

## Self-Insurance Pools and Trusts

### Banding Together to Share Risks

**A**.M. Best Co. has performed a quantitative and qualitative analysis on a group of 16 self-insurance pools and trusts, which are alternative risk transfer vehicles, that have met the stringent requirements necessary to obtain an A.M. Best rating. The results of this study are based on the latest five years of reported financial data and operating information from these organizations.

#### Self-Insurance Pool Profile

These entities differ from traditional commercial carriers and have characteristics that are materially different from other alternative risk transfer entities such as captives and risk retention groups. Self-insurance pools and trusts (self-insurance pools) are formed by members with a common interest of banding together to share risk. Rather than purchasing insurance through a traditional insurance program or forming a captive carrier, these entities become members of an organization offering pooled self-insurance. The pool is established by each member pledging an amount of "capital" that is treated as paid-in-capital on the entity's books and records. This is in some ways similar to the mutual concept.

One major difference between a small mutual insurance company and a self-insurance pool is that the members of the pool have similar risk profiles, by type of industry, geographical location or both. For instance, small contractors in the state of Illinois may, through a sponsoring contractors' association, pool their risks for the mutual benefit of each member.

Another distinguishing characteristic of self-insurance pools is that each member shares the losses and profits of the pool

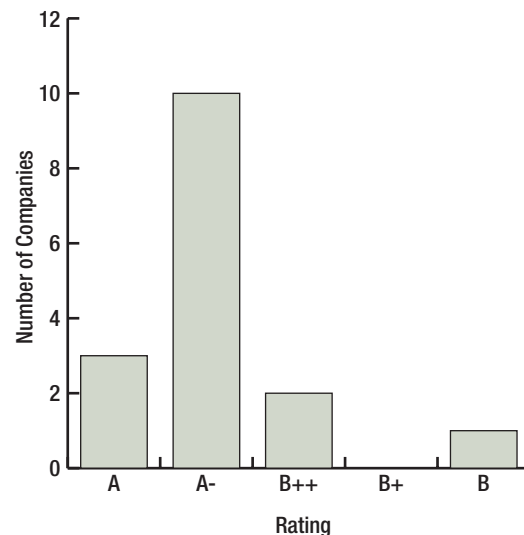
with all the other members. Typically, the participation is more formally defined if the pool employs the joint and several liability concept. Indeed, some states will allow the formation of a self-insurance pool only if the

#### Domicile Distribution, Self-Insurance Pools

Domicile	Count
Alabama	2
Bermuda	1
California	3
Illinois	1
Kansas	1
Kentucky	1
Louisiana	2
Missouri	1
Mississippi	1
New York	1
North Carolina	1
Virginia	1
<b>Total Pools</b>	<b>16</b>

Source: A.M. Best Co.

#### Rating Distribution, Self-Insurance Pools



Source: A.M. Best Co.

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members contractually agree to joint and several liability among all members. Most states tend to exclude business written through a self-insurance pool from the guaranty fund of the state. Instead, the state has the ability to assess members to pay losses in the event of the pool's insolvency. Joint and several liability contractually states that all members guarantee the losses of each other member, without limitation other than policy terms.

In no small part because of the joint and several liability tie, as well as each member's capital being exposed to potential losses generated by other members, admission criteria for these entities tend to be very strict. In addition, pool members commonly commit to significant investment of time and resources to promote loss control and engineering, prudent claims handling, and sharing of loss information. These activities are not found as frequently in traditional insurance programs.

In addition, A.M. Best has observed distinct differences between management's goals and objectives for a traditional, publicly held commercial insurer and those for a self-insurance pool. Traditional insurers emphasize return on equity, cash flow and other objectives that drive retained earnings and share price, while pools emphasize members' risk-mitigation needs through value-added services coupled with substantial dividends and return of capital when deemed prudent.

### Strengths and Weaknesses of Self-Insurance Pools

Pooling serves different purposes from those served by traditional insurance. This market enjoys certain operational strengths that are specific to pooled entities:

- Focused underwriting
- Strong board interaction, with focus on members
- Wide selection of services
- Assessability
- Strong member retention
- Tax exemption
- Active trade association participation
- Tort caps

Pools also have certain weaknesses:

- Limited regulatory oversight
- Lack of standardized financial reporting
- Lack of guaranty fund protection
- Geographical limitations
- Narrow business offerings

### General Requirements for Self-Insurance Pool Formation

- State-determined premium start-up requirement (ranging from \$0 to \$1 million).
- Self-insurance group must be administered under the direction of an elected board of trustees.
  - Must provide a copy of bylaws and trust agreement of the proposed group with application.
  - Groups must include a minimum number of members with separate ownership.
  - Members must be private employers in the same industry or same state.
  - Individual application per member, including:
    - Acceptance or execution of the trust agreement.

