

## 2008 Market Review

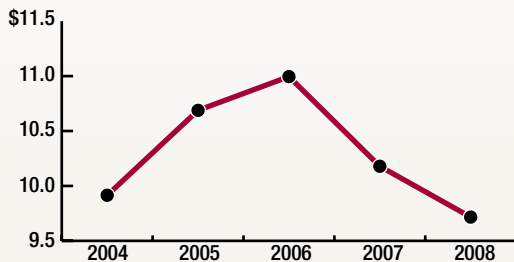
August 3, 2009

### Sector

Property/Casualty

## U.S. Captives – Net Premiums Written (2004-2008)

(\$ Billions)



## Related Reports

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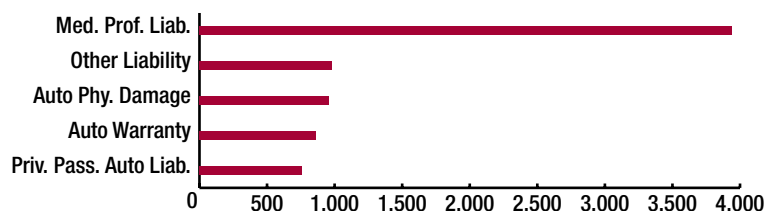
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## Captives Buck Investment Losses With Strong Underwriting Results

U.S. captive insurers' net income declined approximately 66% in 2008 for a composite of 186 captive companies represented in this report. This reflects realized losses of \$1.2 billion for the year, a large percentage of which resulted from one company's investment losses. Net underwriting income actually increased over the prior year – evidence of the captive industry's typical underwriting discipline and its inclination not to rely on investment income.

- Captives had no material exposure to commercial mortgage-backed securities (CMBS) or mortgage-backed securities (MBS) and minimal exposure to Lehman Brothers or Bear Stearns paper.
- Overall, captives generated gross investment income of \$1.8 billion in 2008, down only 7% from 2007.
- Policyholder dividends decreased by 1.6 percentage points to 4.2% in 2008 from a high of 5.8% in 2007, allowing captive companies to return some profits to surplus while remaining attentive to policyholders' needs.
- Captives posted deteriorated results in 2008 as a softening market followed particularly good results in recent years.
- Maintaining steady rates in the hard market has served captives well as the market has softened and captives refrain from chasing rate.
- Captive management teams are increasing their emphasis on enterprise risk management, and successful single-parent captives have integrated their operations as part of the parent company's overall risk management program.
- Captive formations continue amid a softening commercial insurance market, but new captive domiciles are finding it challenging to establish a presence.
- The outlook for the captive industry is stable as participants exercise their financial flexibility in a softening market.

## U.S. Captives – Net Premiums Earned by Line (\$ Millions, 2008)



Source: A.M. Best Co.



## Holding on With Underwriting

The U.S. captive insurance industry's results for 2008 show a significant decline of approximately 66% in net income when compared with 2007, for a composite of 186 captive companies represented in this report. This can be attributed to substantial realized losses of \$1.2 billion that were recorded for the year. A large percentage of these losses result from one company's overall investment losses. It is important to note however, that net underwriting income actually increased over the prior year. This is a testament to the underwriting discipline that is typical of the captive industry, as captives tend to focus on providing coverage and stable pricing to their constituents and not on producing large profits. It also demonstrates that captives

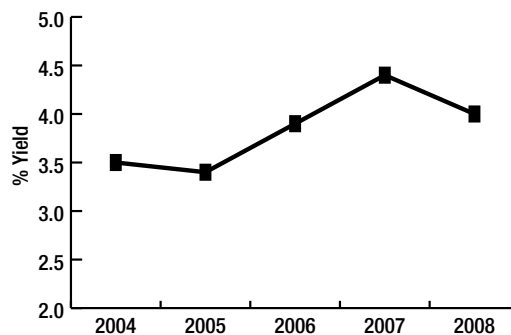
in general are not relying entirely on investment income to compensate for underwriting losses.

### Investments

Captives took realized capital losses of \$1.2 billion and unrealized losses of \$1.4 billion in 2008, battling one of the toughest investment markets since the tech bubble. Out of the losses, one captive contributed \$464.8 million, or 38% of the realized losses, and the same captive represented almost 44%, or \$632 million of the unrealized losses. The S&P 500 stock index lost 39% in 2008, and investors encountered unprecedented volatility as measured by the Chicago Board Options Exchange (CBOE) Volatility Index (VIX), which peaked at 89 in October 2008 – three to four times the average. Contributing to the volatility was the government bailout of Bear Stearns and the bankruptcy of Lehman Brothers, as well as numerous bank failures throughout the year.

