

Your Results May Vary – An Updated Look at RRG Financial Exam Costs

Gregory W. Fears Jr., **ACAS, MAAA, ARM**, Erich A. Brandt, **FCAS, MAAA** & Robert J. Walling III, **FCAS, MAAA, CERA**

When captive managers present domicile options to prospective captive owners, they often go into great detail highlighting the differences in resident agents, capitalization, taxes and fees, board meeting requirements and other differentiators. The costs associated with financial examinations are a detail that is often neglected. One reason for the frequent exclusion of financial exam costs in domicile comparisons is that there is regularly not a fixed cost or budget for financial exams. So, do financial costs really differ significantly by captive domicile? The answer requires a deeper dive into captive financial statements.

Risk retention groups (RRGs) have different financial reporting requirements than most captive insurance companies. In particular, they are required to file financial statements in the format mandated by the National Association of Insurance Commissioners (NAIC). The NAIC format is much more detailed than the financials commonly required for captives. One element of this is a much more detailed expense breakdown, including data that nearly isolates financial examination costs. Data for insurance companies filing NAIC annual statements is available from the NAIC and the A.M. Best Company. This is not commonly true of captive financial statements. Reviewing financial examination costs for risk retention groups, while not giving a comprehensive picture of financial examination costs for captives by domicile, may be enlightening.

Pinnacle gathered data from the "Total Insurance Department Licenses and Fees" category from Part 3 of the Underwriting and Investment Exhibit by RRG along with domiciliary state to gather financial examination costs. This expense category includes financial examinations as well as some other less costly items such as agents' licenses, certificates of authority, compliance deposits, and filing fees which tend to stay relatively constant each year. Pinnacle analyzed five years of financial statement data - 2011 through 2015. We did this to isolate the financial examination costs, which only impacts one or two years, from the smaller ongoing annual fees. There were some RRGs which had not had an exam during these years that were removed to normalize the data. We also captured current year written premium, net held loss and loss adjustment expense reserves and surplus to normalize the results to recognize that there are some very large RRGs with understandably larger financial examination costs. There were 154 RRGs remaining in the final data. Domiciles with a single RRG were excluded from the by-domicile analysis to prevent sharing company specific data.

