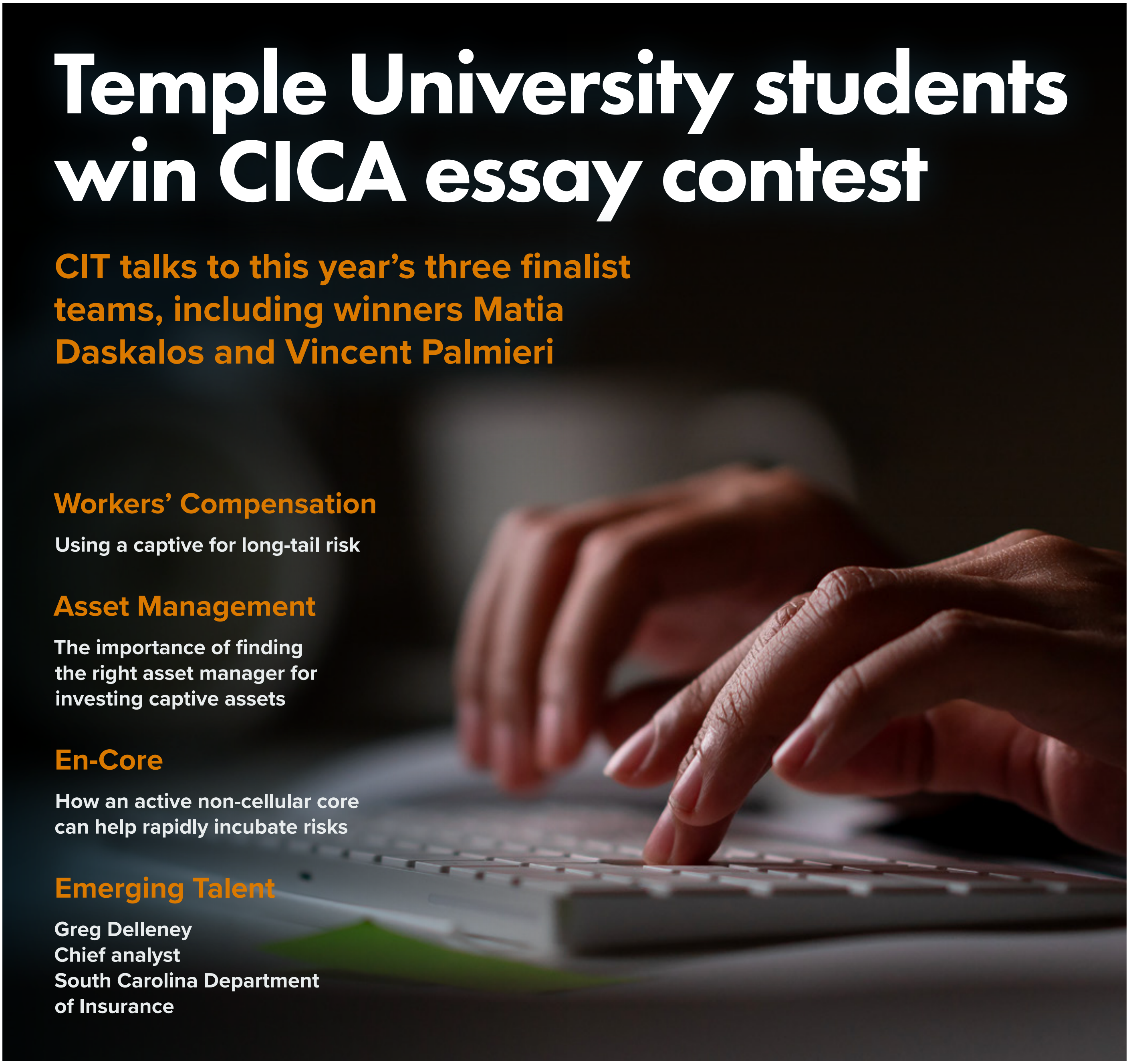
captive insurance times
The primary source of global captive insurance news and analysis
April 2022 - Issue 242



Temple University students win CICA essay contest

CIT talks to this year's three finalist teams, including winners Matia Daskalos and Vincent Palmieri

Workers' Compensation

Using a captive for long-tail risk

Asset Management

The importance of finding the right asset manager for investing captive assets

En-Core

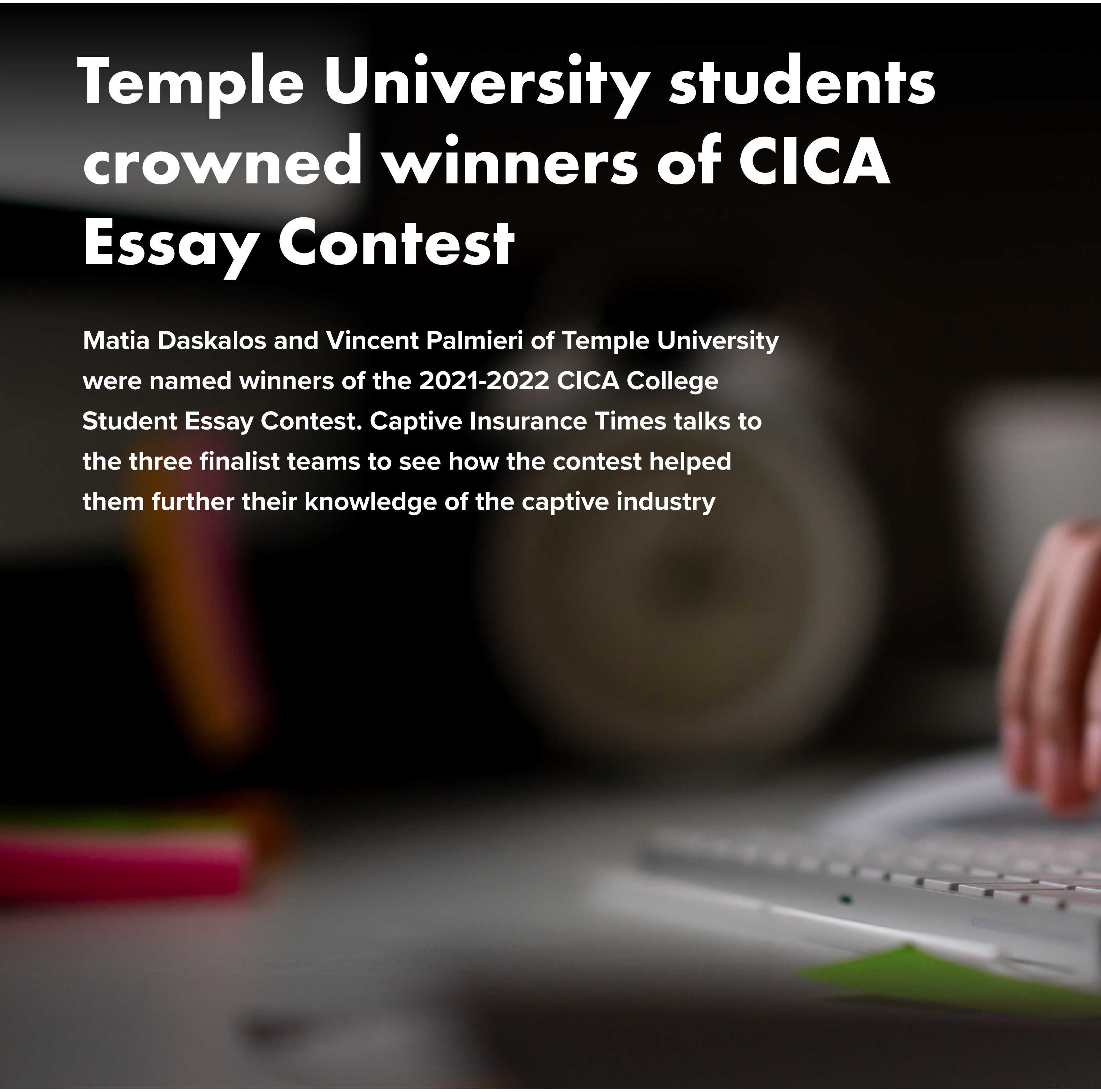
How an active non-cellular core can help rapidly incubate risks

Emerging Talent

Greg Delleney
Chief analyst
South Carolina Department of Insurance

Temple University students crowned winners of CICA Essay Contest

Matia Daskalos and Vincent Palmieri of Temple University were named winners of the 2021-2022 CICA College Student Essay Contest. Captive Insurance Times talks to the three finalist teams to see how the contest helped them further their knowledge of the captive industry



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Matia Daskalos and Vincent Palmieri, students of Temple University, have received first place honours in the Captive Insurance Companies Association (CICA) College Student Essay Contest, sponsored by Strategic Risk Solutions. Winning a cash prize of $2,500 for placing first, Daskalos and Palmieri proposed a group captive solution for the fictional case study of the American Cannabis Association.

The winners were announced at the annual CICA International Conference in Tucson, Arizona last month. All three finalist teams presented their case studies and answered audience questions during a conference session.

