# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Page</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>4</td>
<td>Introduction: How History has Shaped Where We Are Today</td>
</tr>
<tr>
<td>7</td>
<td>US Market Overview</td>
</tr>
<tr>
<td>12</td>
<td>Property Market Update</td>
</tr>
<tr>
<td>17</td>
<td>Casualty Market Update</td>
</tr>
<tr>
<td>21</td>
<td>Change is in the Air for Aviation Insurance</td>
</tr>
<tr>
<td>25</td>
<td>Captives: An Efficient Risk Management Tool or an Over-Engineered Solution?</td>
</tr>
<tr>
<td>29</td>
<td>Social Engineering in Cyber Crime: Your Workforce is the Target</td>
</tr>
<tr>
<td>33</td>
<td>Focus Feature: Cyber Risks &amp; Solutions for the Construction Industry</td>
</tr>
<tr>
<td>38</td>
<td>Punitive Damages: Unpredictable but Worth Solving</td>
</tr>
<tr>
<td>43</td>
<td>Protecting Your Revenue</td>
</tr>
</tbody>
</table>
Introduction: How History has Shaped Where We Are Today

by

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This year Woodruff Sawyer celebrates 100 years of specialized risk management expertise. And over that century, Woodruff Sawyer’s insurance experts have guided clients through dramatic pricing cycles related to catastrophe, economic crisis, and war. Only 30 years ago, an active hurricane season could completely wipe out an insurer or decimate the capital of a larger insurer, all of which, of course, impact our clients.

In 2017, insurers paid $135 billion in catastrophic losses, but certainly weren't wiped out. Industry pricing is essentially flat. How can that be? Have insurance pricing cycles gone the way of the Model T? Maybe. The past doesn't necessarily predict the future in this case because the insurance industry has evolved with commerce and the financial markets.

Insurance pricing cycles are dictated by the amount of surplus (capital) in the industry. Until the 1990s the surplus in the industry was the capital of all the insurers and reinsurers. That changed in 1992 with Hurricane Andrew: Insured losses totaled $15.5 billion, three times more than any insurer expected at the time. Andrew was the largest insurable catastrophe up to that point and forced the insurance industry to realize just how much high-value property was concentrated in catastrophe-prone areas. Eleven insurance companies went bankrupt. Traditional diversification was not going to solve this problem.

A new solution was needed. The solution that emerged was alternative capital by way of catastrophe bonds (cat bonds).

Today, cat bonds are an additional source of industry capital that mitigates premium increases. Cat bonds are attractive to investors because they are uncorrelated to the financial markets. This, along with the historically low global interest rates, makes cat bonds a favored component of diversified investment portfolios. As a result, insurance buyers win.

I've given you some history on how the past has shaped insurance pricing today. In this Property & Casualty Looking Ahead Guide, we
examine insurance market trends and pricing cycles of recent years, while making data-based predictions about what's to come in 2019. We dig deeper into the factors impacting the US market and discuss certain specialized segments such as aviation, auto, and construction. In addition, we offer tips for reducing risk in its many forms (and, potentially, reducing premiums when it comes time for renewal) with trending risk management tools like captives, as well as tools that are often overlooked, such as trade credit insurance. And no 21st-century risk overview would be complete without a discussion of cyber risk and the Internet of Things (IoT). This risk touches every industry regardless of size and is the new frontier of risk management.

If you're considering changing your property and casualty coverage in 2019, want to better understand how the market is evolving, or are looking for ways to control cost and risk, this is the place to start your research.
US Market Overview

by

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The catastrophic events of 2017 tested the resilience of the US property and casualty insurance industry and the ramifications, as expected, continue to be felt. The losses from major Atlantic hurricanes last year will likely cost US commercial insurers $30 to $45 billion in underwriting losses for the full year of 2017, with a projected combined ratio (losses plus expenses, divided by premium) in the range of 104%-106%.

Property and casualty rates have decreased for a few consecutive years, and while these decreases have slowed significantly in 2018, reported capital for the P&C sector will hit a record high by year-end. This overcapitalization will likely result in ongoing soft market conditions, except in the areas of auto, property, and cyber.

Auto Rates Rise but Can't Keep Up

Commercial auto rates have consistently risen over the past two years, but have not kept pace with loss trends and adverse development. Distracted driving, technologically advanced but sensitive vehicles, and catastrophic weather have all played a part in the increases in claim frequency and severity.

Property Rates Continue to Rise

Property insurance buyers will likely see their catastrophe-exposed (cat-exposed) risks continue to rise in price in 2018 and 2019. Hurricanes Harvey, Irma, and Maria, along with earthquakes in Mexico and wildfires in North America, will result in $135 billion in insured losses for 2017. California wildfires alone accounted for almost $12 billion in losses in 2017 and the Carr and Mendocino Complex fires of 2018 will add in excess of $1.5 billion in insured losses. Hurricanes Florence and Michael continued the trend of catastrophe severity into the second half of 2018.

Continued Demand for Cyber Insurance

The continued increase in demand for cyber insurance has drawn additional capacity to the cyber arena, but carriers are also becoming more sophisticated in businesses with advanced control of their data will stand to benefit from better pricing, and those that have not made the investment in such controls may see higher cyber insurance prices.

According to AM Best, the US cyber insurance market grew significantly in 2017, with direct premiums increasing more than 30% over the
prior year. And according to a report conducted by Zion Market Research, the global cyber insurance market accounted for $4.2 billion in 2017 and is expected to reach $22.8 billion globally by 2024, growing at a combined annual rate of about 27% between 2018 and 2024.

### Three Key Exposure Trends

#### 1. Insurers Are Embracing Big Data: How This Benefits Businesses

Insurers have always collected a wealth of data, but historically, their legacy systems don’t allow them to use the information effectively. As carriers upgrade their customer interfaces and improve their data analytics platforms, the carriers will be able to more effectively tailor pricing, products, and services for each customer. Further, predictive analytics and artificial intelligence (AI) continue to evolve and allow carriers to improve their risk selection and pricing—and to use data in forward-thinking ways.