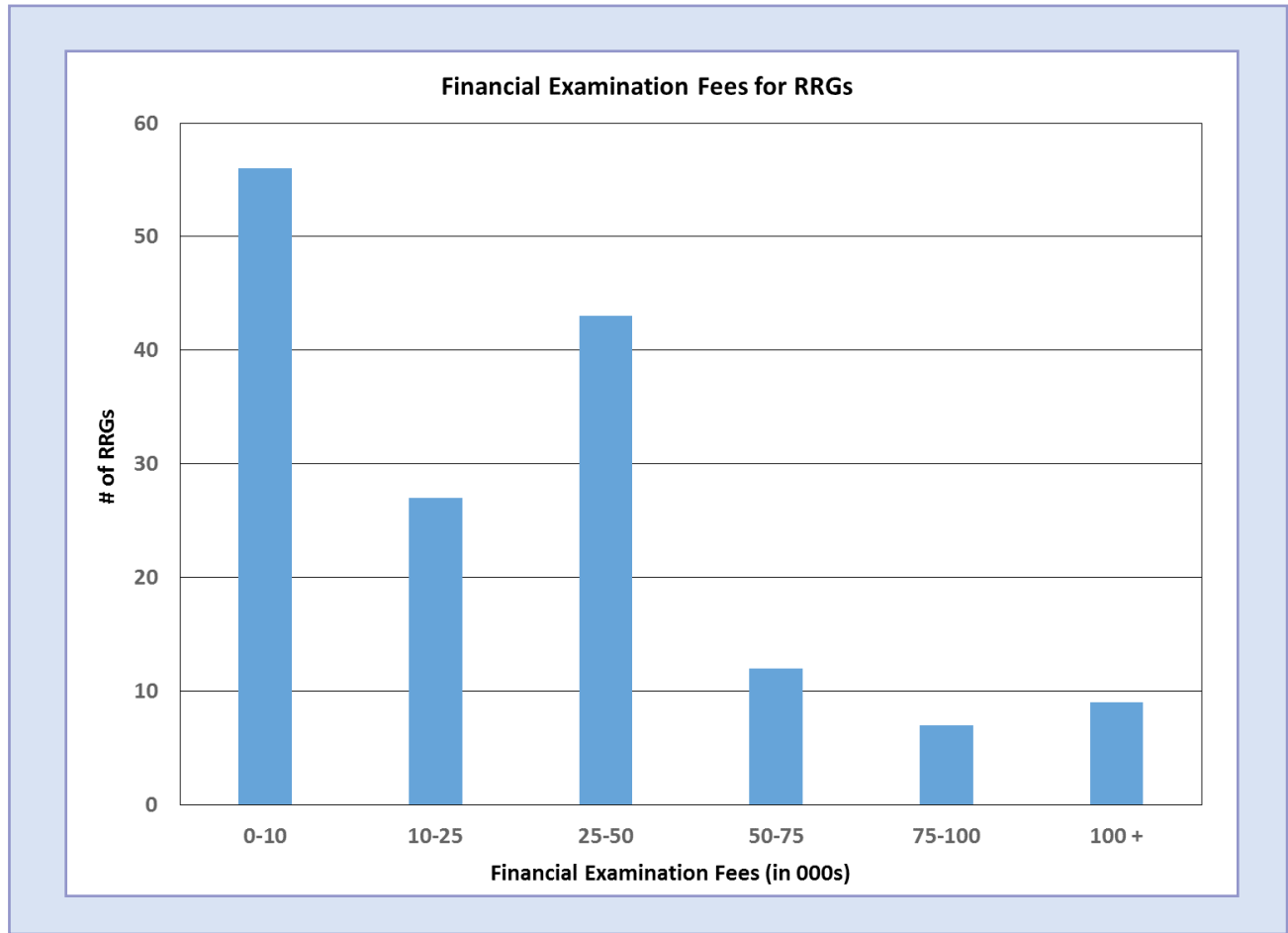


KEY POINT

One of the important ways a captive insurance company or RRG passes savings on to its owners is by controlling expenses. This opportunity can turn into a material risk in domiciles where financial examination fees do not have a clear link to the size and complexity of the captive or RRG.

The average estimated fees associated with the financial examinations of the RRGs included in our analysis were about \$33,800, compared to \$35,700 in a similar Pinnacle study performed in 2015. The largest financial

Exhibit 1



examination fee cost identified was nearly \$305,000, down from \$325,000 in 2015. On average, financial exam costs represented approximately 0.14% of surplus (down from 0.16% in 2015) and 0.13% of held loss and loss adjustment expense (LAE) reserves (also down from 0.16%). There was a significant dispersion in the financial exam costs by RRG. More than a third (36.4%) of the RRGs had financial exam costs of less than \$10,000 and another 17.5% are between \$10,000 and \$25,000. Another 27.9% had financial exams costing between \$25,000 and \$50,000. Twenty eight of the selected RRGs had financial exams costing more than \$50,000, up from twenty seven in 2015. This information is summarized in **Exhibit 1**.

Pinnacle's updated study provides some interesting insights. Vermont remains the largest RRG domicile, with 65 included in our analysis. The District of Columbia, South Carolina, Nevada and Hawaii round out the top five, all with more than ten RRGs. Vermont is also the domicile with the largest RRGs, with average written premium, loss reserves and surplus per RRG usually more than double those of any other domicile.

There are also substantial differences in average financial examination costs by domicile. Arizona, Tennessee and Delaware have the highest average financial exam costs for RRGs. Arizona has three RRGs with financial exam costs on the order of \$150,000. Delaware had two large RRG financial exams, one on the order of \$150,000 and the other approximately \$180,000. The latter has since re-domesticated to Tennessee, which is skewing the results for that domicile. The District of Columbia, Hawaii, and South Carolina had the lowest average exam costs. Vermont's costs were consistent with the overall average, which is quite remarkable given the much larger average RRG size there. As a result, Vermont's average exam costs as a percentage of surplus and reserves are the lowest of any domicile. **Exhibit 2** illustrates the variability in average exam fees and also as a percentage of both policyholder surplus and held loss and LAE reserves by domicile.

Many, but not all, states use a variety of approaches to strike a balance between providing appropriate cost controls without sacrificing regulatory rigor.