With the markets' horrible performance and global economic conditions deteriorating, common stock leverage trended lower to 18.4% of policyholders' surplus in 2008, from a high of 51.7% in 2004. At the same time, captives have increased their long-term bond holdings to 70.3% of policyholders' surplus. The trend in long-term bonds has increased only 5% over the past five years; however, captives increased their cash and short-term investments by 27% in 2008. This shift to cash resulted in a lower investment yield of 4.0% in 2008, compared with 4.4% in 2007, showing a more conservative investment philosophy. Most of the captives that A.M. Best Co. spoke with did take losses but also held onto investments that they feel have been oversold in the past year. Captives had no material exposure to commercial mortgage-backed securities (CMBS) or mortgage-backed securities (MBS) and very minimal exposure to Lehman Brothers or Bear Stearns paper. Overall, captives did manage to generate gross investment income of \$1.8 billion in 2008, down only 7% year over year.

Exhibit 1  
U.S. Captives – Investment Returns (2004-2008)



Source: A.M. Best

## About This Report

As in previous years, A.M. Best has compiled financial statistics of U.S. domestic captives. This year's composite consists of 186 insurers filing statutory financial statements or Vermont Annual Reports with A.M. Best. Of these, 149 carry letter ratings from A.M. Best. Other rated captives that file only GAAP financial statements are not included in these statistics. The term "captive" refers to single-parent (pure) captives and group captives, including risk retention groups, formed to address the insurance needs of specific owners and groups as an alternative to commercial insurance programs. However, the distinction between captive and traditional insurers is not clear-cut. Insurance organizations evolve with time and may move along the continuum between captive business and unrelated, third-party business. Consequently, the population used for this study includes some mutuals, exchanges and reciprocals that have captive or nontraditional origins or characteristics.

## Exhibit 2

**U.S. Captives – Financial Summary (2004-2008)**

From statutory property/casualty statements.

(\$ Thousands)

Financial Indicators (\$000)												
Year	Net Premiums		Pretax Operating		Net Income/Loss		Admitted Assets		Loss & LAE Reserves		Year-End Surplus	
	Written	% Chg	Income/Loss	% Chg	Income/Loss	% Chg	Assets	% Chg	Reserves	% Chg	Surplus	% Chg
2004	\$9,914,886	5.2	\$382,223	6.6	\$733,733	25.7	\$46,327,464	7.6	\$18,801,259	10.9	\$16,005,460	5.3
2005	10,688,313	7.8	1,216,402	218.2	1,263,617	72.2	50,347,159	8.7	20,341,339	8.2	17,571,208	9.8
2006	10,995,263	2.9	2,522,311	107.4	3,001,149	137.5	52,830,499	4.9	21,010,992	3.3	19,534,780	11.2
2007	10,179,141	-7.4	2,890,080	14.6	2,491,342	-17.0	53,639,628	1.5	20,965,429	-0.2	20,392,805	4.4
2008	9,716,339	-4.5	2,520,639	-12.8	837,672	-66.4	50,675,676	-5.5	20,765,342	-1.0	19,345,297	-5.1
5-Year CAGR		<b>0.6</b>						<b>3.3</b>		<b>4.1</b>		<b>4.9</b>
5-Year Change		<b>3.1</b>						<b>17.7</b>		<b>22.4</b>		<b>27.3</b>

Profitability Analysis (%)													
Year	Return on Invested Assets			Return on Revenue			Return on Equity			Underwriting & Operating Ratios			
	Investment Yield	Net Investment Income (w/Real Cap Gains)	Total ROIA	POI/NPE	NI/NPE	Total ROR	POI/PHS	NI/PHS	Total ROE	Loss & LAE	Underwriting Expense	Combined (A/PHDS)	Operating
2004	3.5	5.0	6.2	4.0	7.6	12.2	2.4	4.7	7.5	88.1	19.7	110.9	97.0
2005	3.4	4.5	4.8	11.8	12.3	13.5	7.2	7.5	8.3	80.0	18.9	102.2	88.0
2006	3.9	7.0	6.2	23.0	27.4	24.5	13.6	16.2	14.4	70.6	19.4	94.1	77.9
2007	4.4	5.4	5.0	28.1	24.2	22.2	14.5	12.5	11.4	65.5	22.1	93.4	73.4
2008	4.0	1.3	-1.8	24.6	8.2	-5.9	12.7	4.2	-3.0	67.6	21.8	93.6	75.9
5-Year Average													
<b>Captives</b>	<b>3.9</b>	<b>4.6</b>	<b>4.0</b>	<b>18.5</b>	<b>16.2</b>	<b>13.5</b>	<b>10.5</b>	<b>9.2</b>	<b>7.6</b>	<b>74.1</b>	<b>20.4</b>	<b>98.6</b>	<b>82.2</b>
<b>Industry</b>	<b>4.8</b>	<b>4.7</b>	<b>4.8</b>	<b>14.3</b>	<b>10.9</b>	<b>11.1</b>	<b>13.5</b>	<b>10.3</b>	<b>10.5</b>	<b>71.3</b>	<b>27.9</b>	<b>99.4</b>	<b>84.8</b>

