Despite Mixed Reported Results, RRGs Remain Financially Stable

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A review of the reported financial results of risk retention groups (RRGs) reveals insurers that continue to collectively provide specialized coverage to their insureds while remaining financially stable. Based on 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.

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. 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

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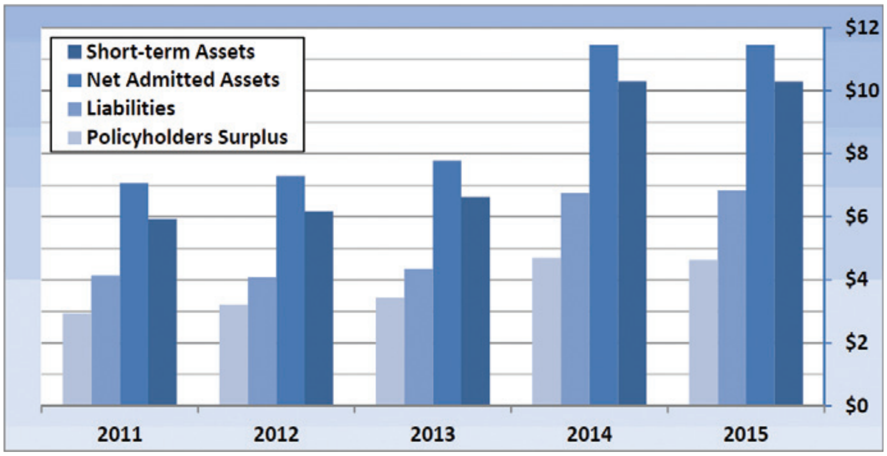
Since year-end 2011, cash and invested assets increased 70.2% and total admitted assets increased 58.4%. More importantly, over a five year period from year-end 2011 through year-end 2015, RRGs collectively increased policyholders' surplus 55%. This increase represents the addition of over $1.6 billion to policyholders' surplus. During this same time period, liabilities have increased 60.8%. 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 year-end 2015 was 65.8%. A value less than 100% 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 65.5% at year-end 2014. This ratio had improved steadily in each of the previous 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 year-end 2015 was 212.9% and indicates a decrease over year-end 2014, as this ratio was 220.8%. 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%. Leverage for all RRGs combined, as measured by total liabilities to policyholders' surplus, for year-end 2015 was 146.4% and indicates an increase compared to year-end 2014, as this ratio was 144.1%.

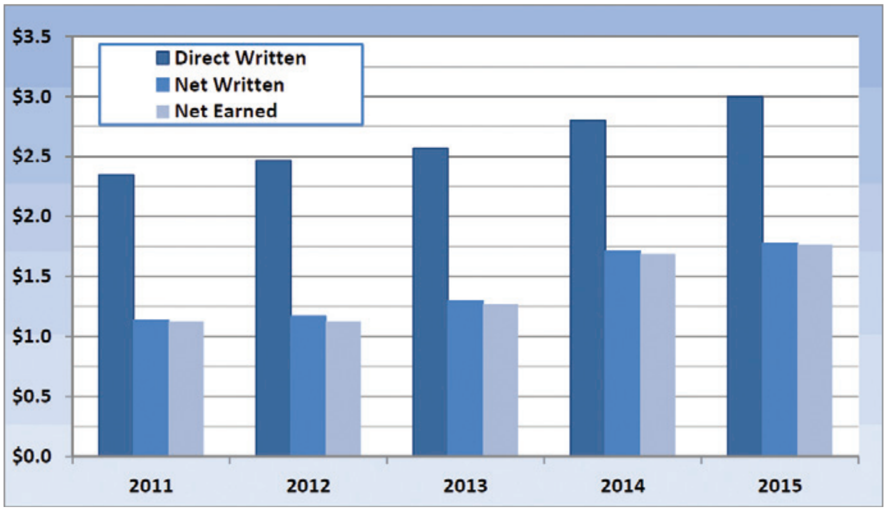
The loss and LAE reserves to policyholders' surplus ratio for year-end 2015 was 104.5% and indicates an increase compared to year-end 2014, as this ratio was 99.6%. The higher the ratio of loss reserves to surplus, the more an insurer's stability is dependent on having and maintaining reserve adequacy.

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 reported direct premium written in eleven lines of business through year-end 2015.

RRGs collectively reported nearly $2.9 billion of direct premium written (DPW) through year-end 2015, an



increase of 3.3% over 2014. RRGs reported nearly $1.7 billion of net premium written (NPW) through year-end 2015, a decrease of 0.8% over 2014.

The DPW to policyholders' surplus ratio for RRGs collectively through year-end 2015 was 63.8%, up from 59.8% in 2014. The NPW to policyholders' surplus ratio for RRGs through year-end 2015 was 37.4% and indicates an increase over 2014, as this ratio was 36.5%.

