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Madison Insurance Group – Insuring Enterprise Risk and Loss of Revenue because of Supply Chain Interruption, Loss of a Key Customer, Cyber-Attack, Ransomware or Reputational Brand

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CEOCFO: ***Mr. Sims, what is Madison Insurance Group?***
Mr. Sims: Madison Insurance Group is a consultancy company that manages and operates two separate insurance companies domiciled in Puerto Rico. There is a direct-writing insurance company by the name of Madison International, which is a licensed property and casualty insurance company. It is authorized to insure businesses' enterprise risk. Enterprise risk is an insurable risk that businesses have if an event happens outside of their control and they lose revenue because of that event, such as a supply chain interruption, loss of a key customer, cyber-attack, ransomware attack, or reputational brand. These are risks that a known.

Physical peril does not have to happen for them to lose revenue such as a building being destroyed in a hurricane or a business being destroyed in a hurricane. These are specific events that could happen that would interrupt the revenue. What the policies would replace is not the loss of the gross revenue, but if they lost net income because of the revenue, their overhead cost associated with the revenue and that is what these policies reimburse. At Madison Insurance Group, we manage Madison International that insures those types of risks. They fall under the category of low probability and high severity type risks.

Most other insurance companies will insure business interruption risk, but there has to be known physical peril loss like a fire, hurricane flood, or something like that. The Madison International policies are more specific to a known loss like a loss of key talent. If you have a key person in your business and they leave or something happens to them, they don't have to die or become disabled but they leave for any reason out of your control and you lose revenue and income. Those are reimbursable.

CEOCFO: ***Do most businesses or businesses that should be using your services, know that this type of policy exists?***
Mr. Sims: No. Most of the policies they do not know they even exist with the exception of cyber. Most businesses do not know they can insure those risks.

CEOCFO: ***Have most businesses heard of it, or is it a new category?***
Mr. Sims: It is not a new category; it is just not a well-known category. Most businesses when they think about enterprise risk think of procedures and protocols that they put in place to manage those risks. Sometimes some of the best procedures and protocols are put in place and still, something could happen that is unforeseen or out of their control.

One of those biggest risks is cyber. Most commercial insurance companies cover cyber but most have what are called sub limits. You have a million-dollar total coverage but if you have a ransomware attack they won't cover it or if you have a hack and they steal an insured's data, most insurance companies will limit the policy to maybe $100 thousand. The Madison International policies don't have sub limits ~~or~~ and they cover ransomware. Most people don't understand they can buy it and they don't know it exists.

CEOCFO: ***How do you reach potential clients and educate the business world in general about Madison?***
Mr. Sims: The distribution channel is where we work with outside advisors. With Madison International, because the policies are so unique, because they are so specialized, the businesses direct-procure the policies from Madison International.

Madison International uses advisory groups that have a direct connection to who is the advocate of the business, to the business owner or owners, such as CPAs. Maybe they are attorneys wealth advisors or risk managers. It is unique because Madison International is considered to be a foreign insurance company. It is based in Puerto Rico but they are not an admitted carrier to any of the States.

The business direct-procures the insurance policies directly from Madison International and we work with the advisory firms that have the relationships with the business or business owners.

"If people could buy insurance, know that risk is covered by a third-party insurance carrier, but if they mitigated the risk and had little or no claims, and they no longer needed the insurance, such as with the sale of their business, wouldn't it be nice to collect all of that underwriting profit and investment income off of your own good risk management. That makes it more palatable for businesses to want to buy these types of coverages." Mark Sims

CEOCFO: ***What goes into crafting a policy for a specific company and how do you evaluate if a company is right for this type of insurance?***
Mr. Sims: Just like any insurance company, we are going to underwrite the company's risks. Some of the policies are considered to be direct reimbursement. One of the policies that would be a direct reimbursement is Madison International will insure for legal defense costs and expense reimbursement. When a business gets sued and goes to court the most expensive part of a lawsuit is the legal costs to defend. For example, Madison International considers insuring a business for legal defense costs and expenses. However, if the business has had four lawsuits in the last two years, Madison is either going to offer lower limits while underwriting a higher premium or not insure them at all.

Everybody goes through an underwriting process just like any insurance company. Insurance companies do not buy risks. In other words, if I have a business and my building is on fire, I can't pick up the phone and call a commercial insurance company and say "Hey I need a property liability policy now because my building is on fire." They will say no. We are going to make sure that they are a good insurable risk. That is how we determine. We then decide what risks they have.

Each insured business is required to complete a risk assessment questionnaire (RAQ). The RAQ will ask about their company where they are located and what they do. The RAQ will then ask specific questions on whether they have key customers, what percentage of the revenues these customers are. We ask if they have key talent, we ask what they do on social media; we ask what kind of risk management procedure and protocols they have for cyber to guard against a cyberattack. These are just some examples that the RAQ will ask.

CEOCFO: ***Is there an algorithm you use to decide?***
Mr. Sims: Madison International uses independent, outside actuarial firms. Once Madison International underwriters collect data, they assess the risk and send it off to an outside independent actuary who determines the policy limits and

the cost to insure. They will assess the risk and determine the premium based on the RAQ and other data collected from Madison's underwriters. I am not an actuary; I don't want to be an actuary. Actuarial methodologies and principles are math, it is assessing data but it works. That is how all insurance companies will determine assessed risk and the correlating premium for the risk assessed.

