

Pools & Trusts – 2006 Market Review

November 5, 2007

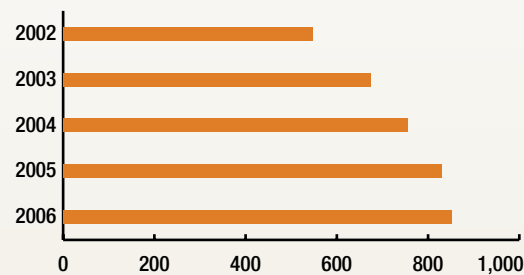
Sector

Property/Casualty

Outlook

Stable

**Self-Insurance Pools –
Net Premiums Written (2002-2006)**
(\$ Millions)



Source: A.M. Best Co.

Related Reports

2007 Special Report:
U.S. Captive Insurers

Methodology:

Captive Insurance Companies

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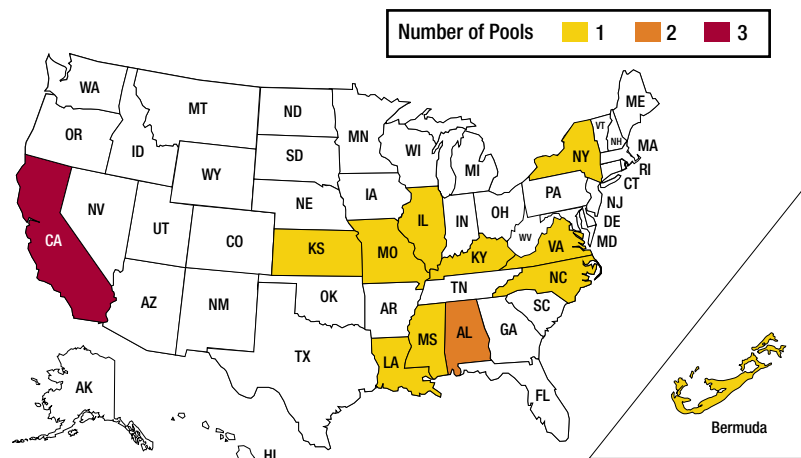
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**Pools & Trusts Show Modest Gains
Amid Industrywide Soft Market**

Operating performance improved moderately in 2006 for self-insurance pools and trusts rated by A.M. Best Co., with preliminary 2007 results indicating more of the same. A softening market, however, may spur increasing competition from commercial carriers and drive self-insurance pools and associations to reduce rates.

- The pools and trusts in this study saw a 4.1-point decrease in the 2006 combined ratio after policyholder dividends.
- Net premiums written continued to increase in 2006 despite softening market conditions across the insurance industry in general.
- Net income grew significantly over the prior year and reflects the increase in premiums coupled with moderate decreases in losses and the associated expenses.
- Investment yields improved significantly on an increasing base of invested assets and favorable interest rates as yields on treasury instruments grew.
- A changing investment market warrants monitoring, but self-insurance pools are somewhat insulated by the conservative nature of their investment portfolios.
- Preliminary 2007 results show growing exposure for the funds domiciled in the Southeastern United States as the local economies in Alabama and Louisiana continue to flourish.
- The five-year average combined ratio for rated pools after policyholder dividends was 90.3, compared with 106.2 and 102.1 for captives and the commercial casualty index, respectively.

**A.M. Best Rated Self-Insurance Pools –
Domicile Distribution (2006)**



Source: A.M. Best Co.



Holding Their Own

Self-insurance pools and trusts rated by A.M. Best Co. showed a moderate improvement in operating performance, based on data for 2006 compared with 2005. Operating results for 2006 were characterized by a gradual decrease in the loss and loss-adjustment expense ratio coupled with a decline in the expense ratio, which resulted in a 4.1-point decrease in the combined ratio after policyholder dividends. Net premiums written continued to increase in 2006 despite the softening market conditions, which the insurance industry in general is experiencing.

The tables in this report provide the key measures of a consolidated quantitative analysis report on all rated self-insurance pools for which data have been reported to A.M. Best. Preliminary 2007 results indicate continuing good operating performance for self-insurance pools. However, operating performance

may be challenged as competition increases from commercial carriers because of softening market conditions. This may require self-insurance pools and associations to reduce rates or offer other incentives to retain members.

