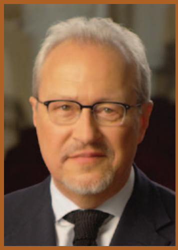
ISSUES & ANSWERS: CAPTIVES AND REINSURANCE PARTNERSHIPS

Industry professionals discuss new business strategies aimed at the captive market and how collaborative data partnerships are benefiting the reinsurance sector.

Interviewed Inside:

Derek Freihaut
Pinnacle Actuarial Resources

Mark Benz
AIG



Michael Maglaras
Michael Maglaras & Company

Joe Stuhl
Munich Re US

Lara Mowery
Guy Carpenter

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Determining Risk Distribution

Derek Freihaut, Principal and Consulting Actuary with Pinnacle Actuarial Resources, said Pinnacle believes clear communication is essential to the work of actuaries and to the work his profession does. “We use Expected Adverse Deviation (EAD) to great effect and to great client satisfaction,” he said. Following are excerpts of an interview.

Derek Freihaut, FCAS, MAAA
Principal and Consulting Actuary
Pinnacle Actuarial Resources

“EAD is an excellent actuarial tool because it can be applied objectively and can be easily understood by captive owners and other stakeholders.”

Go to the Issues & Answers section at *bestreview.com* to watch an interview with Derek Freihaut.

What is risk distribution for an insurance company? Why is it important?

Risk distribution in insurance is the aggregation of risks to reduce the potential volatility of loss. It is also one of the requirements to be an insurance company. To determine whether or not an agreement qualifies as insurance, it is common to consider a four-prong test: 1) the agreement needs to meet the commonly accepted notions of insurance; 2) it must involve insurance risk; 3) it must transfer risk from the insured to the insurance company; and 4) there must be risk distribution within the insurance company. This makes risk distribution vital to captive insurance companies. Insurance companies rely on their ability to distribute risk across a critical mass of exposures to withstand significant losses.

Is there a common way to determine if an insurance company has the necessary level of risk distribution?

Although there is some helpful IRS guidance, there is no single, objective way to determine risk distribution. Historical tax court decisions have been at times inconsistent and ambiguous. IRS guidance to date has been more focused on corporate structures rather than measuring the amount of risk distributed. That said, there have been more recent tax court decisions that recognize that any measure of risk distribution should consider the amount of exposures being covered as well as the reduction in the variability based on aggregating these exposures.

Are there any good objective measures of risk distribution?

At Pinnacle, we felt that the measure of how much risk is distributed based on an insurance company’s risk exposures was an actuarial question. We have worked to develop a straightforward approach to measure it. We considered a number of different potential measures but weren’t satisfied with the initial options available. We felt that any measurement we settled on needed to be transparent, acceptable to regular users and not easily manipulated. Ultimately, we wanted to be able to measure how well an insurance company reduced the volatility of their losses by distributing their risk. And, we wanted to do it in such a way that we could easily explain to key stakeholders. What we devised was Expected Adverse Deviation, or EAD. We think EAD effectively answers the question, “How much risk distribution qualifies as insurance?” But we also think EAD is the most robust risk distribution measure for other key reasons.

What is the EAD calculation?

EAD represents the average amount of loss that the insurance company incurs in excess of the expected losses, or the expected amount of adverse deviation an insurer is exposed to. It is most clearly expressed as the EAD ratio, and to test for risk distribution, we need to normalize the EAD value by dividing by the expected losses. This EAD ratio measures how much volatility or risk an insurance company is taking on relative to its expected losses. The higher the EAD ratio is, the riskier the insurance company. As an insurance company diversifies its risk we should expect to see the EAD ratio decrease. And, the EAD ratio has a maximum value of 100% and a minimum value of 0%, which makes it easier to compare different types of insurance and exposures.

Captive Resources

Mark Benz, Head of AIG Captive Solutions, said the group captive product may help multiple middle-market companies to share risk. “This may help them to share in the rewards of controlling the risk as a group,” he said. Following are excerpts of an interview.

