RRGs Report Financially Stable Results Through Third Quarter 2015

By Douglas A. Powell

A review of the reported financial results of risk retention groups (RRGs) reveals insurers that continue to collectively provide specialized coverage to their insureds. Based on third quarter 2015 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.

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Balance Sheet Analysis

During the last five years, cash and invested assets, total admitted assets and policyholders' surplus have increased at a faster rate than total liabilities (Figure 1). The level of policyholders' surplus becomes increasingly important in times of difficult economic conditions by allowing an insurer to remain solvent when facing uncertain economic conditions.

Since third quarter 2011, cash and invested assets increased 79.8 percent and total admitted assets increased 64.4 percent. More importantly, over a five year period from third quarter 2011 through third quarter 2015, RRGs collectively increased policyholders' surplus 65.8 percent. This increase represents the addition of over $1.8 billion to policyholders' surplus. These reported results indicate that RRGs are adequately capitalized in aggregate and able to remain solvent if faced with adverse economic conditions or increased losses.

Liquidity, as measured by liabilities to cash and invested assets, for third quarter 2015 was approximately 68.8 percent. A value less 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. This also indicates an increase for RRGs collectively as liquidity was reported at 66.4 percent at third quarter 2014. This ratio has improved steadily each of the last five years.

Loss and loss adjustment expense (LAE) reserves represent the total reserves for unpaid losses and LAE. This includes reserves for any incurred but not reported losses as well as supplemental reserves established by the company. The cash and invested assets to loss and LAE reserves ratio measures liquidity in terms of the carried reserves. The cash and invested assets to loss and LAE reserves ratio for third quarter 2015 was 213.1 percent and indicates a decrease over third quarter 2014, as this ratio was 216.7 percent. These results indicate that RRGs remain conservative in terms of liquidity.

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 third quarter 2015 was 153.2 percent and indicates an increase over third quarter 2014, as this ratio was 146 percent.

The loss and LAE reserves to policyholders' surplus ratio for third quarter 2015 was 104.6 percent and indicates an increase compared to

Figure 1
Risk Retention Group Balance Sheet Metrics at 9/30 (in Billions)

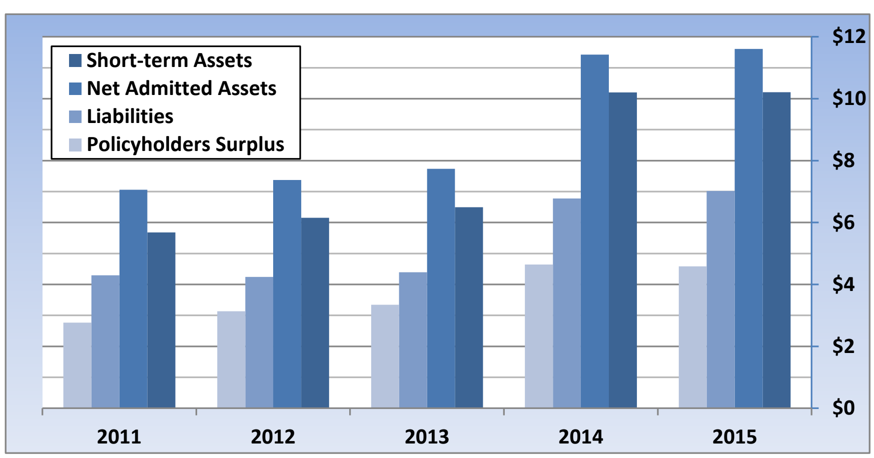

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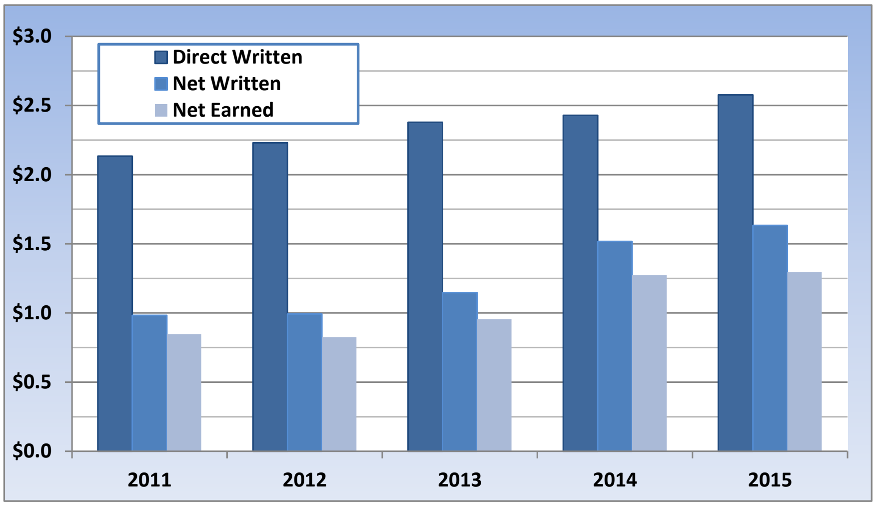
Figure 2
Risk Retention Group Premiums at 9/30 (in Billions)



third quarter 2014, as this ratio was 101.4 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.