Both actuarial science majors, Daskalos and Palmieri say researching and writing their essay demonstrated the critical analysis and problem solving inherent in the development of unique and creative captive insurance programmes.

Following the CICA conference, both Daskalos and Palmieri have since received potential job offers to work directly in the captive insurance industry — demonstrating that CICA is accomplishing its aims of the essay contest to promote networking opportunities for young professionals.

Connor Thomson and Nicholas Vagnozzi of Saint Joseph’s University were awarded second place and a cash prize of $1,500 with their proposal of an association captive for the Craft Breweries Association scenario, while Katie Strohl and Blake Babec of Butler University were awarded third place and a cash prize of $1,000 for their group captive solution for the same case study.

1st Place: Matia Daskalos and Vincent Palmieri, Temple University

How was captive insurance helpful for your chosen industry?

Daskalos: Cannabis-related businesses struggle to find the right insurance coverage, but captives are the perfect solution which allow for a customisable structure tailored to their needs.

Palmieri: Since cannabis companies face a lot of adversity when attempting to find insurance, forming a captive is almost necessary. The inability to access proper coverages with existing companies is the main obstacle for these companies. By forming a captive, they can fulfil their coverage needs.

What did you learn about captive insurance while researching and writing your essay?

Daskalos: I learned how forming a captive can increase a company's control with programme design, increase capacity with reinsurance, and fill coverage gaps. I also learned the captive industry is vastly growing, with US$165 billion in gross written premiums in North America alone.

Palmieri: I learned that there are many different types of captives, and that a business has several options when it comes to deciding what type of captive to form. Additionally, contrary to my initial belief, a tax break should not be a main reason for forming a captive.

Would you consider a career in captive insurance?

Daskalos: Yes! The captive insurance industry can be a creative field in that it can be applicable to almost any industry. I hope to work with captives in some way, shape or form in my future.

Palmieri: I would definitely consider a career in captive insurance. It requires in-depth critical analysis and problem solving which is very rewarding. Captives are an under-utilised tool that offer so many benefits, and working in a more non-traditional role would help my professional development.

How does your college coursework align with a career in captive insurance?

Daskalos: Temple University's Gamma Iota Sigma had the honour of hosting Dan Towle back in April 2019 — Dan's presentation was the first time I was exposed to captive insurance. Our coursework in risk management and actuarial classes aligns well with a career in captive insurance because it prepares us to critically think about solutions for emerging risks in the industry.

Matia Daskalos

I am a senior actuarial science major at Temple University in Philadelphia.

I grew up in Albuquerque, New Mexico. I hold a part-time position at the Center for Student Professional Development in the Fox School of Business. After graduation, I hope to work in the property and casualty insurance market. Outside of school, I enjoy photography and dancing!

Vincent Palmieri

I am a senior actuarial science major who grew up in Lancaster, Pennsylvania.

I have always loved playing ice hockey, and I believe that playing has taught me a lot of skills that transfer well into my academic career, such as perseverance, determination and the willingness to take on new challenges. As a freshman at Temple, I became an undeclared business student, and declared actuarial science at the start of sophomore year and have not looked back since. Currently, I am a peer teacher for Actuarial Modelling 1 at Temple.

Palmieri: My coursework has rarely included information about captives, so being able to learn through research and applying it to a case study has been very valuable.

What did you think of CICA and the captive industry after being able to attend and participate in the CICA International Conference?

Daskalos: This conference excelled my professional development into the captive industry which, in my opinion, feels like a hidden gem. Every person I connected with was kind and willing to share their experience.

Palmieri: I was already interested in the captive industry prior to attending, but afterwards I decided that it is where I want to spend at least the majority of my career.

I enjoy the dynamic nature of the industry and how it requires problem solving on a case-by-case basis. The conference itself was a great experience and I enjoyed talking to like-minded industry professionals.

Were there any additional benefits to participating in the Student Essay Contest and the CICA International Conference?

Daskalos: Yes! After our presentation, a few employers reached out to Vince and I for employment opportunities. We made it known that both of us were looking for full-time positions after graduation. This conference was the perfect opportunity to showcase our knowledge and skillsets to employers.

Palmieri: I was able to improve my networking skills. I would say this is the most important activity for students to engage in, especially for business students. Along with this, I was able to develop my presentation skills.

As a result of the conference, I have found a job opportunity that is a perfect role for me. I have yet to secure the offer, but I do feel that I will end up in the role, and the CICA essay contest gave me a platform to showcase my ability to problem solve in a real world situation. This is something that is valuable to companies so they can ensure they are taking employees that can do more than just receive good grades in school. ■

Matia Daskalos

Vincent Palmieri

2021-2022

CICA STUDENT ESSAY CONTEST

Using Captive Insurance Solutions to Address Coverage Gaps

1

Fox School of Business
TEMPLE UNIVERSITY®

TEMPLE UNIVERSITY:

Matia Daskalos & Vincent Palmieri

AMERICAN CANNABIS ASSOCIATION

American Cannabis Association - Group Captive Solution

Matia Daskalos and Vincent Palmieri

Introduction

The American Cannabis Association (ACA) is an excellent candidate for implementing a captive insurance company. The cannabis industry is growing at an extraordinary rate and is on track to expand at a compound annual growth rate of 26.7% between 2021 and 2028 (*Grandview Research)*. Notwithstanding the cannabis industry's significant growth, marijuana is still considered an illegal Schedule I drug under the Controlled Substance Act of 1970. However, 18 states and Washington D.C. have made the recreational use of marijuana legal, and 19 states have made the medical use of marijuana legal, as illustrated in *Exhibit 1*. The inconsistencies between federal and state regulations across the country have created many challenges for the insurance companies to meet the risk needs of the cannabis industry. There is hesitation from commercial carriers to write or participate as a front in fear of having premiums or collateral taken as well as the fear of being prosecuted for aiding a federal felony. Despite traditional insurance companies' fears, cannabis businesses remain uninsured across all production and distribution stages including cultivators, transporters, and retailers.

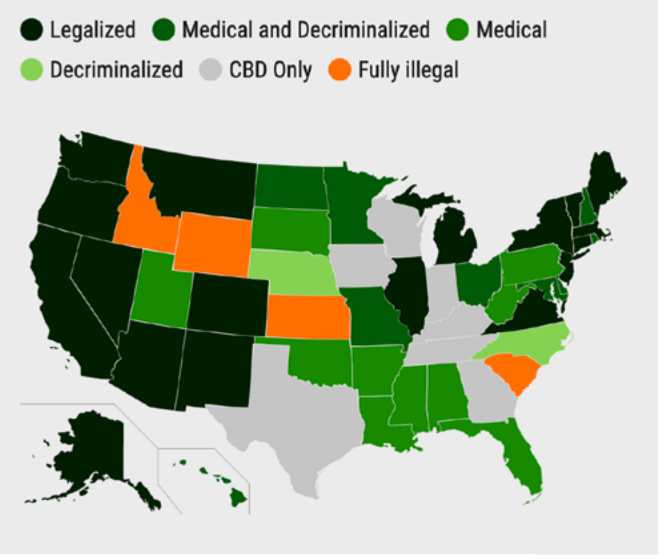


Exhibit 1: Legalization of Marijuana in the United States

The cannabis industry is in a position where it can handle significant losses under a well-managed captive insurance company. In 2021, the cannabis industry reached USD$250 million in premiums, and if properly insured with sufficient capacity, this figure could increase to USD$1 billion(Delaney). This essay will discuss limited insurance coverage options currently available within the cannabis industry, how the formation of a group captive insurance company could help meet the risk management needs of the cannabis sector, and how the ACA membership base could establish and operate its own group captive.

Current Insurance Landscape

Because of federal laws, it is no surprise that the cannabis industry struggles to conduct business with insurers, banks, and other third-party service providers. Perception and reputation are on the line for companies that form relationships with cannabis businesses. Insurance companies generally avoid the cannabis industry because of federal illegality. Banks avoid dealing with cannabis retailers because they are influenced by the Federal Government through regulations and also influenced by the Federal Deposit Insurance Corporation. The most significant bill pending in Congress today is the Secure and Fair Enforcement (SAFE) Banking Act. This act protects banks and financial institutions who decide to conduct business with the cannabis industry from federal penalties. If SAFE were to be passed by Congress it would create major shifts for insurers and banks when deciding to take on cannabis-related risks. Looking to the future, a rise in interest rates will pose yet another challenge for cannabis businesses making it harder for them to raise capital for future growth.

Risks for Cannabis-related businesses

Cannabis-related businesses face numerous risks across the entire supply chain. Cultivators face risks surrounding the growth of cannabis plants. If cultivators have an outdoor farm, it is subject to severe weather conditions. Crop insurance is one way to transfer risk to insurers, although the biggest problem with crop insurance is that the value of one acre of cannabis can reach a million dollars which is much higher than what crop insurance is designed for. Many cannabis farmers assume they will not qualify for traditional crop insurance, causing them to forgo the coverage. After the growing process, the product goes through a manufacturing plant which faces risks of cross-contamination and product liability exposures.