These approaches include:

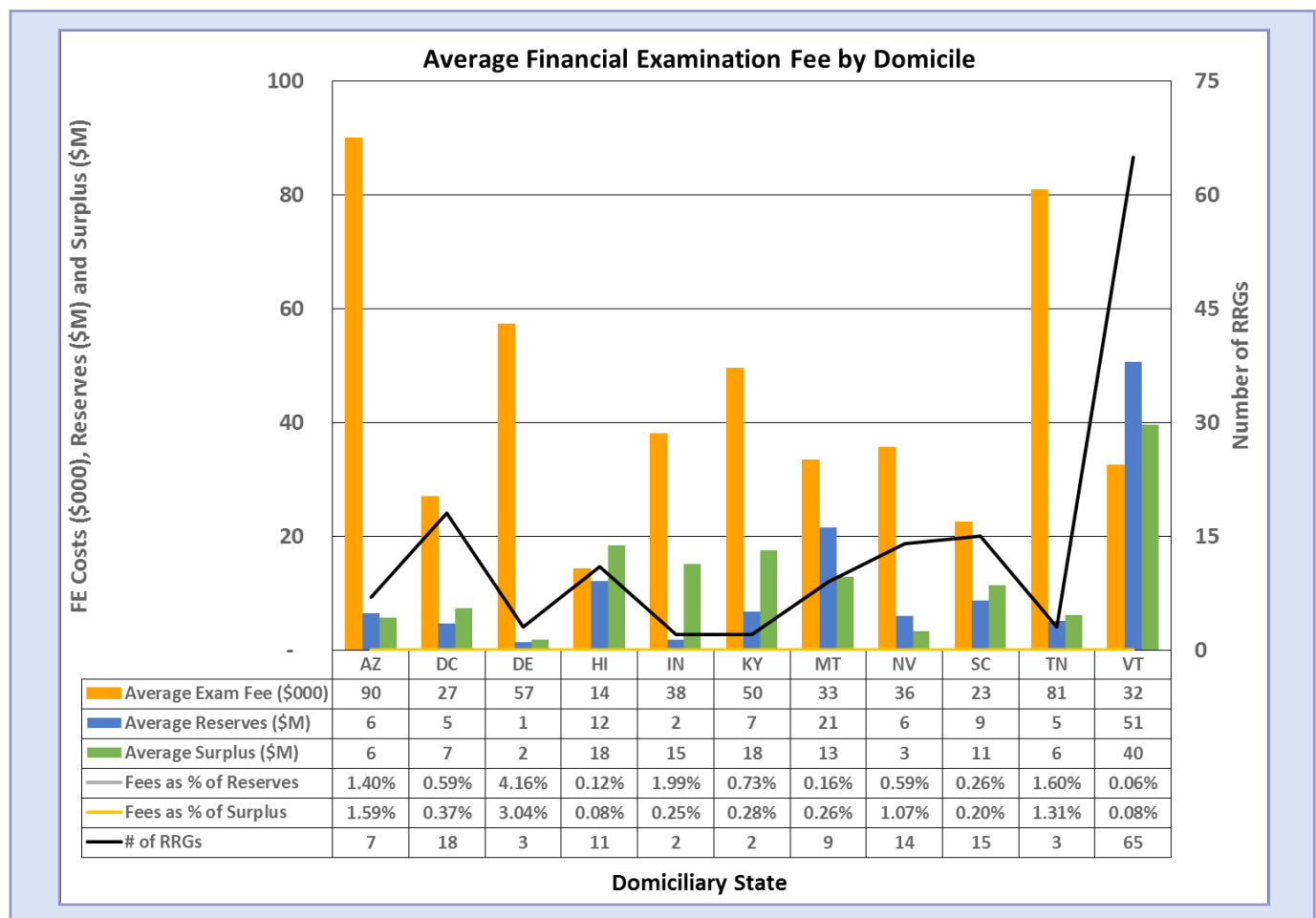
- allowing actuarial peer reviews, rather than full independent actuarial analyses, in some instances,
- competitive bid processes to establish a pool of financial examination service providers, rather than relying on a single provider,
- use of staff examiners versus independent contractors, and
- establishing financial examination fee parameters, budgets and caps prior to the beginning of an examination.