However, self-insurance pools and associations have the advantage of members'

Self-Insurance Pools & Commercial Casualty Index – Quantitative Comparison (2002-2006)

Year	Self-Insurance Pools					Underwriting Expense Ratio	Combined Ratio (A/PHDS)
	Investment Yield	Total ROR	Total ROE	Loss & LAE Ratio	Loss & LAE Ratio		
2002	4.3%	14.4%	29.8%	59.1%	21.1%	89.2%	
2003	3.8%	10.1%	12.0%	60.3%	20.7%	85.2%	
2004	3.7%	8.8%	10.3%	68.4%	22.1%	96.8%	
2005	3.7%	8.9%	10.3%	61.1%	25.8%	92.2%	
2006	4.4%	12.4%	13.6%	57.7%	23.7%	88.1%	
5-Year Average	4.0%	10.9%	15.2%	61.3%	22.7%	90.3%	

Year	Commercial Casualty Index					Underwriting Expense Ratio	Combined Ratio (A/PHDS)
	Investment Yield	Total ROR	Total ROE	Loss & LAE Ratio	Loss & LAE Ratio		
2002	5.1%	-3.2%	-4.2%	81.6%	26.1%	108.5%	
2003	4.9%	9.7%	12.8%	77.8%	26.0%	104.2%	
2004	4.4%	10.4%	13.0%	76.0%	25.7%	102.1%	
2005	4.8%	7.9%	8.9%	76.6%	26.4%	103.3%	
2006	4.6%	18.8%	19.2%	65.7%	26.9%	93.1%	
5-Year Average	4.7%	9.1%	10.8%	75.3%	26.3%	102.1%	

Year	Favorable/Unfavorable Variance					Underwriting Expense Ratio	Combined Ratio (A/PHDS)
	Investment Yield	Total ROR	Total ROE	Loss & LAE Ratio	Loss & LAE Ratio		
2002	-0.8%	17.6%	34.0%	22.5%	5.0%	19.3%	
2003	-1.1%	0.4%	-0.8%	17.5%	5.3%	19.0%	
2004	-0.7%	-1.6%	-2.7%	7.6%	3.6%	5.3%	
2005	-1.1%	1.0%	1.4%	15.5%	0.6%	11.1%	
2006	-0.2%	-6.4%	-5.6%	8.0%	3.2%	5.0%	
5-Year Average	-0.7%	1.8%	4.4%	14.0%	3.6%	11.8%	

Source: A.M. Best Co

A.M. Best Company Special Report

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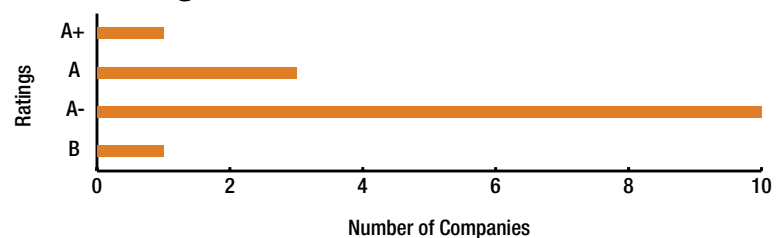
loyalty even during soft market cycles. An additional factor that warrants monitoring is the impact of the changing investment market and exposure to the overall effects of subprime investment risks. Self-insurance pools are insulated, to a degree, from dramatic shifts in the investment market by the conservative nature of the companies' investment portfolios.

Another factor observed in preliminary 2007 results is the growth in exposure experienced by the funds domiciled in the Southeastern United States. This growth is the result of the continuing boom in the local economies of Alabama and Louisiana. Accordingly, net income has risen significantly over the prior year and reflects the increase in premiums coupled with moderate decreases in losses and the associated expenses. As the overall U.S. economy appeared to be in a period of slowing growth and rising inflation in 2006 and after posting three years of minimal movement, investment yields have improved significantly. The improving yields can be attributed to an increasing base of invested assets and favorable interest rates as yields on treasury instruments grew. Pools and trusts generally produce lower net investment yields, compared with the commercial casualty industry, because of a more conservative investment portfolio policy, which typically is dominated by highly rated, fixed-income securities. Over the past five years, the aggregated net investment yield for self-insurance pools has averaged 70 basis points less than the commercial casualty index.

The combination of at-risk member capital, as well as joint and several liability, is strong incentive to maintain underwriting discipline, control losses, minimize frictional expenses, and detect and control fraud. This is borne out in the results, with the five-year average loss and LAE ratio for rated self-insurance pools at 61.3 versus 83.6 for captives and 75.3 for A.M. Best's commercial casualty insurance industry index. The five-year average underwriting expense ratio of self-insurance pools, which is 22.7, is somewhat above the comparative 19.0 for captives but compares favorably with the 26.3 underwriting expense ratio of the commercial casualty index. Overall, the five-year average combined ratio after policyholder dividends of 90.3 for self-insurance pools compares favorably with

the 106.2 and 102.1 of captives and the commercial casualty index, respectively. However, the tendency to issue sizable policyholder dividends substantially affects the captive ratio, while pools and trusts more frequently offer upfront premium discounts to members following favorable experience. Nonetheless, these impressive results are reflected in the ratings of the 15 self-insurance pools currently monitored by A.M. Best. The average rating is A-, which reflects the degree of excellence these entities exhibit. Dominant characteristics of the rated self-insurance pools are

A.M. Best's Self-Insurance Pools – Total Rating Distribution



Ratings as of Dec. 31, 2006
Source: A.M. Best Co.