Transporting products across states is not possible because of individualized state laws. Cannabis businesses are subject to theft while transporting products and without proper risk management controls in place, these businesses could face significant losses. A way to transfer risk is by utilizing theft, fleet auto, and cargo insurance.

An outstanding 70% of dispensaries operate strictly in a cash-only environment which leaves them subject to high risks of theft, fraud, and violent crimes (NAIC). There is a lack of law enforcement to help protect business owners from these violent crimes. Increasing the amount of law enforcement will help prevent losses and theft insurance will transfer the risk.

Cannabis retailers are also susceptible to cyber crimes such as data breaches and ransomware attacks because of the amount of data involved. Any given customer must present a valid identification that is scanned in dispensaries and stored in a database that could be susceptible to hackers. The current insurance market offers cyber liability policies including kidnap and ransom coverages, although those who purchase these should be cautious of the "banned substances" and "Schedule One" exclusions. If a cannabis business fails to negotiate this language out of the contracts, their loss or coverage could be denied.

Every step of the cannabis supply chain faces risks that are currently unmet. Forming a captive allows a tailored approach to insurance and enables legal cannabis business owners to get the basic coverage they need, including general liability, product liability, and workers compensation. A captive can also help provide more individualized coverage such as crop, auto, and cyber coverage.

Advantages and Disadvantages of a Group Captive

Advantages: Member-owned group captives provide its members greater control of premiums, claims, and coverage. Group captives are wholly-owned and controlled by their members who are also insureds; their primary purpose is to insure the risks of their owners regardless of premium size. Each member is an equal owner in their insurance company which entitles each member to have one seat and one shareholder vote. This diversity across all types of cannabis-related businesses establishes a large pool of industry-specific knowledge that acts as a resource to prevent and decrease the frequency and severity of future losses. Group captives incentivize members to develop workplace cultures that exemplify best safety and loss prevention measures. Another advantage to a member-owned group captive is that it eliminates all of the unpleasant surprises with premium rate increases because it is not subject to the rise and falls of the traditional insurance market. Captives create capacity by allowing direct access to the reinsurance market. Members benefit from the group captive by receiving investment income earned on unused loss funds, capital, and cash collateral. The most significant advantage of a captive is that it provides coverage that would otherwise be unavailable in the commercial insurance market

Disadvantages: The captive industry is a heavily regulated market which poses its own disadvantages. As a result, it can be difficult to get a captive approved in a domicile with certain sources of risk that the captive will be insuring. Once approved, captive insurance companies must comply with their domicile's regulations, and if they don't it can lead to liquidation or shutdowns. However, once a captive is approved to do business, adhering to the regulations is a transparent and straightforward process. Another disadvantage of creating a captive is the high sensitivity to losses. A high variation between actual and expected losses can increase future premiums and raise required capital from captive owners. The third disadvantage would be the high start-up and implementation costs.

Group Captive Structure

First, we need to know how many members will be a part of the ACA group captive. There are around 24,000 registered growers and retailers across the United States. We assume about 10% of these business owners will choose to become a member of the ACA group captive. Our homogenous group captive will contain approximately 2,400 cannabis business owners, including growers, transporters, and retailers across many different states, creating a diverse demographic. Establishing certain criteria for members to meet prior to joining the Captive will help mitigate losses to some degree. Ideally, interested businesses would have to report better than average losses in the industry, but since the cannabis industry is relatively new, the criteria will start out as simply not having any abnormally large losses. As data is collected, members will be able to prove their financial stability in order to remain in the captive. Additionally, regular attendance to shareholder meetings will be required so members stay up to date. As of today, finding a suitable domicile is challenging with cannabis being a Schedule I drug. However, Nevada is currently the most accommodating location to establish the captive's domicile.

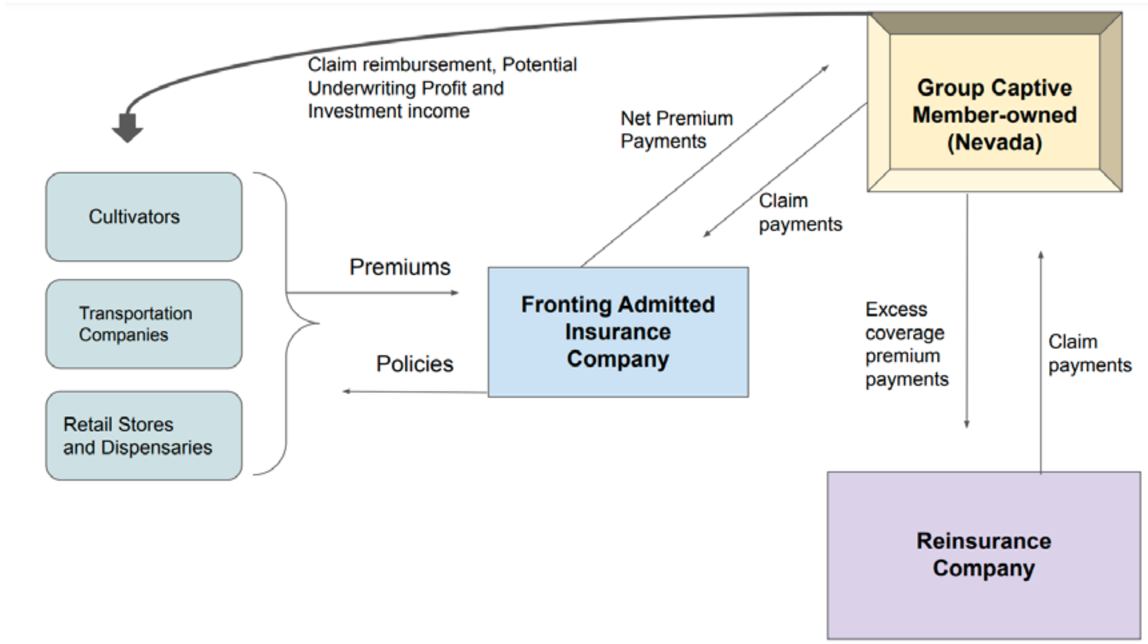


Exhibit 2: Group captive structure

Group Captive Operations

A commercial fronting company will be beneficial for underwriting services. The fronting company will charge around a 5% fee of the total premiums since they will be obligated to pay out claims if the captive fails to indemnify them. Captives are unlicensed insurers, so many states make a fronting arrangement a requirement in order to comply with domicile regulations. Utilizing a fronting company is a form of reinsurance with the captive remaining as the main bearer of risk. This is done by the captive and fronting company signing a fronting agreement which transfers the risk back to the captive. Even if the domicile does not make it a requirement, viewing the fronting company as strictly a form of reinsurance allows the captive to shift some risk over to the fronting company. This admitted insurer will be able to provide policies such as general liability and workers' compensation coverages. In the event the captive fails, the fronting company will take over claims. With cannabis being a schedule 1 drug, this is something we strongly suggest. Lastly, the bonus of the fronting company is that it allows the insured to be in a favorable situation when it comes to tax deductions. Although this should not be the primary motivator, it is an additional result of using this tool.

Before operations begin, a feasibility study would be conducted to decide if forming this captive will be the best action to take. Immediately after, we will develop a cost allocation to create transparency in the captive, so every member knows how their money is distributed. The following is how gross premiums will be allocated: 60%, 35%, 5% towards claim payments, basic expenses, and fronting fees respectively (*Exhibit 3*).

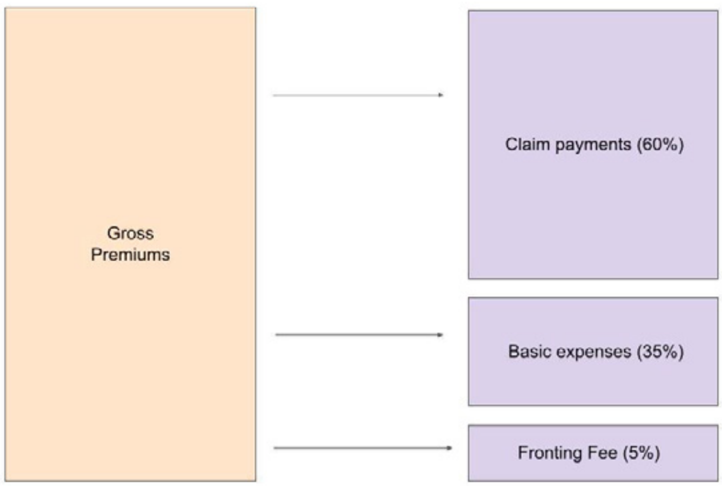
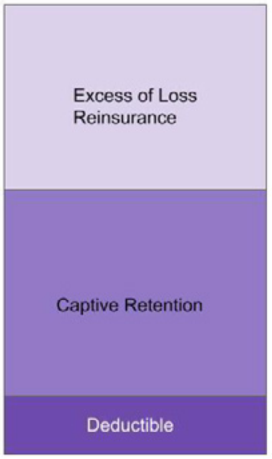


Exhibit 3: Gross premium distribution

Risk Treatment

Exhibit 4



Loss prevention is a risk treatment that creates a physical action plan to prevent and control losses. Workplace safety throughout the entire cannabis supply chain is critical to lowering costs of risk for each business and in turn means fewer workplace injuries. A small portion of each member's premium will be allocated towards loss prevention services as part of basic expenses (*Exhibit 3*). This will fund risk control workshops for members and provide at-risk members a consultant to enhance their loss prevention practices. The captive will be the most viable option to transfer risk from each business. A way to reduce the probability of severe losses is by diversifying the size and type of cannabis businesses that are in the group captive. A crucial way to retain risk is by holding reserves, which allows the captive to set funds aside for future claim payouts.