Financial examination fees for RRGs may not be perfectly correlated to costs for captives, as some domiciles use different regulatory processes for captives versus RRGs. In particular, some use the financial examination staff for admitted companies to review RRGs, while others use their captive staff to review RRGs. However, this review of RRG financial examination costs highlights that material differences in financial examination costs by domicile exist and should be considered when choosing one.

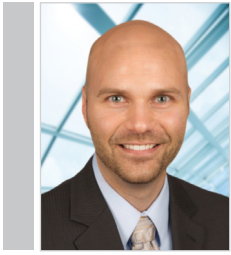
In the captive industry there have long been whispered rumors and anecdotes of instances where specific financial examination costs were unreasonable at face value. The data in this analysis suggests that these rumors may have some factual support. There are six RRGs in our data with financial exam costs of over \$100,000, despite having less than \$15 million of annual premium. Three of those had less than \$1 million in held loss and loss adjustment expense reserves.

One of the important ways a captive insurance company or RRG passes savings on to its owners is by controlling expenses. This opportunity can turn into a material risk in domiciles where financial examination fees do not have a clear link to the size and complexity of the captive or RRG. Competitive bidding processes for service providers, use of state staff and project budgets can also provide confidence to captive managers and owners that financial exam costs will be reasonable and able to be reflected in company budgets. To avoid the risk of unanticipated regulatory costs, captive managers and captive owners should make sure they understand how their selected domicile deals with financial examination fees. Be forewarned: Your results may vary.

Exhibit 2



ABOUT THE AUTHORS



Gregory W. Fears Jr.
ACAS, MAAA, ARM

Greg Fears is a Consulting Actuary with Pinnacle Actuarial Resources, Inc. in the Bloomington, Illinois office, with fifteen years experience in the property/casualty industry.

Mr. Fears has made numerous presentations to brokers regarding loss reserving, future loss projections and how their companies' characteristics impact their actuarial calculations.

He also works with students and faculty at Illinois State University by assisting with the compilation of data for academic research, and discussing the actuarial profession with current and prospective actuarial science majors.

Greg can be contacted directly at gfears@pinnacleactuaries.com or 309-807-2316.



Erich A. Brandt
FCAS, MAAA

Erich Brandt is a Consulting Actuary with Pinnacle Actuarial Resources, Inc. in the Bloomington, Illinois office, with 19 years experience as an actuary.

Erich has considerable experience in assignments involving Loss Reserving, Funding Studies, Cost Allocation Mechanisms, Loss Cost Projections, Competitive Analysis, Captive Feasibility Studies, Personal Lines Ratemaking and Financial Analysis of Insurance Companies.

Mr. Brandt currently serves as a member of the Casualty Actuarial Society (CAS) Examination Committee and is a member of the advisory board for the actuarial science major at Illinois State University.

Erich can be contacted directly at ebrandt@pinnacleactuaries.com or 309-807-2311.



Robert J. Walling III
FCAS, MAAA, CERA

Rob Walling is a Principal and Consulting Actuary with Pinnacle Actuarial Resources, Inc. and has been in the insurance industry since 1989, consulting since 1997.

Rob currently serves as a member of the CAS Board of Directors. He has previously served as the Chairman of the CAS Ratemaking Seminar Committee, Risk and Capital Management Seminar Committee and the New Fellows Committee.

Mr. Walling is a frequent author and speaker on actuarial topics. He has appeared in publications including *Contingencies*, *Inside Medical Liability*, *Captive Review*, *Public Risk*, *Captive Chronicle*, *Actuarial Review* and the *CAS Forum*.

Rob can be contacted directly at rwalling@pinnacleactuaries.com or 309-807-2320.

ABOUT PINNACLE

Pinnacle Actuarial Resources, Inc. is an independent, full-service actuarial firm that focuses on the property/casualty insurance industry. Our home office is located in Bloomington, Ill., with additional offices in Atlanta, Chicago, Des Moines, Indianapolis and San Francisco.

Our *Commitment Beyond Numbers* philosophy encompasses all of who we are and what we do. It drives us to do whatever it takes to help our clients address their risks, understand the challenges they face and find the right solutions to meet their goals.



CONTACT INFO:

Gregory W. Fears Jr., ACAS, MAAA, ARM
(309) 807-2316
gfears@pinnacleactuaries.com

Contact us or visit pinnacleactuaries.com to discover more about how we can demonstrate our commitment to meeting your business needs.