

## 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



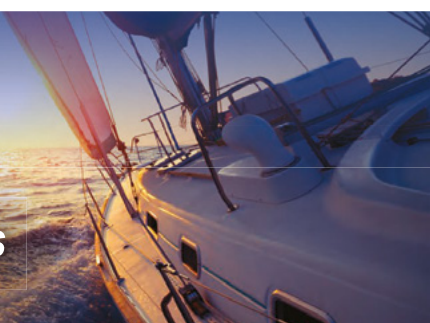
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## Issue 242

www.captiveinsurancetimes.com

Published by

### Black Knight Media Ltd

16 Bromley Road, New Beckenham  
Beckenham, BR3 5JE

#### Editorial

**Group Editor: Bob Currie**

bobcurrie@blackknightmedialtd.com  
+44 (0) 208 075 0928

**Senior Reporter: Jenna Lomax**

jennalomax@blackknightmedialtd.com  
+44 (0)208 075 0926

**Reporter: Rebecca Delaney**

rebeccadelaney@blackknightmedialtd.com

**Lead Designer: James Hickman**

jameshickman@blackknightmedialtd.com

#### Marketing and sales

**Publisher: Justin Lawson**

justinlawson@captiveinsurancetimes.com

**Associate Publisher: John Savage**

johnsavage@captiveinsurancetimes.com  
Tel: +44 (0)208 075 0932

**Office Manager: Chelsea Bowles**

Tel: +44 (0)208 075 0930

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April 2022 - Issue 242

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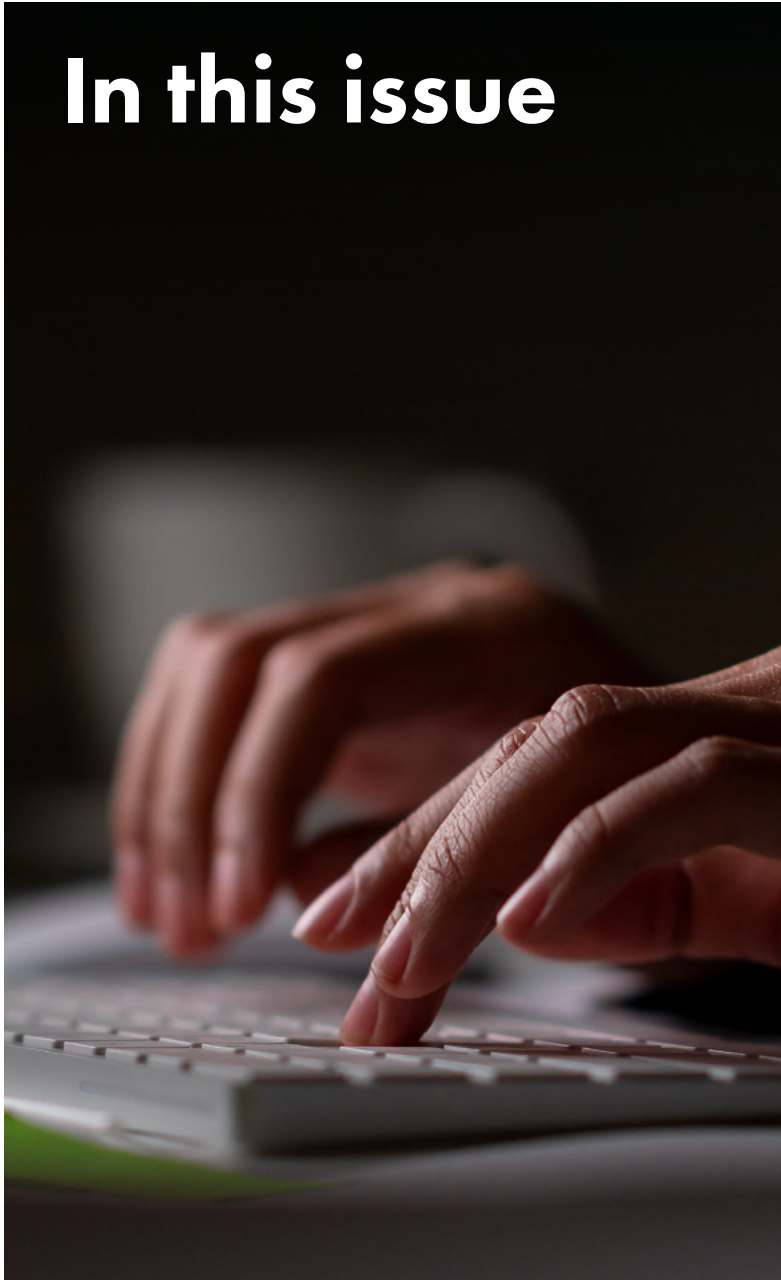
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## CIC Services victory as Notice 2016-66 is set aside

A ruling by the US District Court for the Eastern District of Tennessee has ordered for the Internal Revenue Service (IRS) to set aside Notice 2016-66 in its abiding suit against captive manager CIC Services.