Package Policy

Our ACA group captive will have a customizable package policy with base coverage including general liability, product liability, workers compensation. In the first two years of establishing the group captive, only the base coverages will be offered. After the captive has matured, additional specialty coverages will be offered depending on the specific business needs. Cultivators receive crop insurance, transporters receive auto insurance, and dispensaries receive cyber insurance.

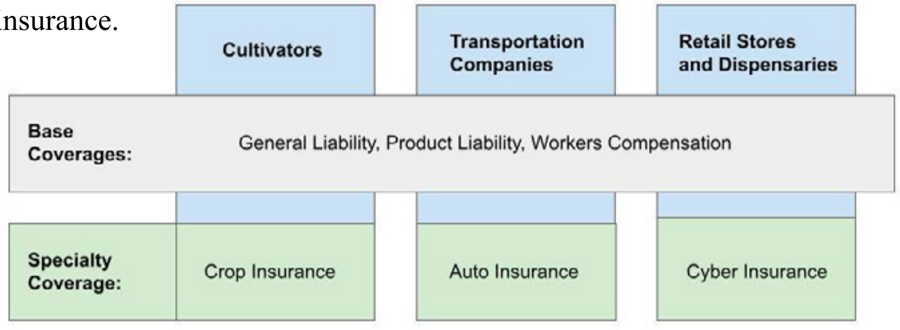


Exhibit 5: Packaged policy

Premium Development

Our captive will be partnering with an actuarial service company. In order for the actuaries to calculate accurate premiums, each member will need to submit their loss history over the past five years or if it is a new company the losses since operations began. The actuarially determined premium will be based on the expected claim losses plus operating expenses. The benefit of our captive is that even if members overpay, any unused premiums will remain internal. This allows the actuary to have a conservative approach when setting premium rates that will sufficiently cover claims. The first year of establishing our captive, all members will have to pay a membership fee which will be used for start-up costs as well as act as a security fund that will not be subject to the 5% fronting fee. If actual losses exceed expected losses in the first year, the membership fees will support these payouts. The more data is collected, the more accurate the actuarial estimates become.

Profit Utilization

When the actual claims in any given year are less than the expected claims the captive earns a profit. In order to make decisions easier, a threshold will be set to decide the amount at which we will start distributing dividends to members. Any amount of total equity under this threshold will be strictly used for investment income.

Profit Utilization	$A > E$	Profit = zero
	$A < E$ given $C < T$	Profits are invested
	$A < E$ given $C > T$	Profits over T yields dividends

Key:
A: Actual losses
E: Expected losses
C: Capital (Total Equity)
T: $X threshold set

Conclusion

The cannabis industry faces numerous challenges stemming from its legal status in the United States. A perfect alternative to the commercial insurance market for cannabis businesses is a group captive which will fill gaps in coverage, mitigate overall costs of insurance, and increase a tailored approach to preventing future losses.

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Connor Thomson and Nicholas Vagnozzi, Saint Joseph's University

What interested you about the CICA Student Essay Contest: Using captive insurance solutions to address coverage gaps?

Connor Thomson: I thought that the CICA Student Essay Contest would be a great way to learn more about a niche type of insurance. I saw it as an opportunity to expand my knowledge beyond textbooks and the classroom, and to showcase my advanced writing skills.

Nicholas Vagnozzi: The CICA Student Essay Contest drew my attention due to the unique product presented within its prompt. This contest provided me the opportunity to grow my exposure and knowledge within the industry, and open a wealth of understanding I previously had very little exposure to.

How was captive insurance helpful for your chosen industry?

Thomson: The Craft Breweries Association is a growing, homogeneous class that has been adversely affected by severe losses and volatile health insurance premiums as a result of the hard market conditions. A group captive for medical stop-loss coverage would offer specialised solutions that may help control rates and provide a sense of stability.

Vagnozzi: Captive insurance provided a very unique and niche allotment of benefits to the Craft Breweries Association. Primarily, a group captive would provide next-level insurance solutions able to support the industry, while providing innovative methods to control rates in a complicated market.

What did you learn about captive insurance while researching and writing your essay?

Thomson: While writing this essay, I learned that captive insurance is creative and innovative. The parent can tailor solutions to their specific needs with manuscript policies. I also discovered that captive insurance is very complex and the risks are unique.

Vagnozzi: While writing this essay, I learned that captive insurance is an innovative and high-level solution to some of the most complex and deeply-rooted issues the insurance industry faces. Captive insurance provides comprehensive and cutting-edge coverage to the most unique risks seen across all different industries.

Connor Thomson

I am a senior risk management and insurance major in the honours programme at Saint Joseph's University. I have passed five Chartered Property Casualty Underwriter (CPCU) exams, received the Collegiate Studies for CPCU certificate, and worked as a claims intern for the United Services Automobile Association.

After graduation in May 2022, I will be attending Villanova University Charles Widger School of Law as my goal is to practice as an insurance defence and coverage attorney.

Nicholas Vagnozzi

I am a senior risk management and insurance major at Saint Joseph's University. I have two years of work experience at Lyons Companies, shadowing accounts of publicly-traded companies and high-net worth individuals. Upon acquiring my Pennsylvania and Delaware property and casualty licences, I managed my own small book of business.

I recently accepted an offer to join Everest Insurance as an associate underwriter in their alternative solutions group focused in private equity.

Would you consider a career in captive insurance?

Thomson: Yes, I would definitely consider a career in captive insurance, as it is a fascinating and dynamic field.

My education at Saint Joseph's University and Villanova University Charles Widger School of Law will set me up for tremendous success as an aspiring insurance defence and coverage attorney.

Earning a Juris Doctor will allow me to advise captive insurance clients about formation, regulation and coverage gaps, as well as facilitate claims through a third-party administrator.

Vagnozzi: As of right now, I am currently pursuing a career in underwriting within private equity and professional liability at Everest Insurance — though as a student of the industry, captive insurance does interest me and is something I could potentially consider somewhere down the road in the future.

How does your college coursework align with a career in captive insurance?

Thomson: My college coursework at Saint Joseph's University aligns well with a career in captive insurance. Some classes I have taken include insurance company operations, property and casualty, underwriting, corporate risk management, enterprise risk management, and cyber law and liability. The Maguire Academy of Insurance and Risk Management (MAIRM) here does an amazing job bringing in professional guest speakers from across the industry.

Vagnozzi: The programmes provided by Saint Joseph's University and MAIRM align very well with a career in captive insurance. My risk management and insurance classes are based all across the industry, including property and casualty, insurance company operations, enterprise risk management and corporate risk management, and have all enforced an amazing insurance foundation for further development of knowledge in the captive industry. ■

Nicholas Vagnozzi

Connor Thomson

2021-2022

CICA STUDENT ESSAY CONTEST

Using Captive Insurance Solutions to Address Coverage Gaps

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SJU

SAINT JOSEPH'S UNIVERSITY:

Connor Thomson & Nicholas Vagnozzi

CRAFT BREWERIES ASSOCIATION

2021-2022 CICA STUDENT ESSAY CONTEST

Connor Thomson and Nicholas Vagnozzi

SAINT JOSEPH'S UNIVERSITY 5600 City Ave, Philadelphia, PA 19131

PERSONAL INTRODUCTIONS

My name is Connor Thomson, and I am a senior Risk Management and Insurance major in the Honors Program at Saint Joseph's University. I have passed five CPCU exams, received the Collegiate Studies for CPCU certificate, and secured two professional internships -- one handling loan policies of title insurance for V.I.P. Mortgage, Inc. and the other adjusting auto, non-injury claims for United Services Automobile Association (USAA). After graduation in May 2022, I will be attending Villanova University Charles Widger School of Law -- a top 53 program -- to earn my Juris Doctor. My goal is to practice as an insurance attorney.

My name is Nicholas Vagnozzi, and I am a senior Risk Management and Insurance major at Saint Joseph's University. I have spent the past two years working as an intern in part-time and full-time capacities at Lyons Companies -- an insurance brokerage in Wilmington, Delaware. I reviewed policies in the Quality Assurance Department, shadowed commercial and high net worth personal brokers in the Risk Management Department, and even placed captives with several accounts. On top of that, I gained my Property and Casualty License in Pennsylvania and Delaware and built a small book of business, which I managed as a busy college student. After graduation in May 2022, I will be employed as an Associate Underwriter (Alternative Risk Solutions) in Everest Reinsurance Group, Ltd.'s Private Equity Department.