Investment and Liquidity Analysis (%)													
Year	Investment Portfolio (% of Invested Assets)					Investment Leverage (% of Policyholder Surplus)			Liquidity & Cash Flow Ratios				
	Long-Term Bonds	Cash & Stocks	Short-Term Investments	Affiliated Investments	All Other	Common Stocks	Nonaffiliated Investments	Affiliated Investments	Quick Liquidity	Current Liquidity	Underwriting Cash Flow	Operating Cash Flow	
2004	65.0	20.7	6.3	3.0	5.1	51.7	64.7	7.6	47.2	135.0	113.3	129.6	
2005	65.2	20.1	6.2	3.0	5.6	49.8	62.6	7.5	48.8	135.9	115.4	126.0	
2006	65.2	13.5	10.9	3.7	6.6	31.3	45.5	8.9	49.1	138.6	107.7	113.9	
2007	69.3	13.3	6.0	3.6	7.9	30.1	46.4	8.5	45.5	142.0	105.5	114.8	
2008	70.3	8.2	8.1	4.9	8.5	18.3	36.0	11.3	36.8	138.3	98.0	109.0	
<b>Industry</b>						<b>9.7</b>	<b>29.0</b>	<b>36.3</b>	<b>19.1</b>	<b>104.5</b>			

Underwriting Leverage and Loss Reserve Analysis (%)													
Year	Underwriting Leverage Ratios						Loss Reserve Ratios						
	Net Premiums Written	Net Liabilities	Net Ceded	Gross	Business Retention	Reserves/PHS	Reserves/NPE	Developed/Original	Developed/PHS	Accident-Year Combined	Calendar Year/Accident Year		
2004	0.6	1.9	2.5	0.6	3.1	81.7	117.5	194.9	-10.6	-12.5	96.1	14.8	
2005	0.6	1.8	2.4	0.6	3.0	83.0	115.8	197.9	-12.7	-14.7	94.4	7.8	
2006	0.6	1.7	2.2	0.5	2.8	83.8	107.6	192.0	-11.6	-12.5	94.5	-0.5	
2007	0.5	1.6	2.1	0.5	2.6	83.1	102.8	204.0	-6.3	-6.4	99.9	-6.5	
2008	0.5	1.6	2.1	0.5	2.6	81.7	107.3	202.7	-	-	105.6	-11.9	
<b>Industry</b>	<b>0.9</b>	<b>2.4</b>	<b>3.3</b>	<b>1.0</b>	<b>4.3</b>	<b>82.6</b>	<b>161.0</b>	<b>182.8</b>					

Top Lines: Medical Professional Liability (40.1%), Other Liability (10.6%), Auto Physical Damage (9.4%), Private Passenger Auto Liability (7.5%), Commercial Multiple Peril (7.5%)

Top States: NY (12.2%), CA(9.3%), IL (5.5%), VT (4.4%), TX (4.2%)

Industry Composite: Commercial Casualty

Source: A.M. Best, statutory property/casualty statements.

### Exhibit 3

## U.S. Captives – Profitability Analysis (2004-2008)

(\$ Thousands)

Sources of Earnings and Surplus Growth							
Year	Net Underwriting Income	Other Income/Expense	Net Investment Income	Pretax Operating Income/Loss	Realized Capital Gain/Loss	Income Tax	Net Income/Loss
2004	-\$1,105,766	\$148,639	\$1,339,349	\$382,223	\$581,066	\$229,556	\$733,733
2005	-299,465	57,069	1,458,798	1,216,402	436,940	389,725	1,263,617
2006	640,377	110,346	1,771,588	2,522,311	1,309,324	830,485	3,001,149
2007	700,523	138,491	2,051,066	2,890,080	467,074	865,812	2,491,342
2008	768,915	-62,815	1,814,539	2,520,639	-1,223,023	459,944	837,672
<b>5-Year</b>	<b>\$704,584</b>	<b>\$391,731</b>	<b>\$8,435,340</b>	<b>\$9,531,654</b>	<b>\$1,571,380</b>	<b>\$2,775,521</b>	<b>\$8,327,513</b>

Year	Unrealized Capital Gain/Loss	Total Return	Other Surplus Gain/Loss	Contributed Capital	Stockholder Dividends	Change in Surplus	Year-End Surplus
2004	\$442,738	\$1,176,470	-\$105,414	\$155,865	-\$423,157	\$803,764	\$16,005,460
2005	125,810	1,389,426	-13,872	367,613	-177,419	1,565,748	17,571,208
2006	-320,766	2,680,384	-20,861	306,794	-1,002,743	1,963,573	19,534,780
2007	-209,628	2,281,714	52,698	269,902	-1,746,290	858,025	20,392,805
2008	-1,439,757	-602,085	109,091	75,685	-630,199	-1,047,508	19,345,297
<b>5-Year</b>	<b>-\$1,401,604</b>	<b>\$6,925,909</b>	<b>\$21,642</b>	<b>\$1,175,858</b>	<b>-\$3,979,808</b>	<b>\$4,143,601</b>	