Improved data collection and analytics have massive implications on the claims side as well. Carriers can better facilitate claims handling by applying automated decision algorithms, and can reduce fraud through better detection algorithms.

Making the jump to a data-driven company will be a challenge for many of the large insurers who are still constrained by legacy systems. Those that adapt and evolve early have a distinct competitive advantage in selecting and pricing risk.
2. Impact of the Internet of Things on the Industrial Sector

The Internet of Things (IoT) is already transforming the American household and the insurance that covers it. Accelerometers, gyroscopes, GPS, and other sensors provide critical information on driving patterns. "Smart homes" provide temperature-change data, water-flow data, and other indicators that help prevent or mitigate losses. The number of connected devices is currently estimated to be somewhere around 25 billion. That number is expected to reach about 30 billion by 2020.

The number of IoT connected devices worldwide will go up 400% from 2018 to 2025. The impact of IoT is also expanding into the industrial sector. Diagnostic sensors provide data on nearly every type of industrial machinery. Automatic shut-off systems help avoid or mitigate a myriad of potential property and workers' compensation losses. GPS and impact sensors help track sensitive or valuable cargo in shipping containers, while telematics are used in commercial fleet management.

Insurers may face technologically superior and more agile competitors from outside the insurance industry (such as Google, Amazon, and Softbank) who are also hungry to collect and utilize this data. The widespread use of IoT devices in the commercial sector also carries risk along with it: IP and customer/patient data may have an increased risk of being stolen. Each integration point of any IoT device carries an additional point of vulnerability, and
safeguarding a highly connected business will become increasingly difficult for IT security professionals.

3. How the Changing Landscape of Work is Affecting P&C Liabilities

In 2018 and beyond, as the gig economy expands and communication technology further develops, we are likely to see a continued shift away from the traditional workday and fixed employment locations to part-time, on-demand, and independent contractor arrangements. For the employer, this shift away from the traditional workday and fixed working locations creates potential issues around workplace safety, ergonomics, and injury prevention. Non-traditional work arrangements also require employers to carefully consider worker classification—as employees or independent contractors.

Larger, multistate companies will need to consider the classification laws of each state. In California, for example, the recent Dynamex decision will put a heavy burden on employers to properly classify their workers under the new "ABC test." Any businesses operating in California that currently classify workers as independent contractors should meet with legal counsel to review the relationship under the "ABC test" and determine whether any or all such workers should be reclassified.

Technology advancements and a changing workplace environment are creating opportunities for businesses to better mitigate risk—while also requiring them to address new or evolving risks.

Overcapitalization resulted in ongoing soft market conditions for many areas of the insurance market in 2018 despite catastrophic events. However, the pricing of auto, property, and cyber coverages remains in flux. Further, technological innovation and workforce/workplace evolution are creating new dynamics in the insurance industry. Rest assured that Woodruff Sawyer is staying abreast of these changes to expertly guide clients through the complex landscape.
Property Market Update

by

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In this look ahead to 2019, we focus on our answer to the question we raised at this time last year: Can (re)insurers will their way to a hard market? Our answer: Not so much.

Property carriers didn't get their hard market, but don't feel sorry for them; they're doing just fine. In fact, many are doing more than fine even in the wake of the worst loss year on record. The 2017 hurricanes, wildfires, and earthquakes hurt earnings, but surplus remained intact or even grew thanks to continued reserve harvesting, well-performing stocks, and rising interest rates boosting bond portfolios.

Meanwhile, clients are getting their claims paid with rate increases that are modest compared to the previous 10 years' cumulative rate decreases. Further, underwriter scrutiny is encouraging clients to take an in-depth look at catastrophe and risk management strategies. Everybody wins.

Well, everyone except perhaps the National Flood Insurance Program (NFIP), and eventually regular citizens like you and me. The NFIP stands to pay $9.7 billion in claims related to the 2017 storm/floods, though it should recover $1.04 billion from its reinsurance policies. The program's debt was $0 in 2004 (before other notable storms like Katrina, Rita, and Wilma in 2005, and Sandy in 2012), and has since borrowed $39.4 billion from taxpayers and repaid $2.82 billion.

The NFIP was extended yet again, from July 31 to November 30, so Congress has a few months to theoretically right the ship.
From a commercially insured standpoint, FEMA's adjusting and claims-paying process was surprisingly efficient based on what our clients saw in Hurricanes Harvey and Irma. The private insurance sector can't bridge the gap on NFIP policy pricing, so we imagine political pressure will renew the NFIP with more of the same—actuarially unsound rates but happy (commercial) consumers.

A Decade of Blissful Ignorance

After a $49 billion 10-year loss average, the $135 billion loss year in 2017 did not bring the rate changes (re)insurers had hoped. The middle market saw no changes in rates. Large, standalone property renewals saw rate changes of 0%–5% for businesses with no losses and little catastrophe exposure, an average of 5% for those without losses but catastrophe-exposed locations, and palatable ranges of double-digit increases for the accounts contributing to the $135 billion industry loss figure.

The more notable outcomes from the record loss year were a return to underwriting and a reminder of the challenges around percent deductibles and business interruption claims adjusting, after evolving contracts went largely untested for 10 years.

Insureds previously unaware of their large net positions on cumulative per-location deductibles have a renewed understanding, and (un)appreciation for what goes into documenting loss of income and extra expense claims.

The marine industry (including cargo/stock throughput) was harder hit with losses relative to premiums, and as a result, that market has seen some hardening. London has the majority share of that market and is under added scrutiny by management at Lloyd's to become profitable, and we are seeing that manifest in double-digit rate increases.