Thank you for giving us the opportunity to compete in this student essay contest!

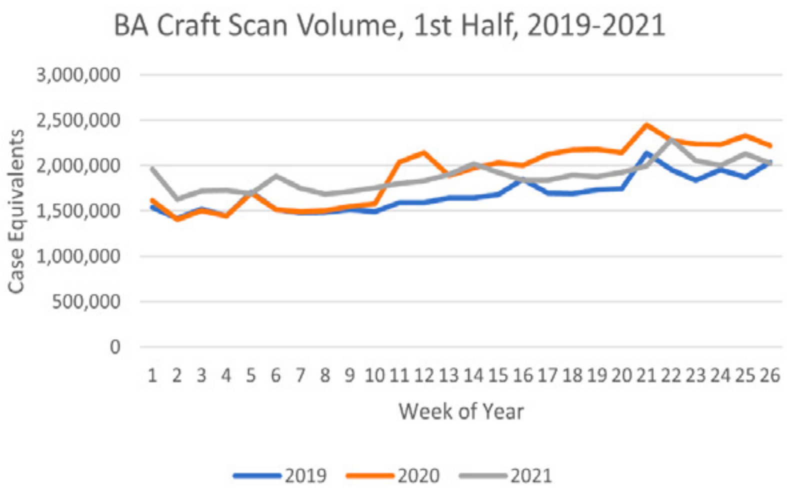
OVERVIEW

Craft Breweries Association

The Craft Breweries Association is the parent organization of over 6,300 member craft breweries throughout the US. These craft breweries are located in all fifty states, and they typically employ 25-75 full-time workers with a mix of part-time, seasonal personnel.

Craft Brewery Industry

According to *Brewers Association*, an American craft brewery is small and independent. Each firm produces roughly six million barrels of beer per year, and two of the most notable craft breweries are D. G. Yuengling & Son, Inc. in Pottsville, Pennsylvania and Boston Beer Co. in Boston, Massachusetts. They interpret historic styles and add their own unique twists with ingredients other than malted barley. Free from interest by non-craft breweries, this industry saw substantial growth from FY 2019 to FY 2020, but that has since slowed. The graph below shows the craft scan volume in case equivalents for the first halves of FYs 2019, 2020, and 2021.



Source: Brewers Association

Medical Stop Loss Coverage

Medical stop loss coverage protects against catastrophic and unpredictable healthcare losses. It is excess health insurance. If payouts surpass a certain threshold, a [captive] insurance company then becomes responsible. Essentially, it offers a layer of protection above what was already self-funded and "… provides a ceiling on the dollar amount of eligible expenses that an employer would pay…" under the commercial plan's deductible attachment point ("What"). We will focus on aggregate and individual medical stop loss coverage for this essay. The model on page eight elaborates on the loss fund layers.

Voluntary Benefits

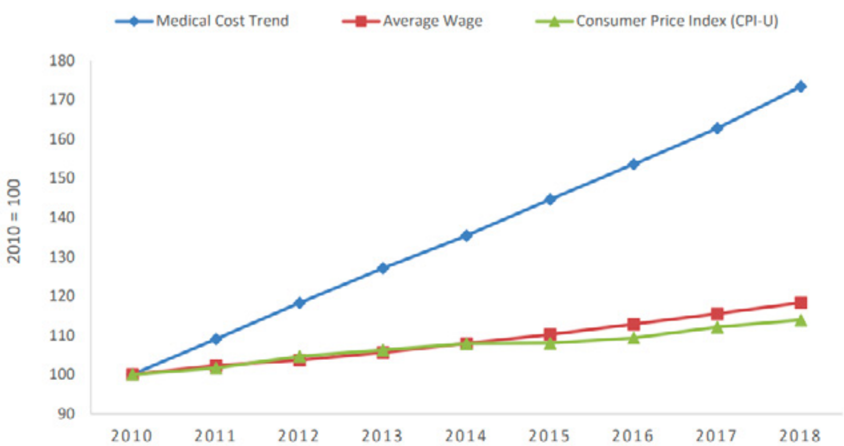
Voluntary benefits are, as they sound, voluntary. This coverage is optional, and the premiums are normally funded by the employer. They [voluntary benefits] "shield" employees, offer financial security, and may be used for critical illness, hospital indemnity, accident, life, and disability claims. Health insurance is *not* included in this mix; there is a difference.

ISSUE ANALYSIS

Rising Healthcare Costs (Broad Market Conditions)

Healthcare costs in the US have been on the rise since the 1960s. The total amount spent in 2018 was $3.6-3.8 trillion, and that number exceeded $4 trillion last year. What is causing this large increase -- one that has been outpacing median household incomes since 2011?

Figure 1: Medical Cost Trend is Increasing Faster than Wages and Inflation (2010–2018)
Source: PwC, Census, BLS, CAHC Calculations

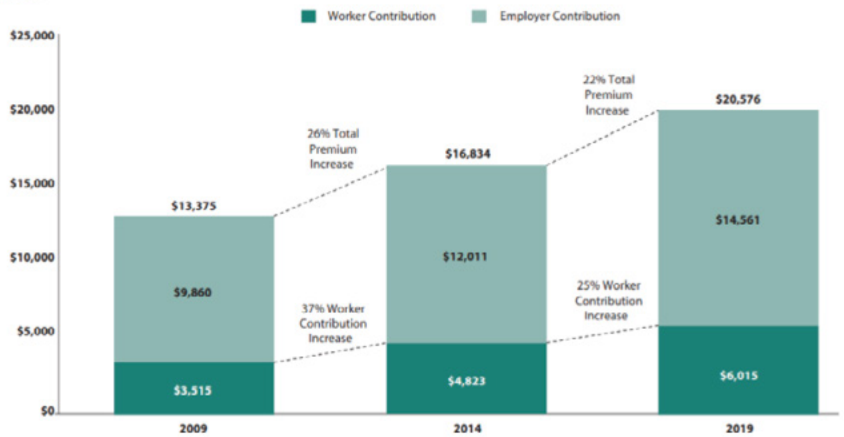


Government policies like Medicare and Medicaid have allowed private insurance companies to raise their rates, and our country is experiencing a growth in senior populations, chronic illnesses, and unhealthy habits. Americans' physical and mental health standards are declining, generally speaking, and that has been exacerbated by the COVID-19 pandemic. It is estimated that healthcare costs will amass to $18,000 per person by 2028 (Probasco).

We believe that rising healthcare costs for independent American craft breweries is a high frequency-high severity risk. They are burdensome for small business owners and entrepreneurs. The 6,300 member craft breweries under the umbrella of the Craft Breweries Association typically employ 25-75 full-time workers and likely do not have limitless capital or a designated HR representative to support their skilled staff.

In 2014, the Affordable Care Act (ACA) required businesses with over fifty full-time workers to provide their employees some form of health insurance. Most craft breweries still offer health insurance as a part of their benefits package even if they employ under fifty people. Paul Siperke, the co-owner of Fat Head's Brewery in Middleburg Heights, Ohio, has been doing that since 2009 "despite some pretty dramatic volatility in rates" and slowed growth (Sarah). He said, "One year we got a 38 percent increase, another year we got 11. One year we got three" (Sarah). A majority of the full-time workers at Fat Head's are in their 20s and 30s, and they are young and enthusiastic. Siperke stated in disbelief, "It just seems odd that we get such a drastic price increase when nothing has really changed with us as far as our employees and health issues" (Sarah). According to the graph below, there has been a 48% spike in employer-sponsored health insurance premiums for family coverage over the past decade-or-so.

Figure A: Average Annual Worker and Employer Premium Contributions and Total Premiums for Family Coverage, 2009, 2014, and 2019



SOURCE: KFF Employer Health Benefits Survey, 2019; Kaiser/HRET Survey of Employer Sponsored Health Benefits, 2009 and 2014

If we use Fat Head's as a sample case study for the 6,299 other member craft breweries, it is clear that the rise in healthcare costs is due to broader market conditions. Fat Head's employees are Millennials who remain in superb shape; however, there are factors on a macro level that cause severe losses and volatile premiums. Without a captive, there is no way for the Craft Breweries Association to control these two issues.

