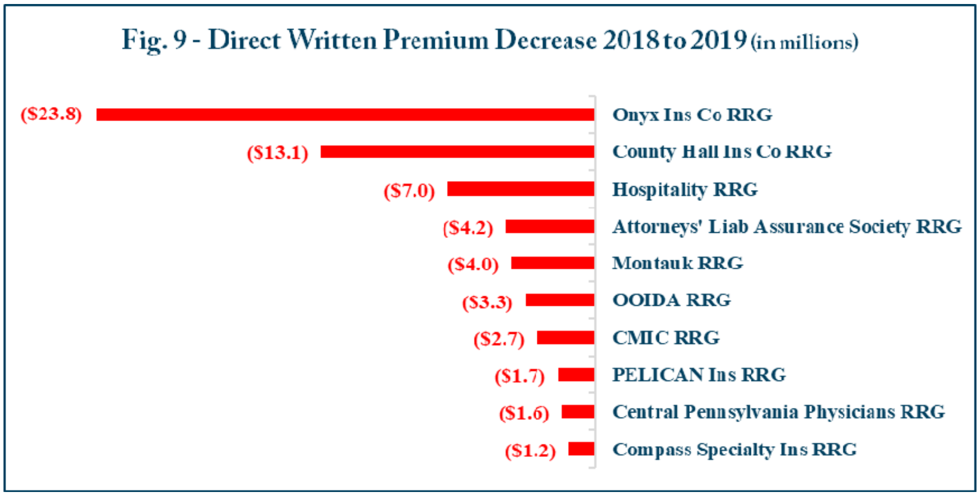
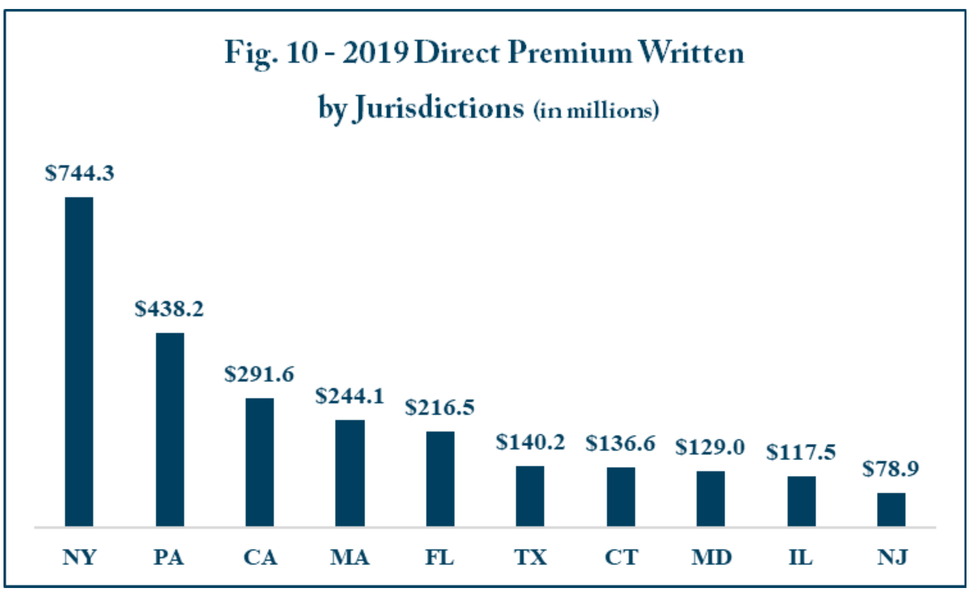


In examining the change in direct written premium for individual RRGs, MCIC Vermont (NAIC# 10697) reported $61.1 million in premium growth from year-end 2018 to year-end 2019, which is the largest reported level of growth in 2019 (Fig. 8). There were 129 RRGs that reported direct premium growth in 2019. Conversely, Onyx Insurance (NAIC# 15208) reported a decrease of $23.8 million in direct premium written, the largest decrease in 2019 (Fig. 9). There were 66 RRGs that reported a decrease in direct premium written in 2019.