Underwriters are paying closer attention to limits, deductibles, and protections against traditional cat perils of wind, flood, and earthquake, but adding wildfire and hail to that list—events which had largely been covered as All Risks (i.e., non-cat perils).
Competition from the domestic market has helped mitigate many of those increases, though companies relying on significant capacity and tenured carrier relationships have felt the reversal in rates on those lines of coverage.

**A Robust Property Market with an Achilles Heel**

If hurricanes, earthquakes, and wildfires aren’t enough to disrupt the property market, the systemic exposure to business interruption from cyber perils could be.

The 2017 NotPetya malware showed the world how attacks that aren’t even aimed at specific businesses can bring those businesses to their knees. Global mammoths like Merck, FedEx, and Maersk suffered losses of $780 million, $400 million, and $300 million, respectively, and property insurers are facing claims for a peril they did not charge for and made every effort to exclude or sublimit.

On one side, this is a glaring exception to the risk-sharing and risk-transfer partnership property insureds rely upon for that bottom-line protection, and on the other, it is a glaring unrestricted exposure on every outstanding property contract. The potential that many of these attacks are state-sponsored blurs lines on proximate causes like war or terrorism, adding more layers of coverage questions that are still unanswered.

The standalone cyber market is evolving at surprising speeds to give those orphaned cyber business interruption coverages a home. While that market first arose to cover third-party damages, it is beginning to provide first-party business interruption. And where contingent supplier coverage once referred only to third-party software or IT providers, it has now expanded to cover cyber losses of suppliers or customers disrupting the insured’s physical supply chain.

The property market hasn’t thrown in the towel yet. FM Global is investing in its engineering expertise to add cyber security to its loss mitigation capabilities and maintaining its current cyber coverage where others are carving it out. The standalone terrorism market in London is offering cyber exclusion buybacks as another option for insureds wanting to add coverage to existing policies before committing to the expense and larger retentions of typical cyber policies.
Predictions for 2019

Property Rates
We expect property rates to hold steady but stricter underwriting to remain. If the 2018 hurricane season produces moderate losses, as we've seen thus far with Lane, Florence, and Michael, we expect rates to soften once again in 2019. This season has produced some of the strongest storms in recent history, albeit in less-concentrated insurance markets, so exposed insureds and carriers will be on high alert for the next few months.

Deductibles
Insureds facing rising deductibles or those burned by percent deductibles and frustrated by adjusting business interruption claims can explore alternative retention structures and parametric trigger products.

Cyber
We'll see growing investment in pre-loss cyber security by insureds, mostly outside the insurance space, and property and cyber forms will continue to evolve to address the changing risk, loss by loss.

We chalk up 2017–2018 as a year of lessons that will serve our property insureds well in the long run. Testing contract wording and rate adequacy for catastrophic events guarantees a healthy insurance market for clients, and keeps innovation a priority for carriers and insureds alike.

Sources:
Munich Re, Insurance Journal, Business Insider, FEMA, WIRED.com
Casualty Market Update

by

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Casualty insurance is a blanket term for four relatively common insurance types: auto liability, general liability, umbrella liability, and workers' compensation. Insurers often quote them as one bundle, though each does operate within its own market. Because these four insurance products are subject to different market trends, the overall casualty market can go different ways depending on which segment is the topic of discussion. We will give some specifics for all four areas and provide a sense of recent trends and what businesses can expect going forward.

Workers' Compensation

Here we've consistently seen the softest casualty coverage with average rate reductions of about 2% nationally. The workers' compensation combined ratio (losses and expenses versus premiums) has declined every year since 2010 and kept the rates down. Workers' compensation insurance is currently operating in a buyers' market. For example, California buyers have enjoyed better than average rate reductions. We can expect more of the same in the future.

Telemedicine, which makes it easier for employees to see doctors, is a promising trend that could ultimately help reduce the cost of lost-time workers' compensation claims.
Auto Liability

The Auto liability sector has been difficult in the last 12 months for many reasons. As a harder market, this segment of casualty insurance differs from the others, and no end is in sight for this trend. For the past 12 months Woodruff Sawyer has seen steadily increasing auto liability rates. By now most business clients are aware of this trend, and increases have been expected and accepted by most as the "new normal" for this line of coverage.

The primary reason for the rate increases has been an industry-wide experience of premiums not covering the losses since 2011. Every year since then, the combined ratio for commercial auto has exceeded 100%. As a result, rates are increasing and most insurers will not write auto insurance without a supporting line of business.

The rate increases from insurers to date have yet to yield profitable results, so there seems to be no end in sight for this trend.

To mitigate rate increases we suggest clients take proactive steps and share them with insurers:

• Develop hiring practices with respect to employees who will drive.
• Include details on how often MVRs (Motor Vehicle Records) are run.
• Identify the consequences of moving violations, i.e., when are driving privileges revoked?

• Determine the minimum personal limits required of employees who drive on the job.

For businesses with trucking or transportation exposures, a key is to differentiate yourself from the crowd. Including the following additional information in your underwriting submission can help:

• Radius of average trip
• Details on any telematics included in the vehicles to monitor driving
• Information on any installed car safety systems such as automatic braking

To mitigate auto rate increases, differentiate yourself in your underwriting submission.

General Liability

The general liability sector has not seen significant increases or decreases in recent history, though certain clients may see changes in their policies. This is currently the most stable of the casualty coverage lines with clients averaging between -2% and +2% in their premiums.

We expect more of the same for most clients as there is plenty of capacity and no compelling trend to justify premium increases. Exceptions would be for clients with a history of significant loss, or a tough products liability exposure.
Umbrella/Excess Liability

As a cover for various primary insurance policies, umbrella insurance (also called excess liability) covers further costs when primary policies run out. While a general or auto policy might be for $1 million, umbrella insurance can provide another $5, $10, or $25 million on top, saving clients from purchasing larger policies for each primary insurance layer.

Clients commonly add umbrella insurance to their bundle, so it’s important to understand that it can be impacted by the primary liability markets underneath it. For example, if you have a tough product exposure on an auto policy (perhaps a truck fleet that carries hazardous materials), cost increases there will flow up to your umbrella policy.

In general, umbrella market conditions remain soft with a lot of capacity. This is especially true above the lead umbrella layer (usually $25 million) with many carriers fighting for the shrinking premium dollars.

The exception is accounts with large auto fleets, especially heavy trucks that drive long distances (typically greater than a 200-mile radius). For these accounts, expect premium increases and/or an increase in attachment point for auto liability coverage. Meaning, an umbrella insurer may require a larger primary auto liability limit.

Market capacity remains abundant and we expect continued softness across all casualty markets. Even clients seeing some increases in the lead umbrella can often offset those increases with reductions in excess layers.

Overall, the casualty insurance market is still soft and ideal for buyers. The one exception to this is auto liability, and we encourage clients to note the underwriting strategies we’ve outlined above when heading into auto renewals. Differentiating yourself from the rest of the pack can help mitigate rate increases and reduce costs for the entire business.

**Umbrella liability market conditions remain soft, especially above the lead umbrella layer.**
Change is in the Air for Aviation Insurance

by
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It seems increasingly likely that 2018 will be seen as a pivotal year in the latest aviation insurance market cycle. After years of low rates and intense competition, the aviation market is showing signs of change. Aviation insurers have long been dissatisfied with premium levels, but the unprecedented amount of available capacity has made the implementation of increases inviable. The result is a protracted soft market. While aviation rates have declined for years, the cost of paying aviation claims has been rising.

**The Impact of Market Consolidation and Exits**

Things appear to be changing in terms of capacity; consolidation continues through mergers, acquisitions, and aviation markets exiting the aviation space altogether. XL and Catlin Merged in 2015, followed by ACE and Chubb in early 2016; and more recently, Axa completed the acquisition of XL. In 2018, Hiscox, Ortac, and Berkley completely withdrew from the aviation insurance market and Amlin and Brit withdrew from General Aviation. The last significant hardening of the aviation market came with the tragic events of September 11, 2001. Worldwide, aviation insurance buyers experienced premium increases, some of them very substantial.

A few years after 9/11, these premium levels began attracting new players to the aviation insurance marketplace. This newly crowded marketplace set in motion an historic price decline and a broadening of coverage that continued through 2017.

The events of 9/11 hardened—but then led to a softening—of the Aviation market that continues today... for now.

**Duration of the Soft Market**

To put the incredible duration of this soft market into perspective, think of it this way: If you had a corporate business jet operation between the mid-2000s and the end of 2017, you likely experienced a premium reduction at every renewal during that period.

Over that same period, however, as the cost of the insurance plummeted, the cost of paying aviation claims has continued to increase. Aircraft repair costs have gone up, as have the costs of resolving bodily injury claims. For aviation insurers to maintain profitability, they would argue, a change is overdue. The aviation insurance marketplace has flirted with increases on a few occasions over the past 15 years, but there was always too much competition among the carriers for those increases to take hold.

With some insurers now heading for the exits, things feel differently this time around. It’s too soon to predict the direction with certainty and definitely too soon to be concerned.
Most of the world's aviation premium is placed in the fourth quarter, so the trajectory of the market will clarify by late 2018/early 2019.

Aviation Insurance 101: The Three Primary Classes

Aviation is a diverse industry in terms of the innumerable aircraft types and their uses, airport operations, the broad manufacturing base, and emerging technology, such as drones. Consequently, the effects of this market change won't look the same to all aviation insurance buyers. The 2017 Q4 airline renewal season has set the tone for 2018 and the future. To better understand this, let's take a look at the three main segments that comprise aviation insurance from an underwriter's perspective:

- Airlines
- Aerospace
- General Aviation

Among these three main segments, this impending market change will look and feel a little different.

There are numerous subclasses within each of these primary classes of aviation insurance. Insurers approach these primary classes of aviation insurance differently—different rates, different appetites, and in some cases, entirely different underwriting teams.

For a loss-free corporate business jet operator, for example, this hardening market could simply halt reductions in the short term. The insurer of a critical aircraft parts manufacturer with some recent losses, on the other hand, will likely seek an increase.

### Insurance Marketplace Realities: Aerospace

2018 Spring Update on Commercial Insurance in North America

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Most of the world's aviation premium is placed in the fourth quarter, so the trajectory of the market will clarify by late 2018/early 2019.

As the Market Changes, So Does Your Aviation Broker's Role

Veterans of aviation insurance sometimes joke that a recent crop of young aviation insurance brokers have never experienced a hard market. For nearly 15 years, aviation insurance buyers have known only fantastic news, but along with a hardening market, aviation brokers must be prepared for new challenges.
During a soft market, an aviation broker's role might consist primarily of establishing a renewal strategy with the client, assembling good underwriting information, marketing the coverage, and advising the client as they navigate many great, competitive options. While the fundamental role of a broker won’t change over the course of a market cycle, a harder market dictates a different dynamic in the broker-insurer interaction, and a shift in the broker’s approach is in order.

As the market hardens, underwriters become more selective; it's far from certain that a broker will end up with several competitive quotes. The broker’s ability to generate interest, i.e., to "sell" an account to a tentative marketplace, takes on greater importance.

**Tip:** Talk to your broker about where your risk profile fits on the spectrum and how you’ll likely be affected by this market change. Begin developing a renewal strategy several months prior to renewal. As we conclude 2018, we will closely monitor the aviation insurance marketplace in order to fully understand premium and rate movement and changing insurer appetites, and advise on the optimal risk management and insurance strategies. We look forward to providing further updates on this dynamic marketplace in 2019.

### 5 TIPS FOR DEALING WITH A HARD MARKET

1. **Develop a collaborative strategy** months before expiration: Your broker should discuss market conditions, establish a marketing plan, and set goals for the upcoming renewal.

2. **Understand how the risk is being perceived** in the marketplace: What corrective action can we take in our marketing to counteract any negative perception?

3. **Invest time** in the creation of a professional, comprehensive submission: Thorough, high-quality submissions matter. It’s imperative to invest the time needed to generate maximum interest.

4. **Highlight loss prevention/loss mitigation initiatives:** A broker must demonstrate to the marketplace what sets this risk apart from the peer group.

5. **Organize opportunities to meet insurers in person:** A broker must give the client a forum to tell their story in their own words. Sometimes that personal connection can make a big difference.
Captives: An Efficient Risk Management Tool or an Over-Engineered Solution?

by Chris Kakel

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Captive insurance has many far-reaching benefits as a risk management tool and is a growing solution for many companies as part of their overall risk management strategy. The captive insurance industry has continued to grow over the past 10 years+ (although some leveling off recently) despite a sustained period of low interest rates and a soft insurance market. While it is effective for many, it is not a one-size-fits-all strategy; so it’s important to analyze its feasibility in the context of your particular company.

In this article, we'll unpack some of the benefits of this alternative to self-insurance, but also examine the common challenges with this strategy. We'll also drill down into the largest area of industry growth: 831b captives. Here, we'll explore what is driving this growth trend and where captive owners should take caution when pursuing 831b captives.

### What is a Captive?

In its simplest form, a captive is a wholly owned insurance subsidiary of its parent, functioning in the same way as a commercial insurance company. A big misunderstanding is that a captive lets organizations assume more risk. Rather, a captive can be a risk management tool assisting the financing (or funding) of the selected amount of retained risk, leaving the decision for how much risk to retain independent of the captive. For example, if a company is looking to increase retentions on its insurance program, it can decide to do this whether a captive exists or not.

### Common Captive Benefits

The benefits of a captive fall into two basic categories: economic and strategic. When reviewing a captive as a strategy, it’s important to analyze it in contrast with an alternative, which is commonly a high retention program not using a captive.

From an economic standpoint, the main benefit of using a captive to finance risk is that it accelerates the tax deduction of captive premiums paid, leading to a lower after-tax cost. Captive premium expense is deducted when the premium is paid, versus a non-captive program where the paid losses are expensed over time.
Apart from the economic benefits, captives offer strategic, value-added benefits, from solving for coverage needs of uninsurable or underinsured risks to formalizing risk retention among subsidiary companies, to direct access to reinsurance markets.

**WHAT ARE THE BENEFITS OF A CAPTIVE?**

- Solves for coverage needs of uninsurable or underinsured risks
- Formalizes risk retention among subsidiary companies
- Provides direct access to reinsurance markets

The cost of capital and the commitment associated with funding a captive and holding reserves is the other reality that prevents many companies from forming captives. If the captive is earning 2% on the funds held, a company that can generate a higher return (by pursuing M&A, paying down debt, etc.) might prefer to allocate that capital to those higher-return investment areas versus tying it up in a captive.

From a strategic standpoint, the common deal breaker, apart from the time commitment, is that there isn't always a meaningful value-add that the captive is bringing when compared to the existing strategy. It’s a long-term commitment, so it’s important to consider the incremental benefits and how that compares with the alternative.

**831b Captives are Enticing**

The growth of the 831b captive marketplace is in large part due to the unique value proposition these captives bring in contrast
with other types. Specifically, these captives don't pay income tax on underwriting income (yet still allow the entity funding the premium to deduct the insurance expense), creating a compelling economic advantage for these captives. Think of traditional types of business risks that might be insured through these captives, such as litigation expense or loss of a key customer. The current premium cap for captives that can elect this treatment is $2.3 million on an annual basis.

Since these captives commonly insure low frequency/high potential severity types of risks, an 831b captive adds near-term expense (administrative costs) for the company.

831b captives don't pay income tax on underwriting income but allow the entity funding the premium to deduct insurance expenses.

Over the long-term, however, for the tax reasons above, it's extremely efficient to finance these risk areas because the underwriting income isn't taxable.

The other main strategic benefit of these captives is access to reinsurance for these retained captive risks through risk pools, where risk is shared among other small captives. This helps smooth the profit and loss volatility in the captive. Since they are commonly uninsurable in the commercial insurance market (examples include loss of key customer or litigation expenses), risk pools also provide true risk transfer that is cost-effective and adds value.

**Scrutiny from the IRS**

While the compelling economics have led to the growth of 831b captives, it has also led to abuse, drawing the focus of the IRS. When exploring these strategies it's important to be compliant, working with reputable consultants to ensure the strategy can ultimately stand up to close scrutiny.

Despite headwinds, captives remain a robust strategy that thousands of insureds utilize, funding hundreds of billions of dollars in annual written premium. As part of your ongoing risk management strategy, it's worth regularly considering captives in terms of its value and alignment with your business.

Determining whether a captive is right for your organization can be a challenge, given the diversity of captives and the range of problems they can help solve. In your evaluation, objectively challenge and isolate the true advantages for your company. While there are many potential benefits, keep in mind that many areas commonly cited as benefits aren't truly unique to captives.
Social Engineering in Cyber Crime: Your Workforce is the Target

by Rachael Cook

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in Criminology at Surrey University, England conducted a study and estimated that cyber crime will generate at least $1.5 trillion this year alone. Government, retail, and technology sectors have seen the most breaches and 43% of cyber attacks are directed at small businesses. According to Dr. McGuire, individual hackers may earn around $30,000 for one or several jobs while cyber-criminal platform managers can earn up to $2 million.2

Digital social engineering attacks are increasing faster than other types of business threats, according to a study conducted by security company Agari. Previously, it was much easier to spot generic phishing emails as they were often wrought with errors and the sender had little to no connection to the company. That is no longer the case. Business Email Compromise (BEC) scams cost $12 billion in losses in the last 5 years.3

You may be wondering, "What's social engineering, and what does it have to do with cyber crime?" If you haven't heard this term before, it's likely that you have heard terms such as vishing, smishing, phishing, malware, ransomware, impersonation, and watering hole attacks. These are all digital forms of social engineering designed to exploit the weakest link in any company's security: its people.

Social engineering, in the context of information security, refers to psychological manipulation of people into performing actions or divulging confidential information.1 These attacks are becoming increasingly common and sophisticated. Designed to bypass controls in technology, they typically involve some form of psychological manipulation over a period of time, tricking users into handing over confidential data, releasing funds, or shipping products.

Recent studies found that 62% of businesses have experienced a social engineering attack, and 65% of professionals surveyed identified phishing and social engineering as the biggest security threat to their organization².

Digital social engineering fraud can be lucrative. It's cheap to implement and the risk is seen as minimal, making this one of the fastest-growing criminal trends as described by Interpol. Dr. Michael McGuire, Senior Lecturer

"Virtually every national security and criminal threat the FBI faces is cyber-enabled in some way."

FORMER FBI DIRECTOR JAMES COMEY,
2016 testimony to the House Committee
Phishing, vishing, and impersonation are the top three methods used in digital social engineering attacks. It is estimated that 294 billion emails are sent each day and 90% of all email is spam or viruses. Phishing represents 77% of all socially based attacks. The average loss for targeted businesses is $42,546 per entity, according to social-engineering.org.

Today, these scams are growing more sophisticated and complex, targeting people rather than computer systems and preying on emotions that make us panic and react quickly.

With the growth of social networks, mobile apps, the sophistication of artificial intelligence (AI), and Millennials in the workforce, social engineering fraud and cyber attacks are expected to continue to evolve and threaten businesses. The recent shift to adopting cloud-based workloads is creating a higher security risk for companies, and according to a recent article on *Wired*, employees often bring unapproved outside devices and use personal applications in violation of IT policies, and are unconcerned with corporate security when using personal applications in lieu of corporate applications.

As an example, in 2012 YouTube and Skype were the most unapproved applications for businesses. However, today they are key social marketing tools and used as a preferred application for communicating with others in the workplace.

What to Do When an Attack Happens

It is now a matter of when, not if, you will eventually deal with a cyber attack or social engineering fraud. So, what’s a company to do? Here are some ideas:

- Defend your organization by securing computing devices with anti-virus software, firewalls, and email filters.
- Conduct real-world penetration tests to identify vulnerabilities.
- Create a security-focused environment by training employees in cyber security best practices to help them identify fraudulent emails, calls, etc.
- Provide guidelines to employees for handling information and actions to take if they become a victim.
- Review newsworthy cases and discuss what you would do if it happened to you.

At Woodruff Sawyer, we offer a comprehensive cyber security solution. Check out our feature on page 37.
Check Your Coverage for Social Engineering Attacks

Various courts have conflicting opinions regarding whether these losses are covered under the commercial crime policy:

• The Ninth Circuit upholds that these losses are unambiguously precluded from coverage.
• The Sixth Circuit upholds the Computer Fraud provisions of a commercial crime policy covering losses from an email payment instruction fraud scheme.

Today, social engineering coverage should be specifically added to crime coverage, cyber liability policy, or both. Although carriers have recently seen an increased number of claims, the coverage is still available in the marketplace and enhancements are continually being added to the coverage to keep up with the growing trends.

Sources:
Focus Feature:
Cyber Risks & Solutions for the Construction Industry

by
Mike Landuccion
Senior Vice President, Construction

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A recent survey from Forrester’s revealed that 75% of construction, engineering, and infrastructure firms have experienced a cyber incident within the last 12 months. As the exposure to cyber attacks grows, the construction industry must reset and analyze its overall risk profile to deal with such threats.

Contractors today rely more than ever on internet-connected solutions, remote access systems, social media, and multi-user platforms. While the technology in the industry has become much more digital and advanced, these businesses often have a low level of data security—a dangerous scenario given the valuable data they maintain, such as employee records and personal information, confidential claim details, credit information, etc. As a result, many construction firms have found themselves the targets of breaches.

Typical Cyber Attacks

Below are some examples of common cyber incidents:

- **Security Breach**: A construction company's unencrypted laptop was stolen after being left at a job site. The laptop contained confidential employee and customer information.
- **Social Engineering**: A large national construction company became the victim of a phishing scheme when an employee forwarded private information to a fraudulent email address. This single act exposed 566 social security numbers belonging to current and past employees across the state.
- **Cyber Ransom**: A large regional general contractor had its systems locked down by a hacker for ransom. To get back up and running fully, the contractor spent over $200,000 in consulting and technology services.

Creating a Solid Cyber Risk Management Program

Protecting your business against these cyber attacks involves creating a solid cyber risk management program. Such a program is multi-faceted and involves employee communications, IT measures, and physical security protocols.

More than 40% of our construction clients now purchase—or are strongly considering—
cyber insurance as part of their overall risk management and insurance programs.

Developing and communicating a cyber risk management program will teach employees to:

- Be aware of phishing schemes and assess the sender's address before clicking on links. For example: When in doubt, don't click.
- Encrypt laptops and implement a clean desk policy to ensure hardware security when you're not around.
- Be cautious when allowing entrance or giving access to your building. Keycard access and other given permissions involving electronic transmission have been the source of recent attacks.

**Risk Mitigation Tools to Get Started**

Here are some cyber security steps you can take to protect yourself, your clients, and your employees:

- Promote a proactive IT department that educates employees about how to identify phishing schemes and other attempts to gain access to your systems.
- Implement a robust data encryption approach with strong password requirements and frequent password changes.
- Use data assessment and profiling to ensure you only keep the information you need.
- Develop and execute an engaging and thorough security awareness program for employees.

- Adhere to industry standard patching cadence for antivirus, operation systems, and software.

**A solid cyber risk management program involves employee communications, IT measures, and physical security protocols.**

**How the Insurance Industry Can Help**

Once largely limited to technology firms, cyber insurance has emerged as the fastest-growing type of coverage among US companies. These types of policies should include coverage for breach response costs, network and information security liability, regulatory defense expense, media liability, business interruption, and cyber crime.

Outside of transferring risk to insurers, you may not realize that the insurance industry actually helps with operational assessment of cyber risks as well as incident response if a cyber attack occurs.

1. **Risk Identification**

   Insurers collaborate with leading cyber security professionals to provide a range of risk identification and assessments services. These include assessments against standard cyber maturity models, security policies and
procedures development, penetration testing, and tabletop exercises of existing incident response plans.

2. Incident Response
Many insurance carriers offer turnkey solutions for incident response from a panel of expert vendors as part of a cyber insurance policy. These vendors often start with a breach response coach (typically a law firm with significant cyber incident response experience), which can act as a guide through the turbulent experience of a cyber attack. Additionally, most carriers have pre-established relationships with experts in IT forensics services, ransomware negotiation, bitcoin acquisition, breach notification services, credit monitoring services, and public relations services to help you respond to a cyber incident. These are all available at rates often lower than you will find on the open market.

At Woodruff Sawyer, we offer similar services to clients as part of our comprehensive Cyber Security Solution. (See our feature at the right).

At the end of the day, raising awareness of cyber exposures and identifying response resources will protect your construction business. All industries are vulnerable to attack. Even in the construction industry, you’re likely using technology in ways that make you vulnerable. It’s imperative that you identify and understand your cyber exposures, are prepared with incident response resources in the event of a breach, and better yet, are proactively protecting your company by establishing robust cyber security plans and systems.
Woodruff Sawyer’s Cyber Security Solution

We believe that today’s cyber security services should be in four categories: risk assessment, risk transfer, incident response, and enterprise coverage evaluation. The first of these is addressed through a new service called the **Cyber Services Network**—a service that gives clients access to vetted third-party cyber security specialists who:

- Provide risk assessment and cyber breach preparedness services
- Identify and develop security measures to protect your business and mitigate cyber attacks
- Help you fully understand your business risks and develop solutions to limit your exposure.
Punitive Damages: Unpredictable but Worth Solving

by

Kristine Furrer

Senior Vice President, Client Success

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It is rare to be found guilty of and punished for punitive damages, but when it does happen the consequences are often financially devastating to a company and/or individual. Let’s explore the details and discuss which forms of coverage are best for covering all the bases.

What are Punitive Damages?

Punitive damages, also known as exemplary damages, are a monetary amount awarded to a plaintiff in a civil lawsuit for the purpose of punishing the defendant and hopefully deterring similar future misconduct. Forty-eight states in the US allow punitive damage awards but differ in the way they determine, treat, and allow insurance for such damages.

Did you know? 48 US states allow punitive damage awards.

Twenty three states do not allow punitive damages to be insurable by US insurers, but there is more to this than meets the eye. Courts in each of these 23 states have ruled that it is against public policy to allow insurance coverage for punitive damage awards, since having an insurance company pay (rather than the client) would defeat the purpose; the damages are meant to punish the defendant, not the insurance company.

However, while nearly half of US states don’t allow insuring punitive damages for a defendant’s own conduct, some now allow punitive damages to be insurable for vicarious liability, which is when someone is held responsible for the actions or omissions of another person.

Punitive damages come into play in three main areas:

- Healthcare claims related to patient care and products such as drugs and devices
- Other types of product liability
- Employment practice liability centered on illegal hiring practices
### Chart of Punitive Damages by State

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Directly Assessed Punitive Damages</th>
<th>Vicariously Assessed Punitive Damages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
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<tr>
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<tr>
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<tr>
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</tr>
<tr>
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<td>Wisconsin</td>
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<tr>
<td>Wyoming</td>
<td>Insurable</td>
<td>Insurable</td>
</tr>
</tbody>
</table>

1. It’s assumed that in states where there is no specific authority, vicariously assessed punitive damages are insurable if directly assessed punitive damages are insurable.
2. Nebraska does not recognize punitive damages in any form.
3. Virginia does not recognize the vicarious imposition of punitive damages.
4. Punitive damages are insurable unless awarded for intentional conduct. (Source: International Risk Management Institute)
In a workplace context, an employer can be liable for the acts or omissions of its employees if those actions can be shown to have taken place in the course of their employment.

Punitive damage awards are infrequent. The conduct of the defendant needs to show significant disregard for the safety of others for the court to consider punitive damages for the plaintiff. Although the instances are limited, in certain circumstances a jury has the power to impose punitive damages, so you must take into consideration the level of uncertainty created by the involvement of a jury.

Punitive damage coverage is available at a reasonable cost, and worth the investment.

Many companies remained uninsured when it comes to punitive liability. But they should understand that coverage is available at a reasonable cost, and worth the investment if it means avoiding potentially high costs and resource drain in the event of a claim. Even if punitive damages coverage is unavailable and uninsurable in your state of operation, it can be obtained.

How Most Favored Venue (MFV) Coverage Can Help

All liability policies should include Most Favored Venue (MFV) coverage. This is a common coverage enhancement that is widely available and should be placed whenever possible on all US liability policies.

Most Favored Venue coverage is a provision in some policies stating the law of the jurisdiction most favorable to the insurability of punitive damages will apply. The jurisdiction must meet specific criteria.

A well-crafted MVF endorsement covers the client for punitive and exemplary damages by requiring the carrier to apply the law of the jurisdiction most favorable for determining the insurability of punitive damages. This approach works as long as the location of the client’s operations and other claim factors support it; this includes a jurisdiction with favorable treatment of the insurability of punitives.
Filling the Gaps with Wrap Coverage

In the early 1990s, Bermuda insurers started offering punitive damage wrap policies (wrap) designed to fill the gaps created by inconsistent US regulations at the state level and US insurers' inability to provide an affirmative punitive damage coverage grant to their insureds.

