Business Better Podcast (Season 2, Episode 29): Is Captive Insurance Right for Your Business? A Deep Dive with AkinovA

Speakers: Steven Burkhart, Dr. Henri Winand, and David O'Gorman

Steven Burkhart:

Welcome to Business Better, a podcast designed to help businesses navigate the new normal. I'm your host, Steve Burkhart. After a long career at Global Consumer Products Company Bic, where I served as vice President of administration, general counsel and secretary, I'm now Of Counsel in the litigation department at Ballard Spahr, a law firm with clients across industries and throughout the country.

In today's episode, I'm joined by two prominent leaders from AkinovA, a company with a single platform providing an animated marketplace, third party and trading data, and fast and efficient clearing, not only to transform the business you do, it also reinvents the whole way you do business. Dr. Henri Winand, CEO and David O'Gorman, Managing Director of client services are joining us.

Today, we're going to discuss captive insurance companies, and I'm sure as you're thinking about insurance, so many adjectives come to mind. Exciting, interesting. This is going to be exciting and interesting. It's not just, when I think of insurance, sometimes I think people think it's boring. This is not going to be boring. My colleagues here are experts in this space and will be talking about what AkinovA can do for your business, whether you are thinking about a captive or actually have one and are looking to make some changes.

Henri, David and I will be at the captive insurance conference on October 25th and 26 in Washington DC to discuss the evolving interest in captive insurance companies. This is the first of what we hope will be many insurance conferences, and if you want more details about the conference, please contact us at Ballard Spahr. Henri and David, thanks for joining me today.

Dr. Henri Winand:

Thank you, Steve. It's great to be here.

David O'Gorman:

Hi Steve. Yeah, great to be here.

Steven Burkhart:

Henri let me start with you. I know we've known each other for a long time, not always in the insurance realm, but what can you tell us about insurance? Why is insurance so important to companies today?

Dr. Henri Winand:

So as you said, insurance is exciting, right? But first and foremost what it's all about, it's really about contingent capital. In the event that something unplanned happens, how do I have the capital to navigate the, let's call it the pothole in the road just in front of you. And the way you should think of it is, what's my cost of capital for perhaps a banking facility? You can use your own capital of course, whether you wrap it up in the captive or you basically use it as a cost of good sold. And then of course you have insurance and reinsurance, which is also a form of contingent capital. You can set up, of course, as the topic to the today a captive.

But you can also do other things. You can swap, you can do hedging like you would, for instance, for currencies. You can have side car arrangements, which are form of insurance. So we can have essentially third party capital to come into their insurance link securities and many other things. So when you think about why insurance is because you need to have a contingent capital

source to help you to navigate these issues that the business you may or may not have, think about the cost of capital as a series of cash flows for your business. Then you'll know whether or not a captive or insurance market or reinsurance for your capable or something else is the right tool for you.

Steven Burkhart:

Well, that's an interesting and I think important way for those who are considering how best to manage risk at their companies to consider the capital investment. So perhaps so many today simply buy insurance. So you're giving folks some ideas on how many other options are out there.

David, as Henri says, it's not always about captives, but it could be when you're thinking about how best to manage your risk. What are some thoughts you have about just what is a captive and what it can do for a company?

David O'Gorman:

Well, effectively Steve, a captive is an insurance company that's wholly owned by a corporate and is formed to provide risk mitigation and services for its parent company. So it's effectively is a type of self insurance, but it's not as basic as putting money aside for a rainy day. It's a company that's formed, owned and controlled by the parent company that it ensures.

Steven Burkhart:

David can companies sometimes choose to have more than one captive?

David O'Gorman:

Not that I'm aware of, Steve. I think typically we look at one captive, one main captive for the corporate in mind.

Steven Burkhart:

So it can have many different coverages inside it that doesn't just necessarily have one coverage. It can have many.

David O'Gorman:

Exactly. The purpose of the captive really is to help the corporate with those coverages that maybe it's finding difficult to place in the traditional insurance markets. Typically this can be for those risks that are large or fairly complex or effectively there are no assurance type vehicles available in the open market.

Steven Burkhart:

Well, that's interesting David, thank you. Because I think this is a good time of year probably to be discussing this as folks are headed into year end renewals and perhaps facing some costs and insurance that maybe weren't there last year or the year before. So Henri, as companies think about, okay, maybe I'd want to establish a captive. Is there a particular issue or a tipping point that maybe is critical to that decision for a company?