ASSOCIATION CAPTIVE

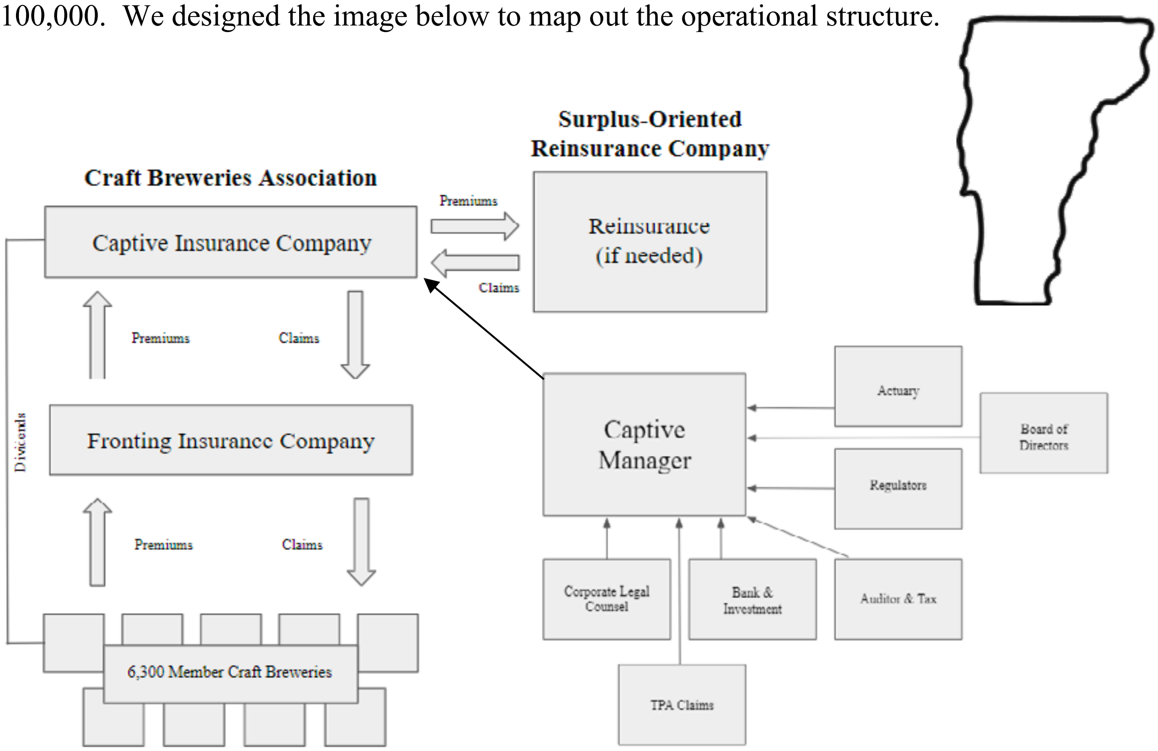
Why an Association Captive?

A captive is an alternative risk retention vehicle that comes in many different molds. We chose an association captive, also known as a group captive, because its primary purpose is to insure the risks of homogeneously sponsored members (owners). It will offer the Craft Breweries Association certain benefits like improved loss forecasting, increased loss control, and specialized loss treatment. The law of large numbers declares that more exposures will result in a more accurate forecast of future losses. 6,300 *similar* member craft breweries may help achieve a combined ratio of less than 100% -- an underwriting profit, which could be applied towards reserves or used in the form of dividends. Additionally, an association captive's "sharing of losses" encourages members to enforce safety and controls, so no [craft brewery] feels like they are generating more than [their] 'fair share' of claims expenses" ("What"). Lastly, "a group captive has the ability to retain higher levels of risk than each of its members could retain on a stand-alone basis … [and] can provide catastrophic coverage limits that commercial markets are unwilling or unable to offer" ("What").

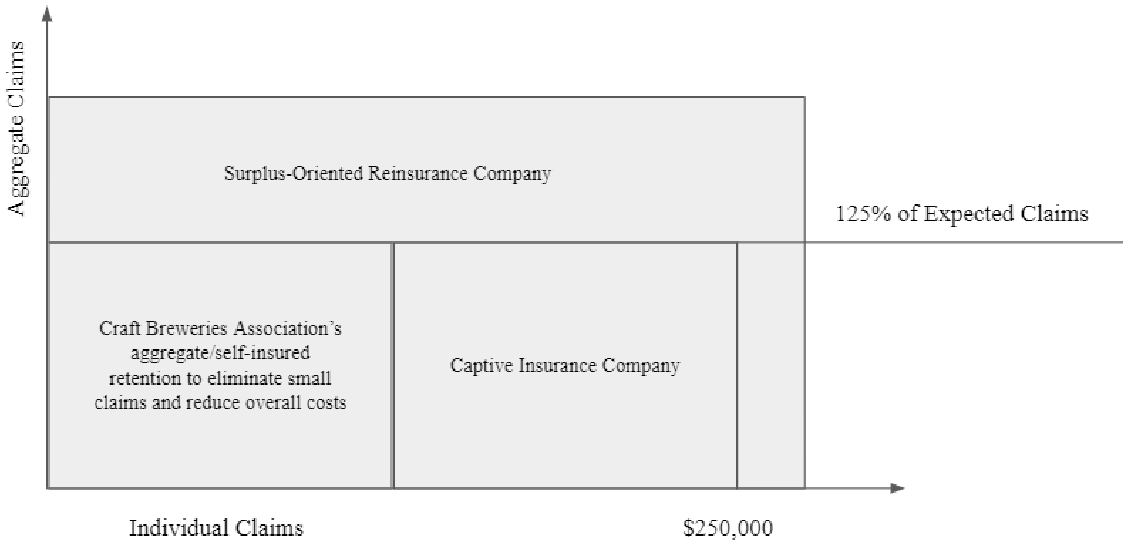
This structure will also mandate that each craft brewery pay a premium based on their past claims history. An association captive promotes equity, facilitates long-term cost stability, and saves 10-30% because it eliminates an insurance company's immoderate overhead.

Operational Structure

The group captive for the Craft Breweries Association will be domiciled in Vermont, US. Vermont is the largest national market for captive insurance companies because of its favorable corporate laws and robust regulatory environment. As of now, the minimum capital and surplus requirement in Vermont is $250,000, but legislation has been proposed to lower that number to $100,000. We designed the image below to map out the operational structure.



The fronting insurance company will cede all risks to the group captive and issue manuscript policies to the 6,300 member craft breweries. Some benefits of this arrangement include customized coverage, more affordable premiums, greater underwriting, claims, and loss control expertise, a possible "preferred vendor" relationship, insurance certificates, and tax deductibility. A caveat, however, is the cost. Fronting insurance companies may charge anywhere from 6-10% of the gross written premium. Nevertheless, we believe that the rewards of this operational structure outweigh the risks. We created the pseudo-A/B loss fund model below to demonstrate how it relates to medical stop loss coverage, specifically.



POLICY OPTIONS

The group captive for the Craft Breweries Association will include provisions in their benefits program, which may help the member craft breweries stabilize and reduce their rising healthcare costs. The specific underwriting factors for their manuscript policies will engender tiered premiums, not one-size-fits-all. Mitigation premium discounts will also be given to firms that invest in employee wellness and mental health counseling initiatives.

Tiered Pricing

"Group business" is underwritten according to the structure and needs of the insured group -- hence the name. With tiered pricing, the 6,300 member craft breweries will benefit from cheaper premiums that take into account the details in the matrix below. While an individual health insurance application asks for someone's sex, height, weight, and pre-existing conditions, Munich Reinsurance Company evaluates the number of employees, geographic location, age distribution, and number of dependents for group health insurance.

	Gold Tier	Silver Tier	Bronze Tier	
Number of employees	75+ employees	74-25 employees	24-01 employees	
Geographic location	E, NE, MW	C, Pacific NW	W, S, SW, SE	
Age distribution	51+ years old	50-30 years old	29-21 years old	*must be at least 21 years old to work in a craft brewery
Number of dependents	04+ dependents	03-02 dependents	01-00 dependents	
	$450 per month	$350 per month	$250 per month	
	$5,400 annually	$4,200 annually	$3,000 annually	

This is a mock version of what the Craft Breweries Association's health insurance premiums will look like. For reference, in the current US marketplace, the annual cost of health insurance is $7,149 per enrolled employee. It is much higher than our example.

Mitigation Premium Discounts

We intend to reward the member craft breweries that take extra steps to prevent and reduce the likelihood of a material claim. The group captive will look to partner with the National Restaurant Association (NRA). The NRA has a program that costs seven dollars a month per employee for access to telemedicine visits and mental health resources. This is a simple but profound way to "care for the hardworking folks who work behind the bar and among stainless steel tanks" (Broesder). It will encourage the 6,300 member craft breweries' employees to remain in superb shape, physically and mentally, so they will not drive up group healthcare and prescription drug costs for non-work-related injuries or illnesses.

FEASIBILITY STUDY

Association Captive

According to *Capstone Associated*, "in the case of medical stop loss [coverage], an actuarial study should be the first step to make certain that … the resulting loss experience can support a medical stop loss program and to identify alternative costs. Once the actuarial analysis is complete, pro forma financial statements covering the next five years should be generated … to assess the surplus requirements and rate adequacy" ("Medical"). Because the Craft Breweries

Association already has the necessary capital to fund a captive's development, implementation, and formation, there should not be any issues. In fact, it is our opinion that an association captive is the best choice for the 6,300 member craft breweries. It is a growing, homogeneous class that has been adversely affected by rising healthcare costs, which are broad market conditions out of their control. A group captive for medical stop loss coverage will limit the severity of these losses and allow the Craft Breweries Association to avoid excess volatility.

