Demotech, Inc.

Advanced via email to LShi@mcgriff.com

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Lei Shi, CRM
Workers' Compensation Program
Colorado Special Districts Property & Liability Pool
P.O. Box 1539
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Concerning: Assignment of Financial Stability Rating® including Calculations of Pool Metrics

Dear Lei,

Colorado Special Districts Property & Liability Pool retained Demotech, Inc. to calculate certain Pool metrics and assignment a Financial Stability Rating® to Colorado Special Districts Property & Liability Pool. This report is based upon the independently audited financial statements prepared by Clifton Larsen Allen, LLP, at December 31, 2021.

The report focuses on several financial metrics established by the board, pool and its administrators. Each financial metric is calculated on a reported, historical basis for the Colorado Special Districts Property and Liability Pool, (the Pool), compared to the Pool's target, and compared to an industry composite as compiled by Demotech, Inc. to reflect the relative size and mix of business of the Pool.

Details and graphs are presented in the report. A summary of our observations is below.

Net Premiums to Surplus

The Pool average over the last ten years is 81%, a conservative ratio given its target of less than 150%. The General industry is at 71%. Despite the relative growth in the Pool's written premium over three of the last four years, the Pool result remains well below the Target.

Gross Premiums to Surplus

The Pool average over the last ten years is 105%, a conservative ratio given its target of less than 150%. The General industry is at 78%. Despite the relative growth in the Pool's written premium over three of the last four years, the Pool result remains well below the Target.

Current Assets to Liabilities

The Pool average over the last ten years is 190%, a conservative ratio given its target of more than 150%. The General industry is 125%. On this important metric, the Pool result remains well above its Target and above the General Industry.

Net Incurred Losses and LAE to Net Premiums

Characterized as the "loss and loss adjustment expense ratio," this metric is a fundamental measure of compatibility of underwriting and pricing. If the selection of insureds is consistent with the pricing of the insured's policy, a reasonable loss and LAE ratio should emerge. The Pool average over the last ten years is 67%, a bit above the Target yet below the General Industry.

Unallocated LAE Incurred to Net Premiums

As these loss adjustment expenses represent the cost of outside claims services, this is effectively a measure of the degree to which claims are investigated, adjusted and settled internally. Lower is preferable to higher. The Pool average over the last ten years is 6%, below the Target of 10%. The General Industry is 19%. On this important metric, the Pool result outperforms its Target and the General Industry.

Other Underwriting Expense (Net of Reinsurance) to Surplus

This metric is NOT an expense ratio. Expense ratios are measured against premium. However, this metric does permit the Pool to benchmark its expenses against similarly sized risk bearing entities. Although the ratio in the more current years has crept up; thereby raising the Pool average to 23%, which is above the General Industry average, we believe that the additional requirements of regulators, including but not limited to reporting procedures, and the growth in premium volume has contributed to the increase. We do not find this variation to be problematic.

Net Combined Ratio

This is a measure of the overall underwriting results of the Pool. It measures expenses as well as loss and LAE to premium. Lower is better. The Target is less than 80%. The General Industry is 97%. The Pool's ten year average is 99%. Our suggestion would be to revise the Target upward rather than be critical of the historical combined ratio.

Net Premiums to Gross Premiums Ratio

The higher the level of premium retained, the more confidence the Pool is likely to have in its portfolio of policies. The Target is greater than 80%. The Pool's Ten Year average is 78%; however, it has been well below 80% for the past few years. The General Industry is 90%. The Pool may want to investigate the trend of this ratio.

Return on Surplus

Recognizing that the Pool's ability to serve its members is enhanced by a favorable return on surplus, the Pool has targeted a 20% return. The Ten Year average has been 5%. General Industry is 7%. Although the low interest rate environment of the past several years has been a contributor to missing the Target, we suggest that this metric be revisited so as to establish a more realistic Target return on surplus.