- Provides a complete range of captive services
- Ability to set up and manage a captive in most of the major domiciles
- A convenient and secure online portal where captive clients can easily post and share documents

Mark Benz
Head of Captive Solutions
AIG

“Whether you are looking to form a new captive or optimize your existing captive program, our experts can provide you with in-depth professional knowledge and guidance.”

What’s driving the growth in middle-market captives?

Well-performing companies often look to the alternative risk market for a better and more economical solution. We’re also seeing coverages such as construction and transportation look for a more tailored insurance solution that may better suit their needs. We are seeing increased growth in the middle market related to their use of group captives.

What should a company look for in a captive manager?

There are a number of qualities and attributes to consider when selecting a captive manager. A company may first want to review the domiciles where the manager can operate and how long they’ve been in the industry. Flexibility is also important. The captive product is very specialized and is not the same for every insured. It can also be beneficial if a captive manager has a broad network of partners that can help support the captive relationship with strong capabilities in claims, auditing and actuarial.

Are you seeing competition heat up between the domiciles, and if so what’s driving that?

Recently, we have seen many domiciles, including several different U.S. states get involved in the captive market, in addition to the big three captive domiciles that have been around for years, Vermont, Grand Cayman and Bermuda. This new activity has contributed to increased growth in the captive market year after year. States such as Hawaii, North Carolina, South Carolina, and Tennessee are breaking into the market and fast becoming popular domiciles. This question ultimately goes back to the captive manager, who should help a company select the domicile that best fits the company’s needs.

How does AIG Captive Solutions address the needs of clients in this evolving space?

AIG created Captive Solutions in 2020 to bring together a collection of our different captive products and services. Right now in Captive Solutions, we offer a fronting structure, which is a solution designed for a national account product utilizing a single-parent captive. Then, we have a group captive product, which brings different insureds together in one captive to potentially mitigate overall underwriting risk. Lastly, we have our captive management services teams, which help set up and manage captives in several domiciles, and also offer and administer protected/segregated cell “rent-a-captive” facilities in Vermont and Bermuda.

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It's All About Claims

Michael Maglaras, President of Michael Maglaras & Company, an international captive consulting firm, said that the captive insurance market is flourishing. "There's a lot going on, and I'm extremely optimistic about the future in this challenging market right now," he said. Following are excerpts of an interview.

Michael Maglaras & Company

- Founded in 1988 by Managing Principal, Michael Maglaras

Michael Maglaras
President
Michael Maglaras & Company

"Captives flourish in these soft markets because when you get in the business of adjusting and managing your own claims, you don't want to go back."

Go to the Issues & Answers section at *www.bestreview.com* to watch an interview with Michael Maglaras.

How would you describe the state of play in the captive marketplace?

I'm more optimistic about the future of captive insurance companies than I have ever been since I started in the industry, period. I'm delighted to be able to say that. I'm sanguine about our future in the captive industry. That said, I'm also seeing some darker clouds on the horizon but in general, I'm very optimistic, and envision a very bright future for the captive industry.

You've been quoted as saying "it's all about claims," when you speak about captives. What do you mean by that?

What is the least sexy topic at a captive industry meeting? It's claims. Claims management, how to reserve, how to adjust a claim, how to go to RFP for defense counsel, how to manage the litigation process. If you want to clear the hall out fast in the captive industry meeting, announce you're having a seminar on claims. But ask yourself this, "What is the lifeblood of the captive movement, and what is the lifeblood of captives?" It is, in fact, the management of claims. At the end of the day, captives are great, huge claim paying mechanisms.

Assuming we're in a hard property and casualty insurance and reinsurance market, what effect is that having on the number of captives being formed?