In 2019, RRGs wrote direct premium written in 56 jurisdictions (Exhibit 5). RRGs wrote $744.3 million in New York, which was the most direct premium written for any jurisdiction in 2019 (Fig. 10). Also, in terms of number of RRGs writing business in a jurisdiction, there were 102 RRGs writing business in Pennsylvania in 2019, the most of any jurisdiction. There were 88 RRGs writing in Texas, 86 in California, 84 in Florida, 83 in Illinois and New Jersey each, and 81 in New York. Vermont, which has 87 RRGs domiciled there, had 42 RRGs write premium in the state in 2019.



Loss and Loss Adjustment Expense Reserve Analysis

A key indicator of management's commitment to financial stability, solvency and capital adequacy is their desire and ability to record adequate loss and loss adjustment expense reserves (loss reserves) on a consistent basis. Adequate loss reserves meet a higher standard than reasonable loss reserves.

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Demotech views adverse loss reserve development as an impediment to the acceptance of the reported value of current, and future, surplus and that any amount of adverse loss reserve development on a consistent basis is unacceptable (Exhibit 2). Consistent adverse loss development may be indicative of management's inability or unwillingness to properly estimate ultimate incurred losses.

RRGs collectively reported adequate loss reserves at year-end 2019 as exhibited by the one-year and two-year loss development results. The loss reserve development to policyholders' surplus ratio measures reserve deficiency or redundancy in relation to policyholders' surplus and the degree to which surplus was either overstated, exhibited by a percentage greater than zero, or understated, exhibited by a percentage less than zero.

The one-year loss reserve development to prior year's policyholders' surplus for 2019 was -0.4 percent. In 2019, 122 RRGs reported favorable one-year loss reserve development compared to 67 reporting adverse one-year loss reserve development. The two-year loss reserve development to second prior year-end policyholders' surplus for 2019 was -5.4 percent. In 2019, 126 RRGs reported favorable two-year loss reserve development compared to 60 reporting adverse two-year loss reserve development.

In regards to RRGs collectively, both of these loss reserve development ratios would be viewed as favorable.

Conclusions Based on 2019 Results

Despite political and economic uncertainty, RRGs remain financially stable while providing specialized coverage to their insureds. The financial ratios calculated based on the reported results of RRGs appear to be reasonable, keeping in mind that it is typical and expected that insurers' financial ratios tend to fluctuate over time.

The results of RRGs indicate that these specialty insurers continue to exhibit financial stability. It is important to note again that while RRGs have reported net income, they have also continued to maintain adequate loss reserves while increasing premium written year over year. RRGs continue to exhibit a great deal of financial stability.

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Exhibits

Exhibit 1 – Jurat Information -
http://www.demotech.com/pdfs/papers/ye_2019_analysis_rrgs_exhibit_1.pdf

Exhibit 2 – Balance Sheet and Schedule P Data -
http://www.demotech.com/pdfs/papers/ye_2019_analysis_rrgs_exhibit_2.pdf

Exhibit 3 – Income Statement Data -
http://www.demotech.com/pdfs/papers/ye_2019_analysis_rrgs_exhibit_3.pdf

Exhibit 4 – Direct Premium Written by Line of Business -
http://www.demotech.com/pdfs/papers/ye_2019_analysis_rrgs_exhibit_4.pdf

Exhibit 5 – Direct Premium Written by Jurisdiction -
http://www.demotech.com/pdfs/papers/ye_2019_analysis_rrgs_exhibit_5.pdf

Exhibit 6 – Statutory Pre-tax Earnings Quality Using Emerging Loss & Loss Adjustment Expense Estimates (SPEQUELLAE) -
http://www.demotech.com/pdfs/papers/ye_2019_analysis_rrgs_exhibit_6.pdf

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