Composition of Underwriting Earnings								
Year	Net Premiums Written	Net Premiums Earned	Loss & LAE Incurred	Commission Expense (%)	Other Expense (%)	Underwriting Expense Incurred	Policyholder Dividends	Net Underwriting Income
2004	\$9,914,886	\$9,644,517	\$8,492,954	23.3	76.7	\$1,953,808	\$303,521	-\$1,105,766
2005	10,688,313	10,280,268	8,222,274	23.1	76.9	2,018,226	339,233	-299,465
2006	10,995,263	10,942,915	7,729,557	25.9	74.1	2,136,407	436,574	640,377
2007	10,179,141	10,277,821	6,731,969	22.3	77.7	2,250,002	595,327	700,523
2008	9,716,339	10,244,840	6,926,669	21.6	78.4	2,121,808	427,448	768,915
<b>5-Year</b>	<b>\$51,493,943</b>	<b>\$51,390,360</b>	<b>\$38,103,423</b>	<b>23.2</b>	<b>76.8</b>	<b>\$10,480,250</b>	<b>\$2,102,103</b>	<b>\$704,584</b>

Underwriting/Operating Ratios (%)												
Year	Pure Loss	Loss Adjustment Expense	Loss & LAE	Commission Expense	Other Expense	Total Underwriting Expense	Combined Ratio B/PHDS	Policyholder Dividends	Combined Ratio A/PHDS	Net Investment Ratio	Operating Ratio	
2004	65.8	22.3	88.1	4.6	15.1	19.7	107.8	3.1	110.9	13.9	97.0	
2005	59.2	20.8	80.0	4.4	14.5	18.9	98.9	3.3	102.2	14.2	88.0	
2006	51.3	19.4	70.6	5.0	14.4	19.4	90.1	4.0	94.1	16.2	77.9	
2007	47.9	17.6	65.5	4.9	17.2	22.1	87.6	5.8	93.4	20.0	73.4	
2008	50.0	17.6	67.6	4.7	17.1	21.8	89.4	4.2	93.6	17.7	75.9	
<b>5-Year Average</b>												
<b>Captives</b>	<b>54.7</b>	<b>19.5</b>	<b>74.1</b>	<b>4.7</b>	<b>15.6</b>	<b>20.4</b>	<b>94.5</b>	<b>4.1</b>	<b>98.6</b>	<b>16.4</b>	<b>82.2</b>	
<b>Industry</b>	<b>57.2</b>	<b>14.1</b>	<b>71.3</b>	<b>11.1</b>	<b>16.8</b>	<b>27.9</b>	<b>99.1</b>	<b>0.3</b>	<b>99.4</b>	<b>14.6</b>	<b>84.8</b>	

Product Line Loss Experience*													
Rank	Product Line	2008 NPE	Pure Net Loss Ratio (%)						Better/(Worse) Than Industry				
			2008	2007	2006	2005	2004	Average	2008	2007	2006	2005	2004
1	Med. Prof. Liab.	\$3,936,993	31.9	38.0	47.2	57.7	71.1	48.9	0.8	-0.8	-4.4	-5.2	-8.1
2	Other Liability	982,022	38.5	41.0	33.3	41.1	38.6	38.4	9.7	12.3	19.3	22.1	29.1
3	Auto Phy. Damage	955,263	59.9	56.0	55.4	58.9	55.0	57.0	0.5	1.6	-0.1	-2.7	-2.2
4	Auto Warranty	865,160	58.8	60.2	61.9	75.4	77.2	66.2	10.8	1.2	2.7	-3.1	5.5
5	Priv. Pass. Auto Liab.	761,160	56.9	61.5	64.5	65.2	62.3	62.3	7.6	1.3	-5.7	-4.6	-1.0
6	Commercial M.P.	634,264	126.8	53.1	43.7	61.3	71.1	71.7	-70.8	-9.8	1.3	-11.8	-19.4
7	Workers' Comp.	528,986	59.2	57.5	62.6	60.4	64.8	60.7	2.9	5.2	-1.6	5.9	5.6
8	Commercial Auto Liab.	307,252	43.7	51.2	51.5	57.6	66.0	53.8	10.7	1.4	2.2	-3.1	-9.8
9	Reinsurance-B	238,015	66.9	94.2	132.8	94.3	90.2	91.1	1.3	-24.4	-57.6	178.2	24.8
10	Inland Marine	162,106	47.1	40.1	50.6	42.9	43.3	44.7	7.8	2.2	-7.9	9.3	1.0
	<b>All Other</b>	<b>529,761</b>	<b>60.5</b>	<b>47.6</b>	<b>51.1</b>	<b>63.2</b>	<b>77.7</b>	<b>59.7</b>	-	-	-	-	-
	<b>Total</b>	<b>\$9,900,983</b>	<b>50.3</b>	<b>48.1</b>	<b>51.4</b>	<b>59.5</b>	<b>66.2</b>	<b>54.9</b>	<b>14.9</b>	<b>7.7</b>	<b>1.9</b>	<b>2.5</b>	<b>-5.8</b>

\* Excludes Vermont domiciled companies that file Vermont Statutory form.

Source: A.M. Best Co.

Note: Dollar amounts and ratios for prior years may not reconcile to historical exhibits due to the pro forma inclusion of the net changed captives count added during 2008 to the rated captive population.