Judge Travis McDonough noted that the ruling was made on two grounds. Firstly, the IRS had failed to comply with requirements of the Administrative Procedures Act dictating that the agency must engage in notice and comment rulemaking to then examine the relevant underlying facts and data to support its decision to enforce the Notice. Secondly, the district court found that the IRS had failed to sufficiently justify its decision to observe micro captive transactions

as potentially abusive. For the latter, McDonough ruled the IRS' Notice to have "arbitrarily and capriciously" defined micro captive insurance arrangements as "transactions of interest" with the potential for tax avoidance or evasion.

The ruling added: "[T]he administrative record fails to include relevant data and facts supporting the IRS decision to designate micro captive arrangements as transactions of interest, and, thus, reportable transactions."

In addition, the IRS was ordered to return all documents and information obtained pursuant to the Notice to the respective taxpayers and material advisors. ■

## CWC: Guernsey is in a good position to promote captive sector

Guernsey has the opportunity to make itself a more attractive captive domicile by taking advantage of increased demand in the alternative risk transfer market, according to a strategic review of the island's insurance sector by Cutts-Watson Consulting (CWC).

CWC was commissioned by the Committee for Economic Development to investigate the current status of Guernsey's insurance sector and to identify key areas of growth and opportunity over the next three to five years.

The review describes Guernsey's insurance sector as "thriving" based on its diversity of offerings, consistency of demand, and complementary positioning to the other financial services sectors.

Captives in particular are highlighted as the core of Guernsey's international insurance market, representing 35 per cent of the island's licensed insurers. The review notes a "renaissance" of captives in 2020 with the combination of the hard market and the economic impact of COVID-19.

In these conditions, demand for alternative risk financing solutions is anticipated to continue in 2022 from all industry sectors, geographies and corporate entities. As well as new captive formations, existing captives are experiencing increased activity, whether exploring new risks or seeing significant increases in exposure in the lines of business already written.

CWC notes that the Guernsey captive industry is strengthened by the island's experienced workforce, business

infrastructure, and flexible and proportionate risk-based regulation, as well as solvency requirements that are less demanding compared to Solvency II domiciles.

In addition, 2021 saw the Guernsey Financial Services Commission trial a pre-authorisation process for captive cells, which CWC describes as a breakthrough in levelling the playing field with other leading captive domiciles for speed of formation.

The review also explores Guernsey's developing insurance-linked securities (ILS) market, which provides an alternative source of risk capital (particularly for property catastrophe risks) and is popular within the institutional investment industry.

The review finds that Guernsey Finance and the Guernsey International Insurance Association are focusing their marketing efforts on promoting Guernsey as a favoured jurisdiction for ILS and collateralised reinsurance.

In the context of these favourable market conditions, CWC's review makes several recommendations to enable Guernsey to capitalise on the most promising growth opportunities.

Specific to captives, CWC recommends the sector continues to exploit hard market conditions by understanding and promoting the role that captives can play for wealth structures (such as family offices), writing for coverage gaps arising from COVID-19 exposures, and educating the fiduciary sector on how the two can collaborate.

In addition, the review suggests resurrecting Guernsey's captive

management diploma to reflect today's diverse insurance management landscape, current best practices and new products. The review indicates that reintroducing the diploma, as well as additional roadshows, virtual events and reintroducing the Guernsey Insurance Forum, will sufficiently develop the island's promotion of its captive and wider insurance sectors.

Similarly, CWC recommends that relevant associations design promotional materials and develop distribution strategies to support Guernsey's ESG green and sustainable finance framework, as well as extend the scope of the framework beyond captives and ILS to include all insurers.

### **Captive industry coalition files amicus brief in DDOI case**

Nine captive insurance domicile associations and the Self-Insurance Institute of America (SIIA) have filed an amicus brief in support of state insurance regulation with the US Court of Appeals for the Third Circuit in the ongoing case, *United States of America v. Delaware Department of Insurance (DDOI)*. Led by the Delaware Captive Insurance Association (DCIA), the other amicus parties represented captive insurance associations from the domiciles of Arizona, District of Columbia, Missouri, North Carolina, Oklahoma, South Carolina, Tennessee and Utah.

The case concerns summons served by the Internal Revenue Services (IRS) on the DDOI to disclose regