Talk to Me About A&E: Episode 19

CHARLIE WOODMAN: If I was an A&E firm looking at a captive, I would probably be looking at a wider range of exposure. I could very well put some of my self-insured retentions for professional liability in there. I would probably also look at any other types of exposures that I might have just by virtue of my size.

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SPEAKER: Welcome to Talk to Me About A&E, a podcast series focused on risk management for architects and engineers. Host, Dan Buelow, managing director of Willis A&E, will engage experts across the A&E spectrum on topics ranging from contract details to the broadest trends impacting design professionals in North America.

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DAN BUELOW: Hello and thanks for joining me for another Talk to Me About A&E podcast. I'm Dan Buelow and our topic today is on captives. What is a captive exactly? And how should your design firm seriously consider a captive as a risk transfer option versus your standard commercial insurance coverages? We will be breaking this discussion into two parts actually. The first discussion today will be on single parent or pure captives. And the second part will be on group captives.

Whenever the P&C marketplace hardens, when rates increase, and/or capacity constricts, more business owners will be interested in possible alternative risk transfer options. And more brokers will be running around promoting captives as a solution despite the fact that captive may not be a commercially viable option for the vast majority of design professional firms at least compared to traditional commercial market options that you currently have.

Over the last couple of years, we have seen a significant hardening of the general property and casualty marketplace. However, the insurance market specific to architects and engineers has been fairly insulated from this. And premium rates and available capacity has been relatively stable compared to the general property casualty marketplace. In fact, we would say that the A&E marketplace is relatively soft certainly in comparison to the general property casualty marketplace and even compared to markets serving other professional service firms, including lawyers and accountants.

In our most recent Willis A&E Market Realities report, we reported the following rate projections for A&E insurance products in the traditional marketplace as follows. Professional liability, we're seeing a 5% to 10% projected rate increase. Project specific, on the other hand, we've seen a real constriction in that market, 15% to 25 plus percent, GL, General Liability, plus 5% in that range. Auto, plus 5% to 15% in commercial auto. Work comp has been relatively flat to 5%. Management liability 5% to 15%, rate increases projected. Cyber, 50 to 100 plus percent. It's actually come down a little bit. So cyber aside, while slight increases across most lines of coverage over the last 12 months, all in all, fairly stable. But despite this, more A&E firms are asking if a captive is right for them or at least are curious about alternative risk transfer options that might be available.

So, to help me address this, I have a very special guest who has considerable expertise in the field of alternative risk transfer and captives in particular, Mr. Charlie Woodman. Hello, Charlie. Welcome to our podcast.

CHARLIE WOODMAN: Hi, Dan. Thanks for having me. It's a real honor, and I appreciate the opportunity.

DAN BUELOW: Well, this is great. So, Charlie leads risk finance, a client advisory and technical resource within WTW North America Construction. And the team specializes in captives, alternative risk transfer, and advanced risk financing solutions for WTW. Charlie is a certified public accountant, a Certified Global Management Accountant, CGMA. And for many years, Charlie was an instructor for an international center for captive insurance education and is currently a lecturer for the risk management and actuarial science programs that GSU. That would be Georgia State University, I assume, Charlie?

CHARLIE WOODMAN: That's right.

DAN BUELOW: All right. So, in other words, Charlie knows what he's talking about when it comes to captives and so we're lucky to have him. So, Charlie, let's lead off here. What is a captive? What are captives? And where do they fit into the insurance and risk finance world?

CHARLIE WOODMAN: That's about the best place to start, I would imagine. Well, captives are an interesting concept that have been around for the better part of 50 or 60 years. The definition of a captive is really very straightforward. It is risk assumption in its most sophisticated form. Captives are special purpose or special mission insurance companies where the owners of the captive, the controllers of the captive, are also the insurers. And the captive insures the interest of its owners and largely nothing else.

They fit into the insurance industry, actually, quite well. Some of the largest insurance companies in the world started out life as captives. Basically, captives have created fundamental insurance capacity and specific insurance capacity all over the world. In their-- I guess their most current form, they basically divide down into two different types, OK? And there are a lot of different forms, a lot of different legal types of captives out there. But if you take a step back, they really exist in two different types.

One is a pure captive that Dan alluded to. And the other is what we would consider to be a group-based captive. And fundamentally, they do two different things. Dan talked about risk transfer. And the opposite of risk transfer is obviously risk assumption. When we look in the world of, say a group captive, where you have many different insureds all of whom are unrelated to each other, they are actually coming together using a captive to pool their capacity and really recreate or replace certain parts of the insurance industry. And we'll be dealing with that a little bit more in our next podcast when we look at groups in a more specific manner. Pure captives are captives that are actually owned by a specific entity or group of entities who have common ownership. So, a pure captive would really be, if we were to look at it in light of day, would actually be risk assumption instead of a risk pooling or replacement of risk transfer.

Captives live in this world based on special enabling legislation that exists in a myriad of domiciles. Not every place in the world can support captives, but there are a fair number of them in the United States and around the world that do sponsor captives. And when I say special enabling legislation, I don't necessarily mean it's special in terms that they can do more than insurance companies, commercial insurance companies do. They're special in that they are allowed a certain amount of leeway when dealing with underwriting and risk assumption for their owners.

Most domiciles will allow an application and will issue a license to a commercial enterprise that can demonstrate that it can assume risk and thereby control its own risk in a very formalized manner. Captives, just for the sake of being a special purpose entity on somebody's combined financial statements, may or may not be a good idea. But we do know that if you have certain characteristics and certain risk tolerances, that a captive takes assuming risk and funding risk to a whole new level in terms of sophistication.

DAN BUELOW: So, Charlie, is a pure captive the same thing as a single parent captive? because we'll hear that term often.

CHARLIE WOODMAN: Yes, exactly. When we think of single parent captive and we think of pure captive, they're one and the same and interchangeable.

DAN BUELOW: OK. OK, so we don't see many architects and engineering firms participating in captives except for some of the very largest design professional firms out there, perhaps, and for specific lines of coverage. And again, since we're focusing on pure captives or single parent for the session, what makes a good candidate for a captive and what are some criteria or a checklist, if you will, of considerations a design firm will want to address?

CHARLIE WOODMAN: That's a great question. When we talk about A&E or any type of professional services, the 800-pound gorilla in the room is always going to be professional liability. And with professional liability, whether you are an architect, an engineer, an accountant, a lawyer, a doctor, often requires that we have not just the capacity and the ability to control risk, but also evidence of financial responsibility that's often required to go along with your services and that type of thing.

For these types of professional firms, we, as you may have alluded to, don't see a lot of single parent captives or pure captives that exist out there, unless we're looking at the very, very largest of firms. Certainly the big four accounting firms have their own single parent captive. Very, very large law firms do. I would imagine some of the very, very large A&E firms may support their own.

For the vast majority of going concerns, we tend to look at risks that are higher frequency but lower severity, where the captive can actually assume a relatively predictable pool of risks. Say worker's compensation, general liability, and by general liability, I mean premises liability or products liability and certain auto liability. Although the marketplace, as you noted, has been extraordinary over the past few years in these particular lines, they are characterized by certain realities. And those realities are because we can measure them, there's generally a lot of losses out there. There's a huge pool of industry losses. We can predict them, and we can get a premium for them to put into captives.

For professional liability, that's far more difficult. Professional liability tends to be much more sophisticated form. It's usually a claims-made form. The underlying development of losses can take many, many, many, many years to develop. So, it's difficult for us to kind of put our fingers around it, and therefore it's difficult to underwrite. If I was an A&E firm looking at a captive, I would probably be looking at a wider range of exposure. I could very well put some of my self-insured retentions for professional liability in there. I would probably also look at any other types of exposures that I might have just by virtue of my size. So, if I have a large workforce, maybe not necessarily all of my professionals, but my supporting workforce, I may put it in there if I have a lot of vehicles or if I have large offices where I have a fair amount of customer foot traffic. Those are some things to consider.

Property can go in there, although property can sometimes be somewhat hit or miss. You either have a loss or you don't. Oftentimes, what we see with property going to captives tends to be more in the contingent area, whereas you may have a fire loss or something like that. And the captive can respond to getting you back up and running while your claim is working its way through your normal insurance channels.

DAN BUELOW: OK, so professional, I understand that doesn't make sense. And you mentioned the SIR could be one of the things you might consider. And I'm, in fact, familiar with a couple of firms, at least, where we have an SIR to raise that self-insured retention, essentially self-funding that and have worked with a captive just for that part of that coverage. But for most firms that are thinking about this, is there a certain revenue size or premium spend or certain thresholds that would typically make sense for this to be worth the effort or the cost to go through with this?

CHARLIE WOODMAN: There's certainly criteria through which you may want to take a step back and look at it. If you are-- let's stay with professional liability just briefly, if you are in the marketplace and given your size and your exposure or the market demands on you are that you take up your self-insured retention into the million, $5 million, $10 million, I've seen it as high as $25 million per occurrence, per claim retentions, then a captive can oftentimes work very well for you. Especially if you're relatively decentralized, you have operations all over the country, and you want to centralize risk management and the buy down of that.

Or alternatively, and this is something we haven't talked about at this point on this podcast, if by raising our retentions we one, reduce the amount of risk transfer cost to the insurance marketplace or alternatively, we find ourselves in a marketplace that has other providers that are willing to take pieces of the captive’s risk assumption, then a captive can be that kind of conduit to do that. What we tend to not realize is there is a whole world of reinsurance markets out there that either by statute, by license or just by demeanor, do not insure directly with insureds, or what we would think of as the direct insurance marketplace.

They have to go through an insurance company. Oftentimes, captives are formed by their parents, and they act as that conduit to the reinsurance marketplace. This last hard market, we've seen more of that happening, where captives are quite literally making up a portion of the company's overall insurance placement. So those are things to consider.

In terms of size, I mean, if you're on guaranteed costs for your workers' comp, general liability, property, auto liability, and you have a relatively small deductible on your professional liability, you don't need to be anywhere near a captive. Because remember that if you're not transferring the risk, you're assuming it. And if you can't afford to assume those types of retentions before forming a captive, you certainly can't afford it after you have a captive because all you've done is formalize that risk assumption. You're still on the risk, but you have now added the better part of $100,000 plus of operating costs to that equation.

So, we need to make sure that our clients are of a reasonable size, a reasonable risk management mindset, and also have the capability of sustaining this corporate insurance company into the future. And it's a going concern. They need to be kept relevant or you're just wasting your money and your time.

DAN BUELOW: Where you're going with that, too, is you would need to have the right collateral for undeveloped or future losses, specific claims, and again, looking at professional liability, you've got your prior acts exposures and you've got some of the longer tail on these claims. I would think that also is an issue to consider in all of this.

CHARLIE WOODMAN: Absolutely. Absolutely. You may underwrite or assume certain risks in your captive, and you may go any number of years without a loss only to figure out that that risk that you underwrote in 2022 has actually led to a claim in 2027. And that can erupt out of nowhere. It's one reason why we see professional liability often written on a claims-made basis. So that each policy year from which a reporting can be made can stand on its own. And thereby you can kind of segregate things a little bit better, but the risk is still there. I mean whether you have it in the captive or you're storing it on your own balance sheet, it's still there.

DAN BUELOW: And when we talk about-- again, we're talking about architects and engineers, that universe if you think about it, the ENR 500, which roughly the 500 largest design professional firms and number one on that ENR list might be several billion in revenue, where number 500 on that list is $20 some million. So, it's quite the drop off, if you will. Is there a sort of a revenue size where it might make sense, and would it vary from firm to firm as far as-- the average design firm doesn't have a whole lot of assets either, frankly so.

CHARLIE WOODMAN: No, the average design firm is a professional co-op. It's a professional organization. Oftentimes, they're partnerships. You have people coming and going and that type of thing. You certainly don't want the risks of one partner hamstringing the remaining partners years after he's left. So those can be issues there. If I had to put a number on it, I would say that if you're into project sizes that are significant, or for our construction clients, obviously because they have a wider range of risks, we typically look at single parent captives when they started to become say $250 million in revenues or contract values.

With architects and engineers, and as with other professional services firms, you're going to want to be a pretty good size, and it's probably going to be based more on your professional base. So, if you've got 100 professionals, then you're starting to become a risk where you need to centralize this stuff and get your arms around it. If you're a shop of 10, you're probably going to look at other means.

DAN BUELOW: And is there a total premium threshold that needs to be met in order to offset any administrative costs of managing these captives?

CHARLIE WOODMAN: Yeah, there really is. And some of it comes down to just an absolute value. Others come down to another gorilla that's in the room, and that is the tax aspect that surrounds insurance in general and captives in particular.

One of the reasons that captives tend to be very efficient for some companies and less efficient for others is that some companies are able to meet what we would consider to be the facts, the circumstances that allow it to qualify its transactions between itself and its captives as insurance. And once it does that, it's allowed to identify and file under the US tax law as an insurance company, and that affords it certain special deductions that only insurance companies can take. And those really have to do with the recognition of losses regardless of when the losses themselves are actually paid or in some cases, actually discovered.

If our clients can substantiate that and can accelerate those business deductions in the form of incurred losses, then that accelerated recognition comes with a significant cash flow benefit. And that cash flow benefit then can overcome the operating costs of the captive. Otherwise, the operating costs of the captive will always be fixed. So, to offset that, you have to find some other external mechanism that saves you enough money from the captive that can offset that. And that's sometimes where the challenge comes in. And that's why we look, as captives mature, to find alternative risk transfer partners that will afford us better terms and conditions, better pricing, and do it because we have the captive versus we're just out in the marketplace and we have a very, very excellent broker out there.

DAN BUELOW: We ran through some of the different lines of coverage. One of the more volatile lines as mentioned earlier, is cyber. Is cyber possible-- what can we do about cyber?

CHARLIE WOODMAN: [CHUCKLING] That's not the 800-pound gorilla in the room. That's the room. Cyber is a very interesting coverage as you know, Dan. Probably five years ago, you could sell cyber to anybody and everybody from your pennies on the dollar in terms of limits and things like that. And that has changed. The industry has figured out, oh no, we've been underwriting into DEFCON 5. And so, what we're seeing in the industry is, we're seeing a lot of not only catching up with the risk that they are underwriting, but also defining what that risk is.

And as a result of that, we're seeing terms and conditions and the pricing of cyber policies just really go through the roof. Will it eventually cap out? I don't know. Is it likely that the capital markets may play a role in stabilizing the insurance capacity? Almost probably. Can cyber be put into captives? Yes, we see it all the time. We see it as part of this concept of contingent business interruption. What can hit us now that we really should have a rainy-day response in place for? And those issues may be things like extreme natural hazards. They can be things like pandemic, but also cyber. Cyber is a huge one. Whether it is intrusion, loss of information, or whether it is ransom, that's just going to come at you from nowhere. Nobody expects it, but it happens all the time. So yes, cyber is something that we can put in there.

DAN BUELOW: All right. So, this is great information. I think, again, it sets the stage and gets people thinking about, well, is this even a viable consideration? How does WTW, Charlie, you and your group, approach the captive assessment of a potential captive program? What are the processes, costs and time frame? And second part of that question would be, how does WTW support and establish captives, and what makes it unique in that area?

CHARLIE WOODMAN: Those are two excellent questions. If I finish answering the first one and I forget the second one, just—

DAN BUELOW: Yeah, go to the first one. How does-- yeah, let's do the approach first, yes.

CHARLIE WOODMAN: Willis Towers Watson has really been amazing. I've been with this company for 17 years. I've been in the industry for a lot longer than that. And basically, they have-- especially in the construction and the A&E side of things, they have separated captive consulting from captive management. I work for the client relationship side. And we are technical resources, which gives us a tremendous amount of flexibility to work with any client that asks very, very straightforward questions.

And the way we approach captives is just that. It's very straightforward. What we'll do is we'll sit down with the client, we'll take a look at what they have, we will assess the market, but we'll also assess where that client wants to go, what its risk profile is looking like, and really other things such as their balance sheet, their cost of capital, tax, any number of things. And we'll vet it. And we'll say, you may want to look in this area instead. Captive may not be the biggest bang for your dollar. Or if you do look at the captive, it will be OK. It's not going to be this huge silver bullet. The werewolf may still come over the fence a couple of times a year, but it's not going to hurt you. Or alternatively, we can see a dynamic strategy that could probably allow you to take more risk control.

That's what we call the vetting process. And that's really a service that we do for any and all of our clients. We don't typically charge for it, unless there's travel or something like that involved. But it's something that we do because captives, over the past half century, have become such an integral part of the risk discussion. And we provide that as brokers and risk management consultants.

If it seems like that a captive has appeal, it has merit, we can come up with a positive economic outlook for it or perform that, then what we do is then we go into a more formal process in which we bring in actuaries who can do the pricing and attest to it. We do we do the design of the captive, how it underwrites things, who owns it, where do we put it, those type of things. And that process is really called the business plan development.

But because we do it after the vetting, it's not really feasibility. We've already determined the merits of whether or not your program should work. Once we finalize the business plan, we then hand it off to the captive management, which is a separate operation within Willis Towers Watson. We're not related to it in terms of our P&L, but we work very, very well with them. And then they take over the active management of the captive. They are, in essence, the regulatory counsel. I say that in more of an informal basis. But they're also the controller, the managers of the captive. And they, along with special attorneys, accountants and actuaries, will then run the captive for you as a turnkey operation.

The real issue that we want to emphasize, though, is that our practice and those in practices similar to mine in other industries, we don't go away. We stay with the account. And that way, the captive is constantly being challenged. We constantly bring the captive back into discussion as facts and circumstances change in the insurance market and your risk profile.

DAN BUELOW: That's excellent. It's a great overview on this, I believe. And to the point where if any of our clients or any firms out there, businesses, want to know a little more about this, that we can work with them to go through this process and some due diligence and certainly offer some more specific insights to their specific business. Well thanks, Charlie. I really appreciate your time and your expertise on this subject.

CHARLIE WOODMAN: Thank you, Dan. I appreciate you having me.

DAN BUELOW: Thank you. And thank you for joining us for another episode here of Talk to Me About A&E. Talk to you soon.

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