## Exhibit 4

**U.S. Captives – Investment & Liquidity Analysis (2004-2008)**

(\$ Thousands)

<b>Quick and Current Asset Composition (\$000)</b>										
Year	Short-Term & Cash	U.S. Government			Common Stock (80%)	Quick Assets	Nonaffiliated Invested Assets excl Real Estate	Other Property Encumbered	Current Assets	Admitted Assets
		Bonds < 1 Year	Bonds 1-5 Years	Bonds						
2004	\$2,603,246	\$2,180,924	\$2,619,823	\$6,615,218	\$14,019,211	\$40,149,532	-	\$40,148,649	\$46,327,464	
2005	2,768,245	2,828,468	2,991,830	7,004,239	15,592,782	43,410,498	-	43,396,216	50,347,159	
2006	5,137,791	3,161,417	2,860,852	4,890,337	16,050,397	45,285,730	-	45,264,758	52,830,499	
2007	2,859,902	4,302,148	2,743,120	4,910,109	14,815,279	46,308,840	-	46,248,866	53,639,628	
2008	3,647,827	2,903,469	1,924,999	2,838,052	11,314,347	42,586,809	-	42,502,906	50,675,676	

<b>Net and Current Liability Composition (\$000)</b>									
Year	Total Liabilities	Conditional Reserves	Encumbered Net Affiliated	Less Balances	Net U.S. Affiliated Funds Withheld	Net Liabilities	Balances Payable	Current Liabilities	Overall Liabilities
2005	32,775,952	337,598		-432,360	36,132	31,969,862	406,927	31,931,442	32,438,354
2006	33,295,719	300,311		-295,198	31,917	32,668,293	448,465	32,655,985	32,995,407
2007	33,246,824	283,841		-306,842	53,809	32,602,331	435,801	32,575,179	32,962,982
2008	31,330,379	224,067		-241,845	56,852	30,807,615	519,433	30,734,749	31,106,312

<b>Cash Flow Composition</b>								
Year	Premiums Collected	Benefits & Loss-Related Payments	Commission & Expenses Paid	Policyholder Dividends	Underwriting Cash Flow	Gross Investment Income	Other (Incl Tax)	Operating Cash Flow
2005	10,425,480	5,270,627	3,464,474	299,142	1,391,237	1,509,786	-432,928	2,468,094
2006	10,746,938	5,956,530	3,681,554	341,484	767,371	1,764,806	-993,632	1,538,545
2007	9,941,890	5,190,878	3,720,673	507,751	522,588	1,958,111	-937,857	1,542,841
2008	9,678,663	5,625,109	3,710,998	537,104	-194,548	1,815,610	-670,569	950,494

<b>Cash Flow Composition (continued)</b>				
Year	Realized Capital Gains	Contributed Capital	Other	Net Cash Flow
2005	436,940	1,693	-2,804,433	102,293
2006	1,309,324	-868,680	348,299	2,327,488
2007	467,074	-1,334,555	-3,017,907	-2,342,547
2008	-1,223,023	-591,595	1,533,569	669,444

<b>Liquidity and Cash Flow Ratios Analysis (%)</b>					
Year	Liquidity			Cash Flow	
	Quick	Current	Overall	Underwriting	Operating
2004	47.2	135	153.7	113.3	129.6
2005	48.8	135.9	155.2	115.4	126.0
2006	49.1	138.6	160.1	107.7	113.9
2007	45.5	142.0	162.7	105.5	114.8
2008	36.8	138.3	162.9	98.0	109.0
<b>Industry</b>	<b>19.1</b>	<b>104.5</b>	<b>141.1</b>		

Source: A.M. Best Co.

Captives, like the overall insurance industry, may face another tough investment year in 2009. Unemployment has reached double digits, and the ballooning federal

budget deficit is putting pressure on the U.S. dollar. Tight credit and the possibility of more bank failures still are weighing on

*(continued on page 8)*

## Exhibit 5

### U.S. Captives – Underwriting Leverage Analysis (2004-2008)

(\$ Thousands)

Premium Composition (\$000)										
Year	Direct Premiums Written	Assumed			Gross Premiums Written	Ceded			Net Premiums Written	Net Premiums Earned
		Affiliated (%)	Nonaffiliated (%)	Total		Affiliated (%)	Nonaffiliated (%)	Total		
2004	\$9,500,142	71.3	28.7	\$3,872,117	\$13,372,259	35.9	64.1	\$3,457,373	\$9,914,886	\$9,644,517
2005	10,063,174	71.2	28.8	3,982,052	14,045,226	34.9	65.1	3,356,912	10,688,313	10,280,268
2006	9,996,141	66.2	33.8	4,194,088	14,190,229	33.4	66.6	3,194,965	10,995,263	10,942,915
2007	9,556,204	66.7	33.3	3,999,634	13,555,838	38.8	61.2	3,376,697	10,179,141	10,277,821
2008	9,321,652	66.0	34.0	3,628,161	12,949,813	32.8	67.2	3,233,474	9,716,339	10,244,840