CEOCFO: ***Would you tell us about the tax advantages your approach provides?***
Mr. Sims: When a business purchases insurance from a third-party insurance company that is licensed and regulated as such, and meets the common notions of insurance which is the sharing of insurable risk with unrelated parties in the commonly accepted notions of insurance. When you and I buy insurance we are paying a premium to an insurance company, but we know we are going in with a pool of other people to share risk so that the law of large numbers can kick-in to accurately predict losses over a period of time. But only certain risks are insurable. For example, you can't insure a supply chain interruption policy if the business has no suppliers. You also can't insure investment risk. The policies and the risks they cover are determined by the insurance company. If you buy insurance as a business and you are buying insurance that meets those common notions of insurance, then payment of the insurance premium to cover that risk is a necessary and ordinary business expense under the tax laws. This is no different than if I have a business and I buy commercial property insurance from State Farm where I get to deduct the premium paid as a business expense.

If you think about how insurance companies make money, they collect their premiums from their insureds, allocate a portion to their overhead costs, operational expenses, big buildings in downtown Manhattan, Jake from State Farm, etc. They also have to pay claims. After insurance companies pay their overhead, claims and expenses then whatever is left over (the underwriting profit) is given to people like Goldman Sachs and Morgan Stanley to make money on that residual underwriting profit. Said differently, Insurance companies make money on the investments made with the insurance premiums they collect.

In the Madison program, Madison International insures the risk no different than any other insurance company but it doesn't keep the premium. Instead, it reinsures its risks with a licensed Puerto Rico reinsurer named Madison Re, I.I.

CEOCFO: ***Why do they do that?***
Mr. Sims: Reinsuring its risks with Madison Re (1) provides support and stability for Madison International while (2) allowing the insured (or someone within the insured's economic family) to realize the investment income and underwriting profit associated with its own risks. Madison RE is unique in that it is organized as a Protected Cell reinsurance company, which allows it to segregate the reinsurance premium it collects within itself through the use of various protected cells. Madison links its segregated accounts to the insurance policies and premiums it collects to fund 50% of any claim that the business had on any of the policies that were linked to that segregated account. The other 50% of that claim is paid by the Madison RE pool account. When the business pays those premiums, they flow down into that linked segregated account. It is in these segregated accounts where the insured's underwriting profits flow. Underwriting profits in the Madison program are all the premiums they pay less the expenses that they are paid to Madison International and Madison RE, less any of the business' owned claims. Once segregated to the separate account, the premiums are invested and can grow with reduced tax friction.

Madison RE owns and controls that segregated account. If an insured has any claims, Madison will go in that segregated account and fund 50% of that claim. If a business did this year after year and insures these policies, that by the way keeps these business owners awake at night, i.e. losing a key customer, having a supply chain interruption, having a reputational brand hit, getting sued, or anything that would interrupt their revenue they would be insuring against a potential, albeit low probability, financially catastrophic event. When the business pays those premiums each year, those premiums will flow into that linked account and will be invested and earn investment income. If the business managed to have little to no claims and they did that for several years and for whatever reason the business no longer needs the coverages anymore, all that underwriting profit and investment income gets to be returned to the owners of the business or somebody within their same economic family.

This program allows for a business to insure against the low probability, high severity type risks that keep the business owners awake at night but instead of those premium dollars going to the commercial black hole to be kept by the commercial carrier, they get the underwriting profit investment income returned. To the business owner, the reason they don't buy these types of coverage typically from a commercial carrier is because they may not be offered specifically and they are expensive to buy. Most business owners would say because it is low probability and expensive they will insure with the hope and pray method. They hope and pray it never happens because if it does, the claims are typically financially severe and they in most cases don't have the cash flow to support the loss. However, here they will have the coverage and if they don't have the loss, well that money does not go to the commercial black hole, but rather gets invested in the link and it can be returned.

CEOCFO: ***Do you deal directly with the clients?***
Mr. Sims: We do because the advisor is the trusted relationship. It is such a unique and sophisticated program, we educate the advisors and they know their clients. By the time they want to introduce the Madison program to their client, we get involved.

CEOCFO: ***When you are speaking with a potential client, can you tell if they understand the benefits?***
Mr. Sims: They get the part that they have the risk but they did not know they could insure it. Where it can get lost in the weeds sometimes is how the premiums flow and the mechanics of the segregated account. That takes maybe two or three conversations with the business owner the CFO or their risk management people. Most of them understand the concept right away but the advisor along with our people, helps them get to the details eventually if they are interested.

CEOCFO: ***Do events like the fires in California prompt interest and action?***
Mr. Sims: Those are a loss of revenues through an actual physical peril. What catapulted our company was COVID. For example, my wife and I remodeled our house and we bought these custom-made couches in April of 2021, we did not get them until May of 2022. The reasoning was they couldn't get the supplies to build them. That company lost revenue because they could not get supplies from a third-party vendor to build their coach because of COVID. The pandemic increased the awareness of companies losing revenue other than a fire, flood, hurricane, or whatever. It is more prominent now and the fires and things like that bring more awareness to the businesses on ways they can lose revenue.

CEOCFO: ***What does 2025 look like for Madison and for ERM in general?***
Mr. Sims: We look to grow exponentially because we are getting better at getting the message out that this exists. Madison has been around for 25 years and we think the outlook is great, but also the risk could potentially be greater for Madison. However, we are getting more sophisticated in our underwriting process and data collection and data management. We are no different than any insurance company; we have to mitigate risk. That said, we think the future is bright for Madison's growth.

CEOCFO: ***Put it all together, why should businesses mitigate risk through Madison Insurance?***
Mr. Sims: People do not like to pay for insurance; they do not like insurance until they have a claim. In most cases, and these fires are an example, they find out what is not covered. However, if people could buy insurance, know that risk is covered by a third-party insurance carrier, but if they mitigated the risk and had little or no claims, and they no longer needed the insurance, such as with the sale of their business, wouldn’t it be nice to collect all of that underwriting profit and investment income off of your own good risk management. That makes it more palatable for businesses to want to buy these types of coverages.