Captive Financial Benchmarking

By John Salisbury, Captive.com Principal & Retired Captive Pres/CEO

Does your captive utilize benchmarking as a valued internal process? If not, should you be concerned that your company doesn't benchmark? What's the payoff for implementing this additional procedure? Financial benchmarking is one tool a captive can bring to bear in its enduring need to discern what improvements to the captive's policies, programs, business plans and strategies should be incorporated, both short and long-term.

For purposes of this brief financial benchmarking article, the benchmarks I will use are taken from the August 8, 2011 A.M. Best Special Report on U.S. Captive Insurance, which is published annually. The data contained in the report comes from a composite of 194 captive insurance entities that are followed by A.M. Best. These captives are varied, both in their respective insurance structures, and in size. According to the report, the smallest captive reported about $1.2 million in surplus, with the largest reporting more than $6 billion. Included in the study are risk retention groups, self-insurers, insurance funds, true captives, pure captives, group captives and some licensed mutual companies that are captives.

Best's data is reliable and makes the task of performing financial benchmarking significantly less expensive and easier to prepare.

If you are only interested in a subset of Best's captive insurance company data for a specific type of captive (e.g., group captives, RRG's, etc.) or some other criteria, A.M. Best is able to prepare a report tailored to your specific needs.

A captive's board of directors and its management should be familiar with the financial regulatory benchmarks used by its captive domicile. These financial benchmarks can be of value in policy, budgeting and business planning decisions. In the case of RRG's, several of the financial benchmarks are required to be calculated and included in the NAIC Annual Statement ("The Yellow Peril"), which is a required filing.

Basic Financial Performance Benchmarks

The basic financial performance benchmarks that are suggested for captives, along with a brief explanation of each, are:

- **Loss Ratio** – The ratio of incurred losses and loss adjustment expenses to net premiums earned, measuring the loss experience on the captive's total book of business.

- **Expense Ratio** – Reveals the captive's operational efficiency. It is the ratio of underwriting expenses, including agent commissions, to net premiums written.

- **Combined Ratio** – Measures the sum of the loss, expense and dividend ratios. It does not reflect investment income or income taxes. The combined ratio reflects the overall underwriting profitability of the captive. A ratio of less than 100 indicates underwriting profitability.

- **Investment Income Ratio** – The ratio of the net investment income to the net premiums earned.
Operating Ratio - An important calculation measuring the operational profitability from the captive’s underwriting and investment activities. The operating ratio is the combined ratio less the investment income ratio. The goal is to have an operating ratio of less than 100. The ratio does not include member policyholder dividends, etc.

Net Written Premium/Equity or Surplus Ratio - A ratio of the net written premium to the total amount of stockholder or member equity/surplus.

Percentage of Invested Assets in Various Investment Classes - The measurement of the percentage of investments in bonds, stocks and short term investments.

Return on Net Investment Income with realized capital gains - The ratio of net investment income and realized capital gains to investments.

Total Return on Captive Equity or Surplus - Net captive income to captive equity or surplus.

Net Risk Retained by Captive - In some states this is established by statute or regulation. A common statutory benchmark for property/casualty captives is 10% of equity or surplus. Captives are encouraged to have their actuaries advise them of the appropriate retention level for the captive.

Selected Best’s 2010 Benchmark Data*

The August, 2011 Best’s Captive Market Review includes summary data for 2006-2010. In addition it contains 5 year and 10 year averages for commercial insurance companies compared to captives. This is great benchmarking information.

Here are the 2010 and 5 year captive averages for the selected ratios noted above. You are strongly encouraged to purchase the complete A.M. Best report and Data for $200 from the A.M. Best website at http://www3.ambest.com/bestweek/purchase.asp?record_code=190480&AltSrc=26. The report alone without the data may be purchased for $75. A complimentary report excerpt is available for immediate downloads,

Loss Ratio

- 2010: 65.2
- 5yr: 67.4
- Your Captive? __

Expense Ratio

- 2010: 22.1
- 5yr: 21.6
- Your Captive? __

Combined Ratio (after policyholder dividends)

- 2010: 92.5
- 5yr: 93.5
- Your Captive? __

Investment Income Ratio

- 2010: 5.7
- 5yr: 4.3
- Your Captive? __
Operating Ratio

<table>
<thead>
<tr>
<th>Year</th>
<th>2010</th>
<th>5yr</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>74.2</td>
<td>75.3</td>
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</table>

Your Captive ? _____

Net Written Premium/Equity or Surplus Ratio

<table>
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<th>Year</th>
<th>2010</th>
<th>5yr</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>.3</td>
<td>.7</td>
</tr>
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</table>

Your Captive ? _____

Percentage of Invested Assets in Various Investment Classes

<table>
<thead>
<tr>
<th>Year</th>
<th>Long Term Bonds</th>
<th>Total Stocks</th>
<th>Short Term Investment &amp; Cash</th>
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</thead>
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<tr>
<td></td>
<td>61.7</td>
<td>10.1</td>
<td>6.9</td>
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</table>

Your Captive?

Return on Net Investment Income with realized capital gains

<table>
<thead>
<tr>
<th>Year</th>
<th>2010</th>
<th>5yr</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>5.0</td>
<td>4.5</td>
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</tbody>
</table>

Your Captive ? _____

Total Return on Captive Equity or Surplus

<table>
<thead>
<tr>
<th>Year</th>
<th>2010</th>
<th>5yr</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>13.2</td>
<td>10.2</td>
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</table>

Your Captive? _____

Does your captive data comparison suggest any actions that need to be considered by your captive’s management team and board of directors?

Other Sources of Financial Benchmark Information

Searching the internet you may also find other sources of benchmarking information. Marsh, for example, has a “Trends and Performance 2011 Captive Benchmarking” publication.

KPMG has also published a “2010 Captive Benchmark Study”

Of course, if none of these financial benchmark sources meet your needs, you can contact the management of several captives that you feel are comparable to your own, and request their annual report and other financial benchmark and program data that you feel will be of value.

Happy benchmarking!!!

* The financial benchmarks in this article are used with the permission of A.M. Best Company.