Wrap policies fill in the punitive and exemplary damage exclusions in US insurers' policies and provide coverage just for that exclusion. A wrap policy does not increase the total limits available to the insured; it simply broadens the US policy to now have one less exclusion.

Wraps are available for both claims made and occurrence policies. They are most common for product liability, employment practice liability, and healthcare professional exposures.

The argument against punitive damage coverage is that cases settle; therefore, the risk of punitive damages being awarded is eliminated. However, when you have the punitive damage coverage, you can remove some of the financial risk of a trial.

Our Advice

As with many risk transfer products, you won't know if they make financial sense without reviewing your particular exposures, the breadth of coverage, and the cost. Put this topic on the agenda for your next renewal strategy meeting. Punitive damages are not common. But they are insurable and reasonably priced, so it's worth the conversation.
Protecting Your Revenue

by

Joe Feigenbaum

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**Why do companies go to such great lengths to insure almost every aspect of their business, but fail to look out for the one component without which they couldn't survive?** Companies can’t live without revenue, yet less than 5% of US companies purchase insurance to account for bad debt, like bankruptcy.

Toys "R" Us folded under a $6.9 billion bankruptcy in 2017, and Claire's is facing a $1.9 billion bankruptcy this year. If one of these companies were your customer, their inability to pay you would have serious impact on your income. Increased bankruptcies for brick-and-mortar retailers (the Amazon effect), trade wars, Brexit, and other events are further fueling financial uncertainty. Yet US companies still assume bad debt can’t happen to them.

**Examples of Large Bankruptcies in 2018**

<table>
<thead>
<tr>
<th>Company</th>
<th>Amount of Liabilities/Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Claire's Stores Inc.</td>
<td>$1.9B</td>
</tr>
<tr>
<td>Southeastern Grocers/Wynn Dixie</td>
<td>$1.5B</td>
</tr>
<tr>
<td>Nine West Holdings Inc.</td>
<td>$1.5B</td>
</tr>
<tr>
<td>The Bon-Ton Stores</td>
<td>$1.0B</td>
</tr>
<tr>
<td>Remington Outdoor Brand</td>
<td>$700M</td>
</tr>
</tbody>
</table>

**How Does TCI Work?**

Trade Credit Insurance (TCI) provides accounts receivable protection from loss due to bankruptcies and delinquent payments.

A TCI policy is typically written to cover a company's entire portfolio of customers. Limits are approved based on the current outstanding balance and peak sales estimate. Policy premiums are based on annual customer sales. You can tailor coverage to protect trade credit risk associated with multiple buyers (a company's largest customers to protect against concentration of risk), a company's foreign customer portfolio, or even for a customer that is either large or concerning—perhaps privately held and not sharing financials.

**TCI for Sales and Growth**

TCI can open up the sales channel to an existing customer. For example, if your company has set an internal limit of $5 million per customer but the insurance underwriter can provide coverage of $10 million, you can now encourage the customer to buy more, assuring that your revenue stream up to $10 million is protected.

**TCIs can open up the sales channel for new business as well as existing business.**
TCI also increases sales and growth related to potential new customers. If a company wants to do business with a prospective customer but can't get financials, a letter of credit, or any sort of payment guarantee (such as cash on delivery) from that customer, the transaction is unlikely to proceed. But if a buyer limit is available from the TCI carrier, not only can a company sell to a new customer, but they can also offer favorable terms, knowing that the receivable is insured.

**TCI Gives Visibility to Credit Worthiness**

TCI also helps augment a company's internal credit function. Financial information on private companies often isn't available, so determining the credit worthiness of a buyer (your potential customer) can be difficult. However, TCI carriers typically keep information in databases with millions of company profiles, or they can reach out and request financials from buyers (your customers). Insurance carriers are usually successful when they request financial information because buyers want to know that trade credit companies have approved them for coverage.

To take the point further, TCI can help you manage risk. Since TCI carriers constantly monitor the financial health of the companies they insure, they are in the unique position to provide timely alerts in the case of negative information. Specifically, if a carrier is aware of adverse financial information for a particular buyer—either from a financial review or because another trade credit client has reported overdue payments—they immediately reach out to all customers carrying limits on the specific company and notify them of the issue. Companies are able to quickly act on this information and reduce or completely eliminate exposures to a bankruptcy.

**TCI insurers will provide timely alerts should negative financial information emerge about the companies they insure.**

With respect to the banking component, TCI can assist in either improving or increasing the terms of a company's own line of credit.
TCI provides additional security to any bank loan that is linked to a company's outstanding accounts receivables. This added protection can be useful when trying to negotiate a lower interest rate or a higher line of credit.

**How to Get Started with TCI**

To get quotes, you typically only need the list of customers to be insured, a recent aging report, and a short application. Carriers can provide a premium and coverage indication usually within a week, though if coverage is for just one or two buyers, a quote can be issued usually within several days.

With the volatility that comes with doing business and the many factors outside of your control—such as your customers' financial soundness, global political environments, and tight credit markets—there's no reason why a company would turn away from protecting revenues especially when trade credit insurance can also lead to growth and improved risk management.
About Woodruff Sawyer

As one of the nation's largest insurance brokerage and consulting firms, Woodruff Sawyer protects the people and assets of more than 4,000 companies. We provide expert counsel and fierce advocacy to protect clients against their most critical risks in property and casualty, management liability, cyber liability, employee benefits, and personal wealth management. An active partner of Assurex Global and International Benefits Network, we provide expertise and customized solutions where clients need it, with headquarters in San Francisco, offices throughout the US, and global reach on six continents.

For More Information
Call 844.972.6326, or visit woodruffsawyer.com.

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