## A.M. Best Co.

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## Market Conditions

### Size

Aggregated, the 16 entities wrote \$686 million of net premiums for the year ended Dec. 31, 2003. Surplus for the same population and period was \$630 million, and total admitted assets were \$1.8 billion. The smallest entity analyzed had surplus of \$7 million at year end 2003, and the largest had surplus of \$99 million for the same period. Membership ranged from as few as 20 members to as many as 7,700. Net premiums written ranged from a low of \$8 million for 2003 to a high of \$129 million for the same period.

### Growth

Aggregated net written premiums grew almost 95% over the four-year period ended Dec. 31, 2003, while surplus grew 70% for the same period. The growth in membership of self-insurance pools is the result of two main factors.

First, since member insureds of a pool or association have similar risk profiles and therefore similar insurance product needs as other member insureds, the pool or sponsoring association generally has a focused product compared with other options that exist in the commercial insurance market. Self-insurance pools generally have customized policy language and focused loss-mitigation products developed specifically for a particular industry or geographic area.

Also, self-insurance pools, like other alternative risk transfer vehicles, generally do not participate in the premium vagaries that determine policy rates in the commercial insurance marketplace. One of the objectives of self-insurance pools is the stabilization of net premium costs to a member insured over the long term. This is accomplished by a combination of loss control and claim-cost mitigation to reduce insurance expense in a targeted manner, supplemented by the return of substantial amounts of premium to members via membership distributions or rate reductions.

## Operating Results

The tables in this report provide key measures of the aggregated, quantitative analysis

report on all rated self-insurance pools for which data has been reported to A.M. Best.

The aggregated data indicate that self-insurance pools continued to post significant increases in net written premium and surplus through year end 2003. Net income has been growing substantially in all years except 2003, which was affected by decreasing investment yields. The self-insurance pools generally

## Quantitative Comparison, Self-Insurance Pools vs. Commercial Casualty Composite—1999-2003

### Self-Insurance Pools

Year	Investment Yield	Total ROR	Total ROE	Loss & LAE Ratio	Underwriting Expense Ratio	Combined Ratio After Dividends
1999	5.2%	8.3%	8.6%	59.9	24.1	100.2
2000	5.2	13.5	13.6	55.0	22.9	93.9
2001	5.3	12.5	14.4	60.5	24.2	93.1
2002	4.6	11.7	10.6	63.1	23.1	95.4
2003	4.0	12.3	13.8	64.5	23.6	92.4
<b>5-Year Average</b>	<b>4.9%</b>	<b>11.7%</b>	<b>12.2%</b>	<b>60.6</b>	<b>23.6</b>	<b>95.0</b>

### Commercial Casualty Index

<b>5-Year Average</b>	<b>5.3%</b>	<b>2.8%</b>	<b>3.1%</b>	<b>80.8</b>	<b>28.0</b>	<b>109.9</b>
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### Favorable/(Unfavorable) Variance

<b>5-Year Average</b>	<b>-0.4%</b>	<b>8.9%</b>	<b>9.1%</b>	<b>20.2</b>	<b>4.4</b>	<b>14.9</b>
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Source: A.M. Best Co.

## Value of A.M. Best Ratings For Self-Insurance Pools

The need for a rating from A.M. Best varies from entity to entity, depending on the market in which it operates. Some of the more common business reasons for a pool to obtain a rating include:

- To alleviate some of the increased competition pools face from commercial writers, as well as from other pools. As individual commercial insureds consider joining a pool or insuring with a commercial lines carrier, the commercial insureds may be more comfortable with the financial stability of a rated pool.
- To expand their pool membership by marketing their A.M. Best Ratings. The third-party opinion indicates a pool's financial strength and puts it on a more even playing field with commercial carriers.
- To allow stakeholders to benchmark against other pools of similar size and business composition.
- To satisfy domiciliary regulatory rating requirements.
- Many reinsurers or excess carriers have financial security analysts that evaluate the creditworthiness of their cedant clients. A.M. Best's ratings of nontraditional companies, such as pooled entities, facilitate those entities' security reviews and recommendations.
- A.M. Best ratings often facilitate efforts to secure external financing.

have lower net investment yields as a result of a more conservative investment portfolio policy. Over the past five years, the aggregated net investment yield for self-insurance pools has averaged 40 basis points less than the commercial casualty composite.