Dr. Henri Winand:

Yes. Typically it's if I'm a company and I just cannot find suitable coverage for my business in the open insurance market. So for particular business rates that I have and the limits are going down, the exclusions are going up and the premium is going up at the same time. So typically I will start to think back to the argument of contingent capital and cost to capital. I will start to think about accessing and structuring my capital in a different way through a captive. You of course have benefits of setting up a captive, which has some tax advantages. So of course you can utilize the premium to offset some of the tax in various jurisdictions that you may have depending on the tax regimes that you experience. And in essence, it enables you to tightly control and be able to prize the risks that you are more knowledgeable of because it's your business. And we'll talk about that I guess a little bit later.

But in essence, the captive can then access still the insurance market through reinsuring itself. So that's a way of limiting the risk that you are comfortable to essentially utilize your own capital through your own captive to ensure yourself. So there are many reasons where you do that. Typically it is when there is the so-called harder market when premiums are going up that people think about captives, but captives should never just be thought through just simply to reduce premiums.

So I'm going to give you a very simple example. If I wanted to use a captive just to reduce premium, and let's assume that I were to consult an actuary and they tell me that the premium annum to ensure that risk should be $10 for the sake of arguments, and I'm hoping that by setting a captive, I can essentially pay into the captive $2 a premium. Well, clearly there's not enough capital because the actuary would tell you that when there's an issue, $10 should have been the answer.

And so you'll either have an argument with your regulator, you'll certainly have an argument with the board, and those who are on the board of the captive and it will be just thinly or under capitalized. So you need to think quite carefully as to gain back to the cost of capital, what are the benefits or tank benefits and others, what are the setup costs? But also make sure that it is not simply just about reducing the premium, it's about controlling that plus other factors in your business.

Steven Burkhart:

Well, that's an interesting distinction. So it's not just about some of the savings that you may see right up front as you're doing your self assessment, but you mentioned the word control Henri, and I think that's a very important element to this.

David, I think I see in your background you're got the actuarial experience that re's alluding to. I wonder how beyond the financial considerations re was speaking about and with your actuarial skills, what do you see on the control side? How do people choose what to ensure and what's the control that they might gain in the captive setting?

David O'Gorman:

Yeah, from actuarily speaking, we try to look for those risks or coverages which are predictable to model typically lend themselves very much to actuarial analyses. So we also have to consider where the captives, for example, are ensuring the risks of a corporate, whereby the risks of that corporate may not be well known outside of the corporate industry, in which case it makes more sense for the corporate to push those risks through the captive because they understand the risks better than anybody else does.

So it's typically a combination of those two things. We want those coverages which are easier to model, easier to predict, and also where typically we would not be able to find the coverage in the standard in the traditional insurance market. So it's often used as a result of that, it's often used for standard lines such as auto or motor property damage and third party bodily injury, which lend themselves extremely well to actuarial analyses. But other lines such as general liability, product liability, professional liability, workers compensation for example, and those are typical lines that would go into a captive structure.

So it's worth remembering at this point, Steve, that captives are not intended to be set up to protect against all the risks of the corporate for a number of reasons. But typically they use them to rely on conventional commercial insurers, really just to protect against certain risks. So it's not the case of seeding the whole portfolio of corporate risk, it's more to the point of being a bit more sort of cherry picking as to what should go in and what should go into the traditional insurance market.

Steven Burkhart:

Okay, thank you David. That's good to know because I could see that folks who are considering establishing one might think everything goes into the captive. It's the whole portfolio and perhaps they need to be thinking more selectively as you say.

We've all just come through this extraordinary time of unknown unanticipated risk with the pandemic. And I wonder, Henri, David's just talked about perhaps some of the more conventional type coverages that might make sense for someone to place in their captive. Are there particular coverages that maybe are more unique or difficult that for those reasons might be a good choice for a captive?

Dr. Henri Winand:

Of course there are, and cyber risk, intangible risks are some of the things that corporates will think about. Before I move to that. There are some risk which should not be or are certainly frowned upon being a captive like directors and offices. So if your own captive ensures you're on corporate for directors and officers are very often people think that there is essentially a moral hazard associated with that. And there are some things that the capital from the captive might not be used to for instance, reinvest in some of the corporate activities.

So there are things that you need to think about in terms of corporate governance, but coming to the lines that you might want to put into captive is the new risk. So for instance, let's say everybody talks about cyber risk, let's call them digital risk for the sake of argument. We are all exposed to it now whether you have an enterprise resource planning systems, some interface with the suppliers, partners, logistic systems, billing systems, et cetera, it's all done digitally. So by definition the cyber risk and the attack surface has increased tremendously.

Now of course you should know better your risk that you have because particularly if you're in a larger corporate, you will have a CSO who will think about the corporate risk the whole day long and how to reduce that risk. Now you have a choice. You can of course go to the insurance markets which has seen quite significant premium increase with ransomware and other activities around this. Or you can decide to say that we'll assume some of that risk myself by doing that.