Value of Best's 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:

- Alleviation of 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 buyer can gain more comfort with the financial stability of a pool that carries a secure A.M. Best rating than with one that does not.
- Many entities are able to expand their membership by marketing their A.M. Best ratings. Indicating a pool's financial strength with an independent third party's opinion puts it on a more even playing field with commercial insurance carriers.
- Having a relationship with A.M. Best and being rated allows pooled entities to benchmark themselves against others of similar size and product lines.
- By working with A.M. Best and subscribing to A.M. Best publications, pools are apprised of key developments in the insurance market.
- Many reinsurers or excess carriers have financial security guidelines that require a minimum creditworthiness of their cedant clients. A.M. Best's ratings of alternative risk transfer vehicles facilitate those carriers' security reviews and recommendations on the creditworthiness of pooled entities.
- Third-party ratings facilitate efforts to secure bank financing.

management expertise, excellent operating results, strong capital position and a defined market presence.

Relatively few self-insurance pools have chosen to be rated by A.M. Best. However, 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 would benefit from a sales and marketing perspective because an A.M. Best rating validates the financial strength and credibility of these entities.

Market Conditions

Size

Aggregated, the 15 entities wrote \$851 million of net premiums for the year ended Dec. 31, 2006. Surplus for the same population increased to \$813 million, and total assets increased to \$2.5 billion. The smallest entity analyzed had surplus of \$10 million at year-end 2006, and the largest had surplus of \$155 million. Membership ranged from as few as 20 members to as many as 7,700. Net premiums

Self-Insurance Pools – Summary Financial Data (2002-2006)

(\$ Thousands)

Year	Financial Indicators									
	Net Premiums Written	% Change	Net Income/Loss	% Change	Admitted Assets	% Change	Loss & LAE Reserve	% Change	Year-End Surplus	% Change
2002	\$545,827	23.9%	\$78,545	88.7%	\$1,543,506	12.5%	\$807,299	8.8%	\$526,367	14.4%
2003	674,264	23.5%	68,111	-13.3%	1,773,389	14.9%	929,238	15.1%	612,647	16.4%
2004	755,475	12.0%	66,513	-2.3%	1,834,810	3.5%	1,057,718	13.8%	673,537	9.9%
2005	829,047	9.7%	73,461	10.4%	2,325,207	26.7%	1,182,568	11.8%	747,096	10.9%
2006	850,975	2.6%	105,927	44.2%	2,481,947	6.7%	1,254,683	6.1%	812,801	8.8%
5-Year Change %	12.6%		19.6%		12.5%		10.9%		11.7%	
5-Year Change \$	\$410,455		\$64,304		\$1,109,411		\$512,866		\$352,740	

Profitability Analysis

Year	Investment Yield	Total ROR	Total ROE	Loss & LAE Ratio	Underwriting		Combined Ratio (A/PHDS)
					Expense Ratio	Ratio	
2002	4.3%	14.4%	29.8%	59.1%	21.1%	89.2%	
2003	3.8%	10.1%	12.0%	60.3%	20.7%	85.2%	
2004	3.7%	8.8%	10.3%	68.4%	22.1%	96.8%	
2005	3.7%	8.9%	10.3%	61.1%	25.8%	92.2%	
2006	4.4%	12.4%	13.6%	57.7%	23.7%	88.1%	
5-Year Average	4.0%	10.9%	15.2%	61.3%	22.7%	90.3%	

Underwriting Leverage Ratios

Net Premiums Written	Net Underwriting Leverage	
	Liabilities	Ratio
1.0	1.4	2.4
1.0	1.4	2.4
1.1	1.5	2.7
1.1	1.5	2.5
1.0	1.4	2.4

Source: A.M. Best Co.

Commercial Conversion

At some point, a self-insurance pool or trust's membership may determine it is in their better interests to convert to a commercial insurer. Some of the business and financial reasons cited in one such recent conversion are listed below. It should be noted that while some risks of the pool form of a risk transfer vehicle are eliminated, additional risks are introduced.

Reasons:

1. Eliminate joint and several liability among members prospectively.
2. Obtain protection from the state insurance guarantee association.

3. Possess the ability to expand beyond the state of current operation.
4. Minimize the exposure to regulatory and legislative uncertainty.
5. Possess the ability to raise capital from other sources besides members' contribution, including the potential of an initial public offering at some point in the future, providing an exit opportunity for members' investment capital.
6. Possess the ability to attract larger insureds that seek multistate and multiline coverages

written for 2006 ranged from a low of \$3 million to a high of \$150 million. Overall growth in premium slowed modestly for 2006 compared with recent history.

Growth

Aggregated net written premiums grew 13% for the rolling five-year period ended Dec. 31, 2006 compared with the same period ended Dec. 31, 2005. Surplus for the same comparison period grew 12%.

The growth in membership of self-insurance pools is the result of two main factors. First, since members of a pool or association have similar risk profiles and therefore insurance needs similar to those of the other members, the pool or sponsoring association generally has a focused product compared with other options 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 occur in the commercial insurance marketplace. One of the objectives of self-insurance pools is to stabilize net premium costs to member insureds over the long term. This is accomplished by a combination of loss control and mitigating claim costs to reduce insurance expenses in a targeted manner, supplemented by the return of substantial amounts of premium to members via distributions or reduced rates.

About Pools & Trusts

Rated self-insurance pools and trusts are alternative risk transfer vehicles organized primarily to meet the need of members to mitigate the costs of risk. 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 rated self-insurance pools bear out the effectiveness of the stringent entrance requirements for members; focused loss-mitigation activities; and ownership interest in both the loss exposure and operational expenses of the entity. Rated self-insurance pools and trusts have, in general, outperformed domestic captive insurance companies and the commercial casualty insurance index.

Rated self-insurance pools and trusts have met the stringent requirements necessary to obtain an A.M. Best rating. For the 2006 review, one entity was removed from the analysis as a result of the self-insurance pool converting to a stock insurance company. The results for the 15 entities included in this study are based on the latest five years of their reported financial data and operating information.

One of the trade-offs for being in a pool or trust is the typical requirement for joint and several liability provisions in the membership contract. This may subject a member to significant assessments to meet the obligations of the pool or trust, which may be well beyond its initial investment. A pool or trust that subsequently goes through a mutualization process can eliminate this requirement, thereby enhancing marketability of the program but subjecting it to state guaranty fund assessments.

Profile

Pools and trusts differ from traditional commercial carriers and have characteristics that are materially different from other alter-

General Requirements for a Self-Insurance Pool

- State-determined premium start-up is required (ranging from \$0 to \$1 million).
- Self-insurance group must be administered under the direction of an elected board of trustees.
- Application to the state must include a copy of bylaws and trust agreement of the proposed group.
- 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 is required, including:
 - Acceptance or execution of the trust agreement.
 - Current financial statements.
 - Experience modifications worksheet.
 - Premium worksheet.
 - Three years of loss experience.

native 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 banding together to share risk. Rather than purchasing insurance through a traditional insurance program or forming a captive carrier, these organizations 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 or reciprocal 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, large commercial contractors in a state that need to insure their workers’ compensation exposure may, through a sponsoring contractor’s association, pool their risks for the mutual benefit of each member insured.

Another distinguishing characteristic of self-insurance pools is that each member insured shares with all the other members the losses and profits of the pool. Typically, the participation is defined more formally if the pool operates under joint and several liability. Indeed, some states will allow the formation of a self-insurance pool only if the members contractually agree to joint and several liability among all members. These states tend to exclude business written through a self-insurance pool from the state’s guaranty fund, which is the vehicle of last resort for claimants. Instead, the state has the ability to assess members to pay losses in the event of the pool’s insolvency.

In no small part because of the joint and several tie, as well as each member insured’s capital being exposed to potential losses gen-

erated by other members, admission criteria for these entities tend to be very strict. In addition, pool members commonly commit to a significant investment in 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 a typical commercial insurance program, but they provide substantial benefits to the members individually and to the pool as a whole.

A.M. Best consistently has observed distinct differences between managements’ goals and objectives for publicly held commercial insurers and self-insurance pools. Commercial insurers emphasize return on equity, cash flow and other objectives that drive retained earnings and share price. Pools, on the other hand, emphasize mitigating member insureds’ risks through value-added services coupled with substantial dividends and return of capital when deemed prudent.

Summary

The growth of membership in self-insurance pools over the past five years is evidence of the desire to gain control over the product, particularly policy terms, and to stabilize premium costs. It can be circumstantially observed that premium rate increases slowed considerably during 2006, primarily as a result of the favorable operating performance demonstrated by the self-insurance pools. This trend likely will continue into 2007 as indicated by preliminary results. Although the pools may be affected to some extent over the next few years as the commercial insurance market softens, the management teams operating most pools are confident that their members, for the most part, 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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