The combination of at-risk member capital, as well as joint and several liability, is a strong incentive to control losses, minimize frictional expenses, and detect and control fraud. These factors benefit the results, with the five-year average loss and loss-adjustment-expense ratio for rated self-insurance pools at 60.6, vs. 89.3 for captives and 80.8 for A.M. Best's commercial casualty insurance industry composite. The five-year average underwriting expense ratio of self-insurance pools, which is 23.6, is somewhat above the comparative 19.4 for captives, but compares favorably with the 28.0 underwriting expense ratio of the commercial casualty insurance industry composite. Overall, the five-year average combined ratio after policyholder dividends of 95.0 for self-insurance pools compares favorably with the 116.9 of captives and the 109.9 of the commercial casualty insurance industry composite.

It should be pointed out, however, that the captive ratio is affected substantially by the tendency of captives issuing sizable policy-

holder dividends, while pools and trusts more frequently offer up-front premium discounts to members following favorable experience. Nonetheless, these impressive results are reflected in the ratings of the 16 self-insurance pools currently followed by A.M. Best. The average rating is A- (Excellent), which reflects the degree of excellence exhibited by these entities. Dominant characteristics of the rated self-insurance pools are management expertise, excellent operating results, strong capital position and a defined market presence.

To date, relatively few self-insurance pools have chosen to be rated by A.M. Best. However, recently there is added pressure for self-insurance pools to obtain ratings due to changes in the regulatory environment and corporate governance. Also, self-insurance pools could benefit from a sales and marketing perspective because an A.M. Best rating tends to validate the financial strength and credibility of these entities.

## Summary

Self-insurance pools are alternative risk transfer vehicles that are organized primarily to meet the risk-mitigation needs of members. These members are bound together by similar risk profiles and an interest in reducing claim frequency and aggressively mitigating those losses that do occur. The results of the

## Summary Financial Data, Self-Insurance Pools—1999-2003

(\$ Thousands)

Year	Net Premiums Written		% Change		Net Income/Loss		% Change		Admitted Assets		% Change		Loss & LAE Reserve		% Change		Year-End Surplus		% Change	
1999	\$351,850		N/A		\$29,930		N/A		\$1,205,108		N/A		\$685,361		N/A		\$369,468		N/A	
2000	380,012		8.0		39,579		32.2		1,291,101		7.1		711,831		3.9		423,676		14.7	
2001	448,946		18.1		41,959		6.0		1,401,491		8.6		749,520		5.3		475,077		12.1	
2002	555,871		23.8		79,165		88.7		1,575,900		12.4		816,269		8.9		542,008		14.1	
2003	685,744		23.4		69,361		-12.4		1,803,205		14.4		939,865		15.1		629,520		16.1	
<b>4-Year % Change</b>	<b>94.9%</b>				<b>131.7%</b>				<b>49.6%</b>				<b>37.1%</b>				<b>70.4%</b>			
<b>4-Year \$ Change</b>	<b>\$333,894</b>				<b>\$39,431</b>				<b>\$598,097</b>				<b>\$254,504</b>				<b>\$260,052</b>			

Year	Profitability Analysis				Underwriting Leverage Ratios				
	Investment Yield	Total ROR	Total ROE	Loss & LAE Ratio	Underwriting Expense Ratio	Combined Ratio After Dividends	Net Premiums Written	Net Liabilities	Net Underwriting Leverage Ratio
1999	5.2%	8.3%	8.6%	59.9	21.4	100.2	1.1	2.5	3.6
2000	5.2	13.5	13.6	55.0	22.9	93.9	1.0	1.8	2.8
2001	5.3	12.5	14.4	60.5	24.2	93.1	1.0	1.5	2.5
2002	4.6	11.7	10.6	63.1	23.1	95.4	1.1	1.4	2.5
2003	4.0	12.3	13.8	64.5	23.6	92.4	1.1	1.4	2.5
<b>5-Year Average</b>	<b>4.9</b>	<b>11.7</b>	<b>12.2</b>	<b>60.6</b>	<b>23.6</b>	<b>95.0</b>			

Source: A.M. Best Co.

self-insurance pools that A.M. Best interactively rates bear out the effectiveness of the stringent entrance requirements of members, focused loss-mitigation activities, and ownership interest in both the loss exposure and frictional expenses of the entity.

The substantial growth of membership in self-insurance pools is evidence of the desire to gain control over the product, particularly poli-

cy terms, and to stabilize premium to the maximum extent possible. Although the pools likely will be affected to some degree over the next few years as the commercial insurance market softens, the management teams operating the pools are confident that most of their members are committed to the long-term stability of their self-insurance programs and the benefits they derive from their participation in them.