Voluntary Benefits

It was just established that a group captive would be feasible for the Craft Breweries Association's medical stop loss coverage needs. However, the parent organization of over 6,300 member craft breweries has a long-term priority of offering voluntary benefits to employees as a "safety net." The statistic is that "52% of households … have less than $10,000 in liquid assets available for use in an emergency" *(Business Insurance)*.

There are some challenges because insuring employee benefits through a captive may be a "prohibited transaction" per ERISA. Since we domiciled the captive in Vermont, it will take approximately 12-18 months for DOL approval and over $500,000 in legal, tax, and advisory fees. Although captives for medical stop loss coverage are relatively straightforward and do not need a fronting insurance company, **one is required for voluntary benefits**.

Despite these drawbacks, we believe that it would be possible and advantageous for the Craft Breweries Association to implement voluntary benefits into their captive. They [voluntary benefits] tend to improve employee well-being and retention because the employer is "investing" in the health of their workers with ease. The premium is deducted straight from payroll at no charge to the parent. Firms may experience anywhere from a 20-25% net return on this strategy.

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Blake Babec and Katie Strohl, Butler University

What interested you about the CICA Student Essay Contest: Using captive insurance solutions to address coverage gaps?

Blake Babec: Captive insurance is such an interesting and unique field that drew me into the CICA Essay Contest. Writing this paper was enjoyable and gave me a chance to dive into a higher level of learning about captives.

The way each captive is established is unique and flexible to a company's needs, which is what I have found to be the best part of captives.

Katie Strohl: The CICA Essay Contest interested me because I got to learn about a different topic that I have not been exposed to much during my college career.

I can now appreciate the differences between the different types of captives and how they can be tailored to each company.

Katie Strohl

I am a senior at Butler University studying actuarial science and statistics.

I am from Boulder, Colorado but staying in Indianapolis, Indiana working for a life insurance company with the internal audit department.

I am very honoured to be a part of the CICA International Conference and expand my learning of the insurance industry!

Blake Babec

I am a senior at Butler University studying actuarial science and statistics. I am from Joliet, Illinois.

I am currently interning in Hylant's global captive solutions department.

I have taken an interest in captive insurance because it provides solutions to many unique problems. No two captives are alike, which makes them interesting to me.

How was captive insurance helpful for your chosen industry?

Babec: Captive insurance has provided another perspective for me as an actuary. When forming a feasibility report or any other type of actuary analysis, actuaries must consider the unique structure of a captive to accurately predict reserves and premiums.

Captives have provided a new window into how an actuary can make insuring risks cost-effective for companies.

Strohl: I am majoring in actuarial science so it has been helpful for determining the risk that companies endure while choosing insurance, and also to predict reserves for the most cost effective solutions.

What did you learn about captive insurance while researching and writing your essay?

Babec: Before I began my research for this essay, I understood what a captive was but did not necessarily know how one was set up and managed. Through my research, I have gained a high-level understanding of captive structures, implementation and management. I owe my greater portion of knowledge of captives to the preparation for this paper.

Strohl: I knew basic information on captives, but as Blake and I researched and wrote the essay I gained a deeper understanding of what each type meant and what it provided, as well as how it can be incorporated into my coursework that I have previously taken.

Would you consider a career in captive insurance?

Babec: Yes! I enjoyed writing and learning about captives. I see how helpful and unique each captive can be in insuring a company's risk.

If possible I would love to continue a career in captives as a unique industry.

Strohl: While I already have a job coming out of college working at an insurance company, I can take this knowledge to help understand more about the insurance industry overall. If I end up wanting to go in a different direction, I will have the knowledge to push myself towards the path of captives.

How does your college coursework align with a career in captive insurance?

Babec: In my actuarial courses I have gained a great amount of information on the preparation needed for an insurance company to ensure it can effectively cover the policies written. In my risk management classes we have analysed the most effective ways to insure or manage a risk. In addition, my finance and accounting classes have taught me about the financial statements necessary to run and manage an insurance company. Through my college courses, I have gained a good foundation for a career in captive insurance.

Strohl: Actuarial classes consist of calculating reserves to know how to protect the company, as well as determining risk factors and their probabilities. These ideas align with captives in a focused manner depending on the type of company and what insurance the company is seeking. ■

Katie Strohl

Blake Babec

2021-2022

CICA STUDENT ESSAY CONTEST

Using Captive Insurance Solutions to Address Coverage Gaps

3

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BUTLER UNIVERSITY:

Katie Strohl & Blake Babec

CRAFT BREWERIES ASSOCIATION

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BUTLER UNIVERSITY'S CAPTIVE ASSESSMENT FOR THE CRAFT BREWERIES ASSOCIATION

Blake Babec
Katie Strohl

Introduction

Captive insurance, an innovative way to solve issues with innovative risk management & funding solutions. When deciding to start a captive you must first analyze your company and see what type of captive structure best fits your needs and will reap the largest benefit at the minimum costs. This structure is just basic economics; how can I maximize my profits while limiting the risks in doing so? Unfortunately, this is easier said than done. In this essay we will be analyzing the risks and coverage needs of the Craft Breweries Association (CBA) and propose a captive solution to their present risks that maximizes coverage and minimizes costs to as many members of the CBA as possible.

Who are the members of the CBA? Each member of the CBA is a brewery that has from 25-75 employees not including part-time and seasonal workers. Member breweries are in all 50 states of the USA. Knowing this we can say each brewery would have a homogenous risk exposure due to their similar sizes, industry, and a wide array of state legal/tax laws.

To better inform ourselves of what would be the best route for the CBA, we must first identify the exposures they face and the coverages they wish to implement. The CBA has stated they wish to "stabilize/reduce their healthcare costs" for their employees. To help in the stabilizing of CBA's member breweries' healthcare costs we can investigate the addition of medical stop loss coverage for each member. This type of coverage brings down the average healthcare costs by easing unpredictable catastrophic medical claims burden. To implement coverage for CBA members, a captive is best suited. A commercial insurance company may be unwilling or unable to provide coverage for all their needs at a similar price. To optimize the benefits of a medical stop loss program, a company must create their own captive. To start the captive a group of members with a good historical loss experience and an interest in a captive insurance option would come together to form a captive for medical stop loss captive that in the future could address other coverage gaps.

The type of captive you decide to implement is as important as the coverage you wish it to provide. When choosing among the options we recommend to immediately eliminate a single parent captive. This decision is due to the higher startup costs and continued operations costs of a single parent captive if they wished to provide coverage to a small portion of the 6,300 breweries in this structure. It would be expensive and unrealistic for the small CBA member breweries to fund multiple single parent captives. So, if a single parent captive is not the solution, what is? The answer depends on the answers to the following questions. What type of coverage does the CBA wish to provide? Would members be interested in high coverage limits that are accompanied by higher premiums? Or lower coverage limits? How far in the future would the members like to consider and be willing to commit to? All these questions are just the start of the important process of the analysis, development, implementation, and formation of a captive insurance entity. Once you understand your appetite for risk and commitment to the future, you can begin to evaluate what type of captive best suits your needs and the feasibility of its implementation.

After you have considered your company's risk management & strategic needs, you can make a more informed decision. Now the decision shifts to: will a cell or group captive best suit your needs? The CBA is a large association of similar industry and size companies with a homogeneous risk exposure. These characteristics of their comparable risk and capital would be more appropriate to be formed into a group captive insurance structure. A group captive thrives off pooling many homogenous risks. Since the member breweries would be prone to similar claims, members would have proportional losses that could be shared efficiently allowing for a cost-effective way to insure their losses. Let's take a deeper look at the cell captive structure and see if it is the right structure for the CBA.

Benefits & Considerations of Cell captives

Benefits

- In a cell structure, anytime a new cell wishes to join the cell captive facility they form a cell that has less barrier to entry for companies with lower premium amounts.
- Administrative costs are purchased with group purchasing power allowing for saving among cells
- Flexibility in coverages provided to each cell

Considerations

- Limited buying power when compared to group captives since individual cells do not pool premiums.
- Cannot support as many members as a group captive due to the large amount of managerial work for each cell's autonomous programs.

From the list of attributes, we can see that the cell structure would not be suited for a large entity such as the CBA's members. Our goal is to include as many of the 6,300 associates as possible in a responsible manner. In a cell structure it is far more flexible to different risk profiles and exposures since no cells share liabilities with other cells. Yet this flexibility has its drawbacks. Since it is more flexible, and cells do not pool risks, it is not as cost effective in this situation. Cells must pay higher individual premiums to support their individual insurance programs, which could prove difficult with the limited exposure units of the smaller member breweries of the CBA. The homogenous pool of risk in CBA's members could not be capitalized on in a cell structure, and in a group, are proportionally rewarded with better operational efficiencies. These powerful advantages of group captives will display how a group captive will better satisfy the needs of the CBA and its associates.