Liability Composition (\$000)									
Year	Loss & LAE Reserves			Unearned Premiums	Reinsurance Funds Held	All Other Liabilities	Conditional Reserves	Total Liabilities	Policyholder Surplus
	Loss (%)	LAE (%)	Total						
2004	77.3	22.7	\$18,801,259	\$6,182,101	\$786,958	\$4,378,024	\$173,662	\$30,322,004	\$16,005,460
2005	76.7	23.3	20,341,339	6,580,841	677,257	4,838,917	337,598	32,775,952	17,571,208
2006	75.8	24.2	21,010,992	6,686,390	633,265	4,664,760	300,311	33,295,719	19,534,780
2007	75.6	24.4	20,965,429	6,612,687	723,363	4,661,504	283,841	33,246,824	20,392,805
2008	75.3	24.7	20,765,342	6,001,136	1,256,589	3,083,245	224,067	31,330,379	19,345,297

Source: A.M. Best Co.

## Captive Market in Transition

Although growth in the captive market was somewhat slow in 2008, regulators and industry experts are optimistic that the sector, particularly domestic domiciles, will return to historical activity in 2009. The past few decades have proved the fundamental fact that captives know their underlying risks much better than commercial insurers, and this is a sustainable advantage that continues to impact captive insurers' growth.

Numerous uncertainties impacted the captive industry in 2008, including the continued soft commercial insurance market, the economic slowdown and crisis, ambiguity over an IRS tax proposal and the new White House administration's views on regulation and treatment of captives.

While President Obama's recently released briefing paper indicated that the administration wants to remove "tax advantages for investing overseas;" reform tax-deferral rules; close foreign tax credit loopholes; and hire nearly 800 new Internal Revenue Service employees devoted to international enforcement, among other things, the paper did not mention insurance or reinsurance specifically, and it appears domestic captives currently are not on the radar screen.

Many believe the initiative is aimed at U.S. companies with offshore subsidiaries and not the insurance industry

per se. Although this proposal still is unclear and light on details, most offshore captives of U.S. parents already pay U.S. taxes through the option provided by Section 953(d) of the Internal Revenue Code, under which the captives are taxed as U.S. taxpayers.

The combination of a soft insurance market, the overall economic slowdown and the administration's push to remove tax advantages thus far has slowed the efforts of many companies, groups and agencies to form new captives, but this could well be a time of transition. A hardening of professional lines could push up the formation of new captives in 2009-2010. Pointing to this transition, two emerging captive domiciles, Kentucky and Delaware, significantly increased their numbers of captives to 62 and 36, respectively, in the first half of 2008. A third, Utah, added 31 captives in the same period.

Given the market conditions and the regulatory environment, if a captive is formed primarily for reasons other than tax flexibility, the prospects are good for success. Many domestic captive domiciles are planning their own state and premium tax incentives to lure new enterprises, including, among others, Vermont and Montana. The entry of new domiciles, such as Michigan and Connecticut, into the captive world through new legislation shows opportunity and faith in the sector.

## Professional Liability Results Indicate Stable Outlook

Among the companies providing financial data and included in the overall captive study for this year, there are 69 dedicated professional liability insurers operating as alternative risk transfer vehicles. Of these, 52 have interactive ratings from A.M. Best Co. Among the lines of business these 69 insurers cover, medical professional liability by far predominates, including physicians, hospitals, dentists, chiropractors and other health-related specialties. The data also include smaller shares of other professional liability business such as attorneys, accountants, and architects and engineers.

These professional liability carriers tailor coverage to the needs of their insureds and member/owners. Focusing on their niche markets provides the means to analyze their exposures in depth. It allows them to direct their risk management and loss-control efforts directly to the unique hazards generating losses in this field. The insurers typically carry the endorsement of their relevant national, state and/or local professional organizations.

Nonetheless, professional liability carriers must compete with national and regional players that also offer professional liability coverage, often at competitive rates. Some of these companies have substantial operations committed to this line, while others are more opportunistic.

Furthermore, the carriers included in this analysis often are state specific or concentrated on one narrow segment of the professional liability market. As a result, they are especially subject to the effects of regulation and changes in the legal and judicial environments within their operating jurisdictions.

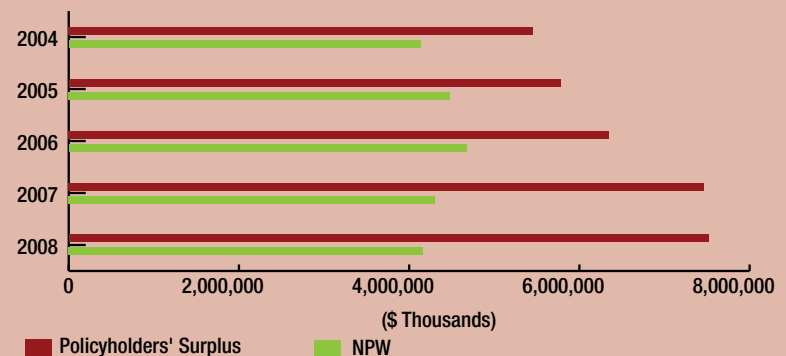
Given these market dynamics, the financial results of this group of companies, particularly in medical professional liability, have exhibited recurring periods of strong profitability followed by intervals of significant adverse outcomes. Currently, the market is reaping the benefits of several favorable factors, stemming in part from the latest financial crisis. Responding to a period of rapidly rising claim frequency and severity in the early 2000s, insurers increased rates substantially, implemented aggressive approaches to fighting baseless claims, and upgraded risk management and loss-control training programs for their members/insureds.