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A Best's Rating is an independent opinion, based on a comprehensive quantitative and qualitative evaluation, of a company's balance sheet strength, operating performance and business profile. Best's Ratings are not a warranty of a company's financial strength and ability to meet its financial obligations.

### Financial Strength Ratings

A **Best's Financial Strength Rating** is an opinion as to an insurer's ability to meet its obligations to policyholders.

	Rating	Descriptor
<b>Secure</b>	A++, A+	Superior
	A, A-	Excellent
	B++, B+	Very Good
<b>Vulnerable</b>	B, B-	Fair
	C++, C+	Marginal
	C, C-	Weak
	D	Poor
	E	Under Regulatory Supervision
	F	In Liquidation
	S	Suspended

A **Best's Long-Term Issuer Credit Rating (ICR)** is an opinion as to the ability of the rated entity to meet its senior obligations. In certain markets or product lines, particularly where the credit market scale is widely recognized, A.M. Best also assigns Issuer Credit Ratings to insurance companies using its Long-Term Credit Rating Scale. The definitions applied to insurance companies that are assigned a long-term Issuer Credit Rating are as follows: (aaa) - Exceptional; (aa) - Superior; (a) - Excellent; (bbb) - Very Good; (bb) - Fair; (b) - Marginal; (ccc-cc) - Weak; (c) - Poor.

A.M. Best may also assign Short-Term Issuer Credit Ratings to certain insurance companies using its Short-Term Credit Rating scale.

Rating Modifiers		Affiliation Codes	
"u"	Under Review	"g"	Group
"pd"	Public Data	"p"	Pooled
"s"	Syndicate	"r"	Reinsured

### Not Rated Categories (NR)

NR-1	Insufficient Data
NR-2	Insufficient Size and/or Operating Experience
NR-3	Rating Procedure Inapplicable
NR-4	Company Request
NR-5	Not Formally Followed

### Long-Term Credit Ratings

A.M. Best uses its long-term credit rating scale when assigning:

- **Debt Ratings** (an opinion as to the issuer's ability to meet its financial obligations to security holders when due) and
- **Issuer Credit Ratings** (an opinion as to the ability of the rated entity to meet its senior obligations).

	Rating	Descriptor
<b>Investment Grade</b>	aaa	Exceptional
	aa	Very Strong
	a	Strong
	bbb	Adequate
<b>Non-Investment Grade</b>	bb	Speculative
	b	Very Speculative
	ccc, cc, c	Extremely Speculative
	d	In Default

Ratings from "aa" to "ccc" may be enhanced with a "+" (plus) or "-" (minus) to indicate whether credit quality is near the top or bottom of a category, and a "u" modifier for Under Review.

Ratings prefixed with an ("i") denote indicative ratings. Issuer Credit Ratings may also be assigned a "pd" modifier, which indicates that a company does not subscribe to A. M. Best's interactive rating process.

These Issuer Credit Rating descriptors apply to entities which do not issue insurance obligations.

### Short-Term Credit Ratings

A.M. Best uses its short-term credit rating scale when assigning:

- **Debt Ratings** (an opinion as to the issuer's ability to meet its obligations having maturities generally less than one year) and
- **Issuer Credit Ratings** (an opinion as to the ability of the rated entity to meet its senior financial commitments on obligations maturing in generally less than one year).

	Rating	Descriptor
<b>Investment Grade</b>	AMB-1+	Strongest
	AMB-1	Outstanding
	AMB-2	Satisfactory
	AMB-3	Adequate
<b>Non-Investment Grade</b>	AMB-4	Speculative
	d	In Default

A company's Short-Term Credit Rating also may be assigned an Under Review modifier ("u") that generally is event-driven (positive, negative or developing) and indicates that the company's Best's Rating opinion is under review and may be subject to near-term change. Ratings prefixed with an ("i") denote indicative ratings.

### Rating Outlook

Best's Ratings (A++ to D, aaa to c) are assigned a Rating Outlook that indicates the potential direction of a company's rating for an intermediate period, generally defined as the next 12 to 36 months. Public Data Ratings are not assigned an Outlook. Rating Outlooks are as follows:

<b>Positive</b>	Indicates a company's financial/market trends are favorable, relative to its current rating level, and if continued, the company has a good possibility of having its rating upgraded.
<b>Negative</b>	Indicates a company is experiencing unfavorable financial/market trends, relative to its current rating level, and if continued, the company has a good possibility of having its rating downgraded.
<b>Stable</b>	Indicates a company is experiencing stable financial/market trends and that there is a low likelihood that its rating will change in the near term.

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