And by structuring through your captive, what you signal to the open insurance market and beyond is that you are grown up in the way that you're managing your risks, and in particular in that distance, the cyber risks. Because of course the captive will also want to know that you are managing passwords, that your systems, the data which are there, the redundancy of your systems in a way that is more proactive than if you were just to go to a standard market and fill in one of these attestations or four or five power pages and you find, say with lots of Q and A, are you doing all these things and then hopefully you have an insurance at the end.

So cyber is a good one, but there are other things that you would want to put in there. So David mentioned earlier the risks that better, cyber being one of those, but here's another one. So let's assume that I am an engine manufacturer, and I make those engines and they go in cars and somehow I also monitor all these engines. And therefore I have really a through life view of the engines and whether or not the warranties or the services associated around the engine or the likelihood of them to cause third party damages. I am therefore far better placed to understand that risk to be able to provision for that risk in a captive than if I were to offer that to the open insurance market who may prize... But then it will be high because of course they don't have that granularity of data or indeed they may not quote at all. And so these are specific risks that you may also wish to put into your captive.

Steven Burkhart:

So it seems like the options for someone considering a captive, a company considering a captive, can actually be quite personal. There's certainly obvious ones that are insurance programs exist today, coverages that perhaps the company knows best. They're perhaps obvious for placement in the captive, but beyond that, perhaps your imagination's the limit in some ways because you know your risk tolerance, you know your exposures better than anyone. So that's an interesting dynamic for those considering captives.

I guess David, as Henri was talking about some of the options that folks might consider now we come back to you, you're the actuarial expert, perhaps someone's presenting, we'd like to consider this list of coverages, there will be premiums to pay, reserves to apply... These sorts of things. How does someone with your expertise help guide a client on what kind of capitalization may be required for a captive?

David O'Gorman:

Well, typically, Steve, when a captive is set up and following the setup of the captive, there will be regular studies done in terms of the feasibility of the captive, in terms of the actuarial analysis that have to be done for the purpose of understanding the premium as you say, the expenses, the risks that are being taken on. It's incredibly important to ensure that there is sufficient capital to meet policy holder obligations as they fall due. And this is not only in terms of the actual size of the policy holder obligations are either claims, but also we have to understand the quantity in terms of the size of the amounts of those claims,

but also the timing of when we have to pay those claims, which will also have an impact on the investment instruments that are used for the capitalization of the captive.

So the amount of capital having been first established through the feasibility study will then be determined typically on an annual basis. And effectively the hurdle that it has to meet is the change in surplus or the difference between the assets and the liabilities over that 12 month period at the 99.5 percentile, which is the one in 200 return period.

So that's the starting position, that's the basic capital base that the captive must have in place. And then what we can look to following these actual analyses is whether a proportion or whether that's large or small of the risk is actually placed within the reinsurance market whereby reassurance is of course a form of contingent capital. And the captive can then manage how much capital it requires using that reinsurance, both on a proportional basis or non-proportional basis. And we would typically look at various combinations of proportional, non-proportional reinsurance using a reinsurance optimization exercise.

Steven Burkhart:

Well, so this is interesting because this, I feel like for our audience, this is where AkinovA is really a resource because you all are in London, there's the land of Lloyd's, I'm here in Connecticut, Hartford, the insurance capital of the world, and as we said, so many people are so excited for the topic of insurance. One of the key exciting elements for me is the investment. So we have a situation now where folks have decided we're going to make, establish a captive and we've decided what we're placing in it in terms of the coverage requirements. David, you've helped us establish what money is appropriate to invest there to cover the needs of the captive, Henri, where can we invest this money?

Dr. Henri Winand:

So it's a matter of timing. So let's assume your captive is completely new and shiny. You've just opened the wrapper and it's not ready to rock and roll. You've got your team, you've got your board, it's an insurance company. So it is going to collect premium. The premium are going to be accumulating, and of course premium minus claim should be, it should show that you're capitalized enough. Of course you need to show that you have end of capital to pay claims as they follow you.

So typically if you have a completely new and well shiny captive, you're starting from a position of you have to show that you have strength of capital liquidity in the captive. Because you haven't really shown to the board or the trustees of the captive and certainly the regulator that you have a track record.