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 professional industries. RRGs collectively reported nearly $2.6 billion of direct premium written (DPW) through third quarter 2015, an increase of 6 percent over third quarter 2014. RRGs reported $1.6 billion of net premium written (NPW) through third quarter 2015, an increase of 7.6 percent over third quarter 2014. These increases are favorable and appear reasonable (Figure 2).

The DPW to policyholders' surplus ratio for RRGs collectively through third quarter 2015 was 75 percent, up from 69.8 percent at third quarter 2014. The NPW to policyholders' surplus ratio for RRGs through third quarter 2015 was 47.5 percent and indicates an increase over 2014, as this ratio was 43.6 percent. Please note that these ratios have been adjusted to reflect projected annual DPW and NPW based on third quarter results.

An insurer's DPW to surplus ratio is indicative of its policyholders' surplus leverage on a direct basis, without consideration for the effect of reinsurance. An insurer's NPW 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.

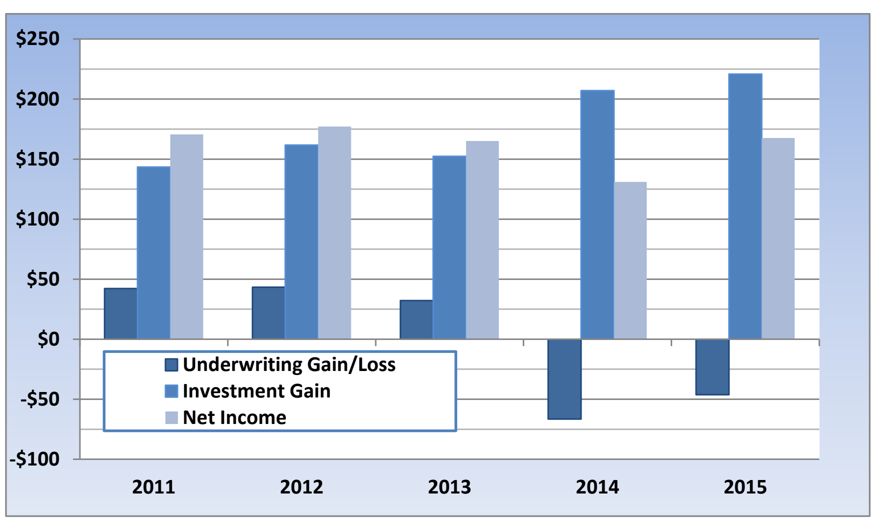
A DPW to surplus ratio in excess of 600 percent would subject an individual RRG to greater scrutiny during the financial review process. Likewise, a NPW to surplus ratio greater than 300 percent would subject an individual RRG to greater scrutiny. In certain cases, premium to surplus ratios in excess 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.

Income Statement Analysis
RRGs collectively reported a $46.3 million underwriting loss through third quarter 2015 (Figure 3). The collective underwriting losses were offset by strong investment gains and other sources of income. RRGs reported an aggregate net investment gain of $220.8 million and a net income of $167.6 million.

The loss ratio for RRGs collectively, as measured by losses and loss adjustment expenses incurred to net premiums earned, through third quarter 2015 was 79.1 percent, a decrease over 2014, as the loss ratio

Figure 3
Risk Retention Group Income at 9/30 (in Millions)



was 80.6 percent. 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 written, through third quarter 2015 was 19.6 percent and indicates a decrease compared to 2014, as the expense ratio was reported at 20.6 percent. This ratio measures an insurer's operational efficiency in underwriting its book of business.

The combined ratio, loss ratio plus expense ratio, through third quarter 2015 was 98.7 percent and indicates a decrease compared to 2014, as the combined ratio was reported at 101.2 percent. This ratio measures an insurer's overall underwriting profitability. A combined ratio of less than 100 percent typically indicates an underwriting profit.

Regarding RRGs collectively, the ratios pertaining to income statement analysis appear to be appropriate. Moreover, these ratios have remained fairly stable for each of the last five years and within a profitable range.

Conclusions Based on Financial Results

Despite political and economic uncertainty, RRGs remain financially stable and continue to provide specialized coverage to their insureds. The financial ratios calculated based on the financial 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.

Douglas A. Powell is a Senior Financial Analyst at Demotech, Inc. Email your questions or comments to dpowell@demotech.com. For more information about Demotech, go to www.demotech.com.