Over the past several years, as shown in **Exhibit 5**, surplus has grown as the rate increases generated greater earned premiums. In addition, over the past five years, the industry experienced a steady and substantial decline in claim frequency, generally considered a positive outcome of the improved educational efforts and hesitancy on the part of plaintiffs' attorneys to bring to trial any but the most egregious cases because of the costs involved. Reserve levels that had been boosted significantly in anticipation of worsening conditions are proving to be somewhat redundant. Their reductions now are contributing to improving operating statistics and increasing surplus.

In recognition of the strongly favorable financial results seen over the past several years, the insurers are reducing premium rates, applying premium credits or offering dividends to the better risks within their books of business. As shown in **Exhibit 5**, net premiums written started to decline in 2007 and 2008 as a result. Concomitantly, underwriting leverage measures have improved, with lower premium volumes and reduced loss reserves compared with higher policyholders' surplus.

A.M. Best currently views the professional liability lines of business as stable. Nonetheless, it will continue to track whether the premium rate changes will remain sustainable, given changes in claim frequency patterns and the severity of incurred losses. It also will monitor the impact of increased competitive activity from well-funded diversified carriers, as well as among the dedicated professional liability entities themselves. A longer term issue will be the effects on the medical professional liability industry from, and its participants' responses to, changes in health-care technology, delivery, and utilization.

**Exhibit 6**  
**U.S. Professional Liability – Key Figures (2004-2008)**



Source: A.M. Best

the markets and on corporate profits. All of these factors, along with the fortunes of the housing market, will influence the 2009 investment year results.

In 2008, policyholder dividends decreased by 1.6 percentage points to 4.2% from a high of 5.8% in 2007. Returning a smaller portion of dividends to policyholders allows the captive companies to return some of the profits to surplus, while

remaining cognizant of policyholders' needs. Having this level of flexibility allows captive insurers to adapt quickly to changing market conditions.

### Market Conditions

Captive insurance companies recorded severely depressed results in 2008, primarily due to softening market conditions, after experiencing particularly good results in recent years. As the market continues to soften and competition intensifies, insureds have more options in terms of pricing. One advantage for captive insurers is the ability to compete not only on price but with customized policies and services for their insureds. Additionally, captives can offer premium credits or dividends to offset the overall cost or effective rate of the insurance policy. Many captives have stated that they are "holding the line and will let business go if the rates are too low." Maintaining steady rates during the hard market phase of the underwriting cycle has served the captive industry well as the market has softened and captives refrain from chasing rate.

The insurance industry is cyclical by nature, and as the market softens, captives are seeing moderate price pressure as companies take advantage of reduced pricing from the commercial market. Prudent management teams have used profits from the past several years to increase surplus in anticipation of the current, adverse results that are inherent in the insurance cycle.

Captive management teams are placing greater emphasis on enterprise risk management, which encompasses a comprehensive review of a company's overall risks. Although this is time consuming, it encourages companies not only to evaluate risks, but to develop internal controls to help mitigate the effects of those risks. In the case of single-parent (or pure) captives, successful entities have integrated the captive's operations as part of the parent company's risk management program. Over time, the captive will have opportunities to refine internal controls and improve overall operations. This in turn will enhance the captive's competitive position.

## Ratios Flatten Out

For the rated captives, loss and loss-adjustment expense, underwriting expense and operating ratios continued to decline from 2004 through 2007 and stayed relatively flat through 2008. However, the five-year average performance ratios for captives remain below industry averages.

Exhibit 7

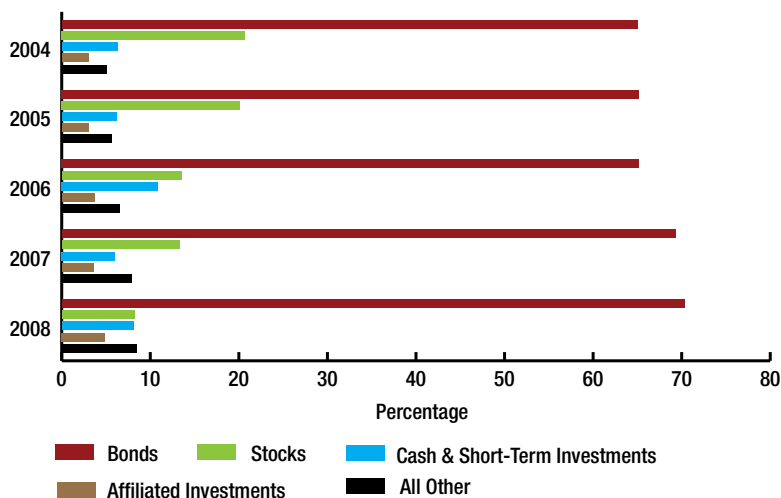
### U.S. Captives – Underwriting & Operating Ratios (2004-2008)



Source: A.M. Best

Exhibit 8

### U.S. Captives – Invested Assets



Source: A.M. Best

Captive formations go on even as the commercial insurance market continues to soften. New captive domiciles currently are finding it difficult to establish their presence in the market. The well-established domiciles are updating their captive legislation to adapt to the industry's changing needs.