Now as you develop and you show that the captive is generating surplus, then of course you start to be able to reinvest those. Now typically the board of a captive will think about that very carefully and that typically they will have an investment committee with their risk advisor, typically a broker who will review the effectiveness of what type of instruments you can hold. Typically at the start it's cash and bonds who are highly liquid. And over time you can start to think about where to place that capital. So for instance, people may choose to look at investments which would give them more return than a straight cash market or bond market, and/or have have a strategic value for the corporate and the captive in its owners. So it may that you are going to allocate some of the capital to some, let's say a new PE fund, for instance, that you would like to hold.

All of those have of course, considerations on the amount of reserving and capital that you need to keep within the captive. But as you develop the captive and you are more mature, you suddenly have more options as to how you're going to reinvest and deploy the capital.

Steven Burkhart:

So now this is where I think the skills and the insights of AkinovA are helpful because David, as I'm listening to on redescribe the investment options, there's thinking too of, well there's the day to day requirements though of do we have the appropriate reserves, do we have some rainy day fund type monies in case we need to pay a claim that was perhaps not reserved at a high enough amount or we're going to trial or whatever the inflection point is. Can you help the audience understand just what are some of the day to day considerations as it relates to capital to make sure that the captive stays compliant with its capitalization amounts?

David O'Gorman:

Yeah, so as I mentioned earlier, typically when we set up a captive is necessary to go through a series of studies. First of all, the feasibility study followed by actuarial studies, which will of course include the type of analysis that you're talking about with triangulations, for example, large loss analyses, anything where the uncertainty of the claims that are being covered could cause volatility or uncertainty on the balance sheet of the company.

So there will be a number of projections, as you've mentioned, that would need to be used to cover things like capital, their solvency, where the actuaries very much are heavily involved, financial information and projections, which come from the risk oversight committee, which would include typically audit compliance, underwriting risk management, etc., in addition to the actuarial side.

So the visibility study at the very beginning will provide some light in terms of what the type of projections will be needed to determine the claims payouts in the future. As I mentioned earlier, when we talk about the claims payouts, we have to consider not only the quantum, but also the timing from the perspective of matching with the assets of the company. So once we've got those done, we just effectively repeat those as part of the typical general business cycle or the actuarial cycle. They would be repeated typically on a three to six month basis. At the very minimum, you would expect that to sort of exercise to be done on an annual basis, but typically it would be three to six months.

Steven Burkhart:

That's great. Thank you, David, that's helpful because I'm thinking just with my own experience that you're right, that annual meeting where we're doing with meeting with auditors too to make sure everything is compliant or state filings, of course here in the US if you have a domestic captive, everything is quite buttoned up with internal resources, external resources. So that's helpful. Thank you for those insights.

I guess as we come to a conclusion here, gentlemen, and we think about all that we've shared with the audience for sure, we've given them great insights I think on captives. But I think too, it would be helpful if Henri maybe you could share too, captives are a key element in anyone's enterprise risk management considerations. And at AkinovA, you guys certainly have shared expertise there, but there's more that you have to share as well for other elements of enterprise risk management. Can you just give the audience please some other considerations from your expertise, what they might consider as they look to further develop their enterprise risk management plans?

Dr. Henri Winand:

So sure, I think look, again, it's coming back to that corporate focus, the cost of capital and which route is the most effective to utilize for my business, as well as I said earlier, showing that you have a captive and that you operate it properly shows that you as a corporate have a good handle on risk management because there are certain regulation filings in authors.

What you should think about as well is how you can utilize that strategically to position your business on the growth area for your business. So let's assume that you were a business that was entirely brick and mortar. Again, going back to the digital risk and now you have a major push and you go online and you want to strategically make sure that you have an understanding of the risk that you are basically exposing yourself to and that you want to manage. Then you're going to start to think as to how much risk of should the captive retain, how much premium should the business essentially pay to them captive to be able to do that new things. So whether it be that you enter a new country and you look at the logistics risks that you are starting to open yourself to, you could choose to again assume that you will cover that out of cash flow from operations of business. So part of the cost of good sold or actually strategically look at review of what are the risks of, for instance, by containers to be stuck in a particular harbor somewhere. And you can essentially, there are plenty of data now that you can essentially expand and be able to say what's worth and therefore capitalize your captive to do so.

You can use it as a way to think of strategically if I want to develop my business in particular area, and as my business changes throughout the year in a flexible way, I can think about taking some of those risks. Now, what David said earlier about being able to understand and be able to model the risk still stands. If you are going to a new area and you have no idea of the risks, then of course it would be very difficult to tell you regulator, I'm capitalized enough, it's all good.

So there's that balance, but there are many, many risks now where that we see, for instance, in credit risk, where historically the data were not available. Now you have more data you can drink at a... It's like drinking from a fireman's hose pipe, you have immediate indigestion. So being able to filter the big data from the small insight, which then allows you to choose as to whether or not you're going to put this into your captive is really important.