Feasibility report: An actuary's view

One of the most important aspects of the feasibility report is the actuarial analysis. Actuaries project future premiums and loss costs from the past and current data of the insureds. When considering these numbers, we must understand they are projections or 'educated guesses' based on what has happened in the insured's past. To get a more accurate picture of the future you must back up your predictions with more evidence. So, if knowing more about the past increases our confidence in our predictions of our future, then how do we acquire more knowledge about the past in a captive setting? If you do not have a large amount of data, the actuaries would look to an industry benchmark instead of specific numbers that more accurately define your risk when you have ample data from your own members. Collecting large amounts of data from their members yields a captive that becomes quite efficient at "seeing into the future" allowing for more accurately priced premiums meaning members pay, proportionally, closer to their "true" risk instead of also paying for the possible adverse situations due to a lack of certainty in their possible losses.

Law of large numbers application

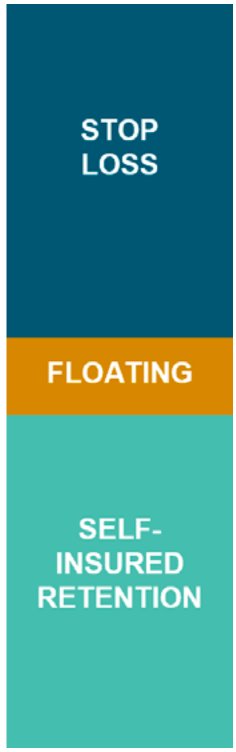
The law of large numbers is paramount in statistics and actuarial science. This principle increases our confidence in our predictions, giving the actuary, and ultimately the insured, a more accurate result. This law theorizes that as the size of the data increases the credibility of the data pool under consideration also increases. For our purposes we can assume the data of the members of the CBA are identically distributed and randomly generated. Now that we know this, what does it mean to the CBA? It means that as the group captive grows in membership, the amount of data increases, allowing actuaries to predict losses with increasing accuracy, and therefore member premiums will accurately reflect their true level of risk. From the process of approaching the population mean in the law of large numbers, we can observe reduced variance of loss levels allowing for the captive to assume greater retention levels and ultimately providing the same coverage at a lesser cost in the long run. Another attribute is a narrower range of probable losses resulting in fewer required funds contributed by each member of the captive. We have realized some of the benefits such as pricing stability, coverage stability and easily attained high level coverage. Now that we have determined more members is ideal, we must discern which structure allows more members and why.

To take advantage of the perks of the law of large numbers we must increase the sample size we draw from in the captive. In a group captive, anytime a new member wishes to join they must undergo a vote by the members and see if their risks align with the existing members' risk appetite. Although this selection process may be a barrier to entry to some new members, it is a necessary process because it allows for a captive to grow responsibly. In the future, a group captive will gain "good risk" members paving the way for forming a more efficient growth. In the group captive structure, this allows for CBA to capitalize on their similar risk profiles in a cost-effective structure. So, although the group captive will not add all members that apply, they will be adding productive members that will not take more than their fair share of the pooled claim funds. So now we have established the benefits of larger membership in captives, but how do we manage such a system?

After observing the benefits from the increase of accuracy in actuarial models, we must determine if there are additional benefits to be gained from a larger group captive. We see many of the benefits of this captive structure in the operational and implementation aspects. Some of these benefits include mass purchasing power, that is a result of the pooled premiums of the captives, for smaller companies such as these breweries to punch above their weight class and potentially attain higher coverage limits. When considering managerial costs in a group captive structure one manager manages all the group captives and volunteers from members of the captive serve as board members to help keep costs low.

Coverage layers

The CBA hopes to safeguard the employees of its companies from catastrophic losses through medical stop loss coverages. One approach to stop loss coverages is a layered approach that can diversify the risk and spread it out among different entities. This scenario begins with a self-insured/retention layer that functions as a deductible for the captive. Any claim amount in this layer will be the responsibility of the insured to pay for whether they retain the loss or purchase outside insurance to cover the losses. This layer can be adjusted to the individual brewery member's risk appetite. The next layer is a floating layer that kicks in directly after the retention level and would pay for all losses above the first layer and below the final layer using the pooled premiums from the group captive members. This floating layer would be a standard amount predetermined by captive founding members under advisement from actuaries and insurance pricing professionals. In the excess layer, the losses would be the responsibility of the medical stop loss carrier. This layer would put an aggregate maximum on the risk for the pooled funds preventing large amounts of risks. This scenario can be easily viewed in the image to the right. The medical stop loss captive would use an admitted fronting insurer who would take a slice of the premiums to provide the stop-loss coverage and then give what is left of the premiums to the captive to cover the floating layer. In this format of medical coverage for employees it provides excellent coverage that eases unpredictable catastrophic medical costs by splitting the claims into three blocks of minimal risk.



The stop loss structure allows for any unused funds at the end of the coverage period to be paid back proportionally to each member of the captive, upon a group vote. Since in a group captive, there is a pooling of resources, members are liable for the risks of other members, but this also allows members, collectively, to attain greater coverages for catastrophic claims that could never be attained in a cell structure (or even the traditional insurance marketplace) without contributing significantly more funds. Although the pooling of funds and sharing of liabilities in a group captive may seem unwise, if you are willing to share the claims of other members there are a host of new benefits that would not be possible without pooling premiums and liabilities.

Possible fallouts of sharing risks and solutions

For companies worried about sharing the risks of other members, before joining the captive, many force the new member to undergo a series of risk controls to lower either the frequency or the severity of claims. A risk control example for the CBA is enforcing all employees to undergo routine annual medical screenings. This risk control is an example of reducing the severity and frequency of claims in a company. If an employee undergoes annual medical screenings, they are more likely to catch a condition or diagnosis early on and treat it before it becomes a more serious, severe, and expensive issue. This is a simple example of a practice carried out in large and small companies across the world to reduce claim severity keeping employees healthier and preventing larger losses for the company. It is easy to see how risk controls can become an integral part in the implementation of a group captive as it can save the group millions in claims. Since the companies in the CBA are breweries in the same industry, it would be easy to create a standard risk control document that each company would implement to save the captive from unnecessary risk that could be prevented. This is standard practice in group captives to hold each member accountable and not use up more than their "fair share" of the funding.

Although group captives have many benefits, they are not necessarily a fit for all entities. Since there is more than one owner, there can be conflicting goals and objectives among members of the group. Some members will disagree on different subjects such as the decisions of what action is best. Also, looking into the future, one of the members may outgrow the group, and since the member has more capital, it could now require greater coverage offerings that the other companies cannot or choose not to pursue. These issues can become enough of a problem to some members and could cause them to withdraw from the group captive. As we analyze these problems the most apparent one is the withdrawal of group captive members. If members begin to withdraw, it slowly eats away at the pooled premiums and it becomes harder to provide the same coverage that it had before because there are fewer parties sharing the risk and contributing premiums to the pool. There are certain paths you can take to either prevent or deal with the withdrawals of members.

One of the first steps you can take if members are unhappy with the captives current standing is to communicate with your other members and formulate a compromise to suit all parties needs so you can continue to share the risk, and all contribute to the claims pool. This will be especially important in the case of CBA, as there are many members that could potentially join the group, and the current members would still like their voices to be heard when it comes to captive operations. One easily implemented strategy to combat these issues is to appoint an experienced board of directors that can settle disputes between captive members. On top of this certain committees could be put into place to solve arising issues to reduce the board meeting frequency and time. Examples of these committees would be a risk committee that would regulate and appoint new risk controls and a new members committee that would handle the reviewing of new members' applications to join the group captive. These committees could resolve disagreements among members and hopefully reduce possible member withdrawals from the captive.

During the feasibility study of CBA's members, we would utilize a survey and ask its members to review the risk appetites and coverage desires. Based on the response of the CBA's members there is a possibility to set up two captives that each could satisfy the different groups' needs for coverage options. This setup could allow for those who wish for more coverage and lower coverage to each participate in a captive that helps them cover their employees. On top of different coverage amounts the two different captives could provide different coverages. For example, one captive may provide exclusively Medical stop loss while the other provides medical stop loss and other coverages such as general liability or property. Although this type of situation does not come without its faults. The amount of capital required to start up this scenario is greater than only one captive. Therefore, it is important to survey CBA members to test their risk appetites and what sort of captive would best suit their needs. Also, if possible to set up two captives, it would be more expensive in the short run, but in the long run it would even out and it would provide a more stable group of captives. The ideology and characteristics of the two distinct captives would be more aligned allowing for a lessened chance that the previous withdrawal problems occur in the future. This type of scenario is intended to allow for maximum participation among the CBA's associates for long run coverage.

Final Recommendation

Looking back on the discussions of this essay we see that the group captives best fit the CBA's needs rather than a cell or single parent captive. The group captive offers more customization and can provide more coverage for a lower cost. In the long run a well-run group captive will outperform a cell captive and be more cost effective. Therefore, for the CBA's current situation it is recommended to pursue a group captive structure to provide medical stop loss coverage and allow for more of its member breweries to participate in a captive.

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