The outlook for the captive industry is stable. Pure captive companies typically can withstand a softening market because of their financial flexibility, which results from their relationships with their parent companies. As discussed in the

overall investment section above, with a few dramatic exceptions, captives' predominantly conservative investment portfolios enabled them to withstand the turmoil of late 2008 in the capital markets.

**Exhibit 8** shows the shift of invested assets from the equity markets to cash and short-term investments as well as affiliated investments. For captives with multiple owners, such as risk retention groups, enduring the soft market becomes more difficult. However, multiple-owner captives typically have high

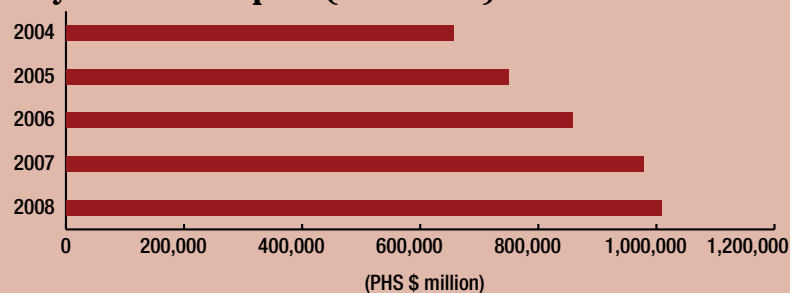
## RRGs' Profitability Continues Amid Difficult Economy

The federal Liability Risk Retention Act of 1981 (amended in 1986) prompted and encouraged formation of risk retention groups (RRGs). The liability crisis that began in the 1980s prompted passage of the act. The new organizational form, which gave insurers incorporated under the act rights and privileges not available to other state-licensed insurance companies, provided an alternative to commercial insurance.

Within the universe of 30 A.M. Best-rated RRGs, admitted assets and surplus increased by 3.0% and 3.1%, respectively, in 2008 and 2007. Loss and LAE reserves increased by only 1.9% over the same period. Surplus for these companies at Dec. 31, 2008 exceeded \$1.0 billion.

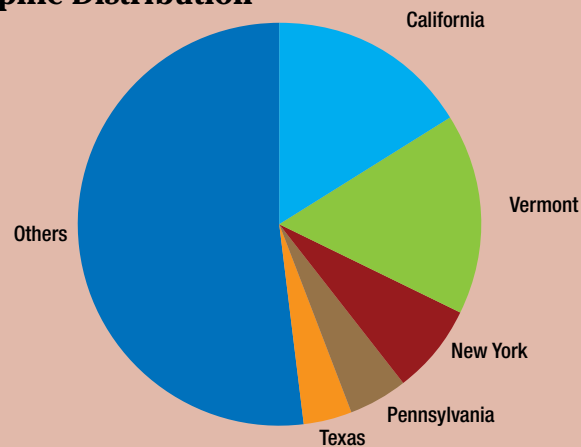
The average combined ratio for a rated RRG was 80.8 for 2008, much less than the industry average of 99.4. Rated RRGs' combined ratios have been declining on average since 2004. A similar trend was seen in the operating ratio for this group, which was 61.0 for 2008 versus 84.8 for the commercial insurance industry. Current and quick liquidity ratios improved to 148.0 and 44.4 versus industry averages of 104.5 and 19.1, respectively. Reserve redundancies for 2008 were 10.8%. RRGs wrote premiums for medical professional liability (44.9%), aggregated other liability (50.9%), commercial auto liability (2.8%), fidelity (1.0%) and products liability (0.4%). Geographically, the RRG domiciles were distributed among California (16.3%), Vermont (16.0%), New York (7.3%), Pennsylvania (4.6%)

**Exhibit 9**  
**Rated U.S. Risk Retention Groups – Policyholders' Surplus (2004-2008)**



Source: A.M. Best Quantitative Analysis Report

**Exhibit 10**  
**Rated U.S. Risk Retention Groups – Geographic Distribution**



Source: A.M. Best

and Texas (4.1%), with 51.7% in other states. A.M. Best's Commercial Casualty Composite was used for these classifications.

member retention rates, the result of more flexible pricing due to the deeper relationship these captives have with their owner/insureds and the value-added services provided. Therefore,

management must have strategies in place for the captive to adjust to a continued softening market without placing excessive pressure on the captive's financial position.

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August 3, 2009

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