Steven Burkhart:

That's great. Thank you. David, did you have any thoughts on what Henri was just saying in terms of the data and the ability to maybe analyze things we just haven't had chance to before?

David O'Gorman:

Yeah, in fact, what Henri just finished with is exactly the hardest part, I guess, of the exercise because a lot of the time you are dealing with risks or coverages that typically haven't been there before. So it really is a case of seeing what you've got available in terms of data, in terms of experience, maybe looking at similar types of coverages whereby that experience can be applied to it and to try and come up with a view as to how things can be in the future. It's always a case of looking to the past with a view with one eye always on the future as you are driving your car as it were.

So it's a very, very good question to ask. It's a very difficult question to answer. A lot of it be gut feeling and ultimately it's a question of determining whether it makes sense, whether the conclusions that you come to are reasonable always, as I said, with one eye on the pass and compare comparison with other types of coverage which may have similar experiences. So it's a hard one to nail down Steve, but it's a very relevant one because obviously as you point out, there are different types of risks coming to the fore. We've seen the pandemic of course in the last couple of years. We've seen cyber in the last few years as well, whereby a number of carriers have been to use a word burned from not really understanding exactly how that risk risk operates. So it's a good question and one that we're going to continue to answer I guess over the next few years.

Steven Burkhart:

Well, thank you gentlemen. I think in all seriousness, insurance is extremely important for companies obviously, and then the ability to consider taking on some more control over what is a very important element of business today is perhaps reason enough why we've seen in just the past few years, hundreds and hundreds and hundreds of captives formed. And I think too, as we've discussed today, it's an opportunity for the finance teams, the risk teams, legal inside the company to come together and thoughtfully scope out how best to not just protect the company, but as we said, add some control there, be a bit more of a master of your own destiny. Captives can help this in this way.

We mentioned we'll see each other next week in Washington DC, for the first ever captive insurance conference. It's an invitation only conference for industries and retail and restaurants and distribution and so forth. And the interest is extraordinary. So I think the audience will be excited to learn more there and I think we'll do be doing these again sometime. So I thank you for the time and attention today. Any closing remarks from you both and for AkinovA? Henri, I'll start with you.

Dr. Henri Winand:

I'll just jump in that the way we have to think of captives and contingent capital for corporates is what do we need? And I mean as the industry, whether it be advisors, digital marketplaces like AkinovA, what do we need to make the corporate's life easier at renewal? What technology can we help them with? And also how do we make sure that we can over time add more capital available for the corporates to underwrite the new risks? If you go to an underwriter today and you ask them, Can you do this brand new race? They'll probably tell you, come back in two years because I don't have the data yet. So we need to educate the capital so the capital is there when it's required by the corporates.

And then the third one is how can we make sure that on the writing of the corporate is done as efficiently, and I mean capital efficiently as well as at the front efficiently for the renewal as possible. And there are few things that we've been working on at AkinovA, which will be very much looking forward to sharing with everybody next week. So stay tuned, I think so to speak,

and to be able to make that a more richer experience, not necessarily just in dollar terms, but also in the understanding and the control of the risk services that your business is going through.

Steven Burkhart:

Great. Thank you. David, Any closing remarks?

David O'Gorman:

Yeah, just to finalize by saying, of course, I've got my actuarial hats on. Again, captives are a very important risk transfer solution, a risk transfer instrument out there for CERs corporates for a number of reasons. We've already discussed possible tax benefits, reduce insurance costs, the idea of being able to effectively ensure those large and complex risks that we are unable to place in the insurance market. But at all times, one must keep the eye on the board with regard to what the reasons are for setting up the captive and having completed the various analyses that we've already discussed in terms of actuarial and the feasibility.

Nonetheless, there are, in addition to the captive as a solution in its own right to the corporate it AkinovA, as Henri has already alluded to, we are looking at our number of solutions which can be implemented to help in improve or work with the risk transfer of the corporate to the captive and out to the larger sort of traditional markets. So again, it's watch this space, I think within the next week or so when we discuss that.

Steven Burkhart:

Super. Okay, Thank you. Well, gentlemen Henri, David, thanks so much for joining us today. This has been a very interesting conversation and I'm sure one that we'll be speaking about again soon. Thank you. Safe travels to DC I'll see you next week.

Make sure to visit our website, www.ballardspahr.com, where you can find the latest news and guidance from our attorneys. Subscribe to the show, an Apple Podcasts, Google Play, Spotify, or your favorite podcast platform. If you have any questions or suggestions for the show, please email podcast@ballardspahr.com. Stay tuned for a new episode coming soon. Thank you for listening.