I would say that we are not in a hard market but rather a course-correcting market. You're in a hard market when pricing deteriorates, when availability of limits deteriorates, but you're mostly in a hard market when you can't get it. We're not there yet. We're in a course-correcting market. The key here is understanding that captives are going to play an increasing role in this course-correcting market by doing something that they haven't done in a long time. That is, not replacing coverage but rather augmenting it. The way to augment the property and casualty insurance market is by using your captive insurance company. In a hardening course-correcting market, we're going to see a brand-new role for captives augmenting existing P/C coverages.

Do you think there's a secret sauce that guarantees the superior performance of a captive over an extended period of time?

There is a secret sauce, and it is ownership engagement, period. I'm a business owner. I buy commercial insurance. Once I authorize that check to be signed to renew any of our commercial insurance programs, I'm an industry professional. If I had my insurance placed in a captive, and they're not large enough for me to do that, but if I did it, where would my mind be focused? My mind would be focused on, what's the premium I'm paying and what's the net retained risk I'm taking in my captive. My mind would be focused on looking at quarterly financial results on claims in reserve to be paid. The one thing about captives that make them so very different over time is it force functions ownerships' laserlike attention on that balance sheet.


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Collaborative Data Partnerships

Joe Stuhl, Executive Vice President, Broker Executive for Munich Re US, and Lara Mowery, Global Head of Distribution for Guy Carpenter, discuss how collaborative partnerships to co-create innovative data solutions are becoming a critical element of the insurance and reinsurance industry. Following are excerpts of an interview.

Joe Stuhl
Executive Vice President, Broker Executive, Munich Re US

Lara Mowery
Global Head of Distribution
Guy Carpenter

Go to the Issues & Answers section at *www.bestreview.com* to watch the entire interview with Joe Stuhl and Lara Mowery.

What's the benefit of using standards for creating a data model?

Stuhl: When you think about the ways that we have historically done our business together, actually the process itself creates a lot of stress on the relationships. What I mean by that is the broker will work for many months putting together a submission with all this data. They send it to the reinsurance market. Then we, in turn, are trying to manipulate this data to fit into our own pricing models. This can take quite a bit of time and energy. Most times, we're going back to the broker with additional data requests. We may have missing information or pieces of information that we need for our models. The broker now has to go back to the client, a lot of times, and ask for additional data. If you multiply this by the number of markets they're sending the submission to and having to go back and forth with the client, that just creates stress in and of itself. It's just one point in the puzzle for how not having data standards creates an inefficient process.

How can we better leverage proprietary and public data to understand client needs and the changing nature of the risk that they're facing?

Stuhl: Historically, we've looked at the data the client gave us, and we looked at our own database. Increasingly, there are third-party vendors and other sources of public information that people are tapping into to better understand the exposure. You have to create a foundation for being able to do that and set yourself up to be able to feed that kind of information and enrich the data that you already have so that you're making better decisions, you're understanding your client better, and you're providing more value.

Mowery: There's an amazing amount of third-party data out there and available. There are some data sources that historically would have provided really good information, that weren't digitized and were stuck in places in manual files. How do you leverage that and gain access to that? More and more of that information is now available through different third-party data sources.

What will your workplace look like in the near future?

Stuhl: It's a great question. Certainly, it's going to be revolving around data. I just see the evolution there of being much more data oriented. We're developing a lot of AI-type technologies to bring better insights into the risks that our clients are facing. Some of these risks, like cyber and climate change, may not really be able to be modeled in our traditional way, looking in the rearview mirror, so to speak. We may have to look at different data sets and be able to think differently about how we evaluate those risks.

Mowery: We have transitioned to a bit of a different focus in terms of taking the traditional broking role, taking the traditional actuarial and cat modeling roles and thinking about what new technologies or different ways of thinking about data science help to supplement and enhance all of that more traditional focus on the business. Still bringing that underlying expertise and knowledge but wanting to connect with some of the other disciplines that are out there and move forward in a slightly different way.

Munich Re has a strategic focus on working with our clients and brokers to understand their needs. Using these insights, along with our industry expertise, proprietary data and new technology, we look to continue to co-create innovative solutions with our broker partners that address the ever-changing needs in the marketplace.