Net Leverage Ratio

Leverage is created by premium, which represents the potential impact on the Pool in the future as well as liabilities; i.e., unearned premium and loss and LAE reserves, which represent current and past impact of the Pool's underwriting decisions. With surplus as the ultimate protection available to members, aggregate leverage has been Targeted at less than 300%. The Pool has average 204%, a safer measure. The General Industry has averaged 224%.

Gross Leverage Ratio

Gross leverage is created by gross premium, which represents the potential future impact on the Pool prior to the utilization of reinsurance plus liabilities; i.e., unearned premium and loss and LAE reserves, i.e., the current and past impact of the Pool's underwriting decisions. With surplus as the ultimate protection available to members, aggregate leverage has been Targeted at less than 360%. The Pool has average 227%, a safer measure. The General Industry has averaged 232%. Given that the Gross Leverage Ratio has crept up in the past two years, keep an eye on this metric.

Surplus to Retention

The Target is more than 2000%. The General Industry is 3000%. The Pool has averaged approximately 2676% over the past ten years, and the more recent years have been declining.

Change in Member Equity

Year-over-year changes in financial position should contribute to the stability of the Pool, not detract from it. In other words, Member Equity should increase, not decrease. The Pool's Ten Year average has been 3%. The Target is a rate of increase of more than 5%. General Industry is 7%. The recent string of negative changes should be reviewed to determine the proximate causes; i.e., low interest rate environment, increase in expenses, etc.

Loss and LAE Reserves to Surplus

Losses and LAE reserves, whether case reserves or incurred but not reported reserves, are the riskiest balance sheet items. Available surplus is the safety barrier. The lower this ratio, the better. Over the past Ten Years, the Pool has averaged 80%; however, each of the last three years has exceeded 100%. The Target is less than 75%. The General Industry is 78%. If loss and LAE reserves have remained adequate during the period reviewed, the exacerbation of this ratio can be viewed as a consistency of claims procedures and processes.

Net Income to Net Premium

Realized capital gains or losses and investment income is a contributor to the profitability of the Pool. Given the interest rate environment of the past several years, and the conservative investment portfolio of the Pool, the 3% Ten Year average is appreciably more realistic than the Target of greater than 10%. The General Industry return of 9% is consistent with the industry's presence in the equity markets.

Operating Ratio

Recognizing that the operating ratio is dependent upon investment income, given the low interest rate environment of the past several years, increasing loss ratio and LAE ratio and increase in expense, each of the last three years has seen an operating ratio above 100%. Although the Pool's Ten Year average has averaged 95%, quite comparable to the General Industry's 92%; the Target of less than 70% should be revisited.

Net Investment Income Ratio

The Target ratio of more than 10% was likely set well before US long term interest rates were managed so as to remain low. The Pool's Ten Year average of 3% is comparable to the General Industry's 5%. Although interest rates and yields are likely to rise, the Target of 10% may need to be revised.

Other Underwriting Expense Ratio

This is the percentage of premium absorbed by operating costs; i.e., commissions, salaries, benefits, contracted services, rents, etc. Lower is preferable as long as the quality of services are not adversely impacted. Although the Pool's Ten Year average is 32%, the most recent three years have been in excess of 35%. This actual result is above the Target of less than 30%, and also above the General Industry of 27%. A review of the changes over the past years may be in order.

Yield on Invested Assets

Investment income earned from invested assets is an offset to member contributions. If the risk of default is consistent, higher yields are preferable to lower yields. The Pool Target is more than 5% despite the Ten Year Pool average being 1%. General Industry is 2%. This metric has been impacted by the lower interest rate environment.

Liabilities to Current Assets

As this is the inversion of the liquidity ratio, lower is preferable to higher. The Target is less than 70%. The Ten Year Pool average is 54%. The General Industry is 77%. All in all, there does not appear to be any cause for concern.

Conclusion

The Pool has sustained its Financial Stability Rating® of AAA.

We would be pleased to discuss this analysis and report with you or other members of the team.

Very truly yours,

Joseph L. Petrelli

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