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% would subject an individual RRG to greater scrutiny during the financial review process. Likewise, a NPW to surplus ratio greater than 300% 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.

Loss and Loss Adjustment Expense Reserve Analysis

A key indicator of management's commitment to financial stability, solvency and capital adequacy is their desire and ability to record adequate loss and loss adjustment expense reserves (loss reserves) on a consistent basis. Adequate loss reserves meet a higher standard than reasonable loss reserves. Demotech views adverse loss reserve development as an impediment to the acceptance of the reported value of current and future, surplus and that any amount of adverse loss reserve development on a consistent basis is unacceptable. Consistent adverse loss development may be indicative of management's inability or unwillingness to properly estimate ultimate incurred losses.

RRGs collectively reported adequate loss reserves at year-end 2015 as exhibited by the one-year and two-year loss development results. The loss reserve development to policyholders' surplus ratio measures reserve deficiency or redundancy in relation to policyholder surplus and the degree to which surplus was either overstated, exhibited by a percentage greater than zero, or understated, exhibited by a percentage less than zero.

The one-year loss reserve development to prior year's policyholders' surplus for 2015 was -4.9% and was more favorable than 2014, when this ratio was reported at 24.4%. The two-year loss reserve development to second prior year-end policyholders' surplus for 2015 was 18.9% and was less favorable than 2014, when this ratio was reported at 14.7%.

In regards to RRGs collectively, the one-year loss reserve development to prior year's policyholders' surplus ratio would be viewed as favorable while the two-year loss reserve development to second prior year's policyholders' surplus ratio would be viewed as unfavorable.

Income Statement Analysis

In regards underwriting gains and losses, RRGs collectively were not profitable in 2015. RRGs reported an aggregate underwriting loss for 2015 of $58.7 million, a decrease over 2014 and a net investment gain of $330.1 million, an increase over 2014. RRGs collectively reported net income of $243.6 million, a slight decrease of 0.2% over 2014. Looking further back, RRGs had collectively reported an annual underwriting gain since 2004. While that run had come to an end, RRGs have collectively reported a net income at each year-end since 1996.

The loss ratio for RRGs collectively, as measured by losses and loss adjustment expenses incurred to net premiums earned, through year-end 2015 was 79.6%, a decrease over 2014, as the loss ratio was 131.5%. This ratio is a measure of an insurer's underlying profitability on its book of business.

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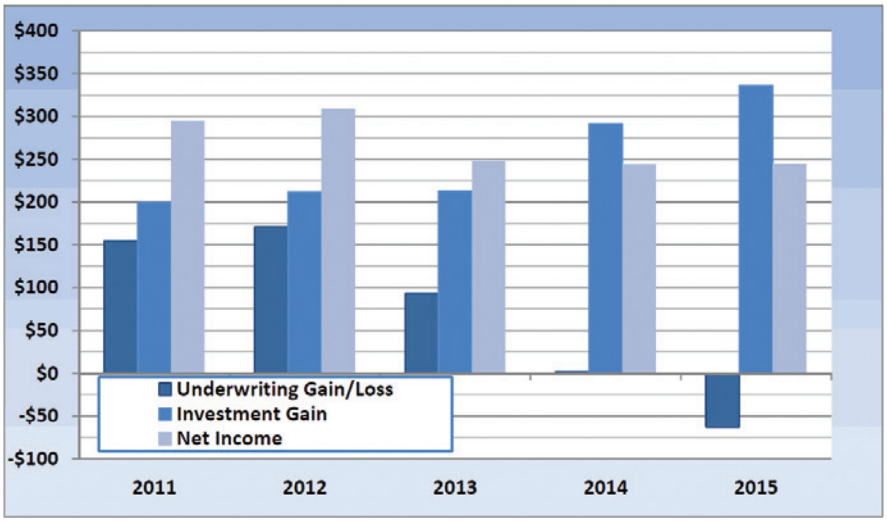
The expense ratio, as measured by other underwriting expenses incurred to net premiums written, through year-end 2015 was 23.1% and indicates a decrease compared to 2014, as the expense ratio was reported at 23.5%. This ratio measurers an insurer's operational efficiency in underwriting its book of business.

The combined ratio, loss ratio plus expense ratio, through year-end 2015 was 102.8% and indicates a decrease compared to 2014, as the combined ratio was reported at 154.9%. This ratio measures an insurer's overall underwriting profitability. A combined ratio of less than 100% indicates an underwriting profit.

Regarding RRGs collectively, the ratios pertaining to income statement analysis appear to be appropriate. Moreover, these ratios have remained within a profitable range.



Conclusions Based on 2015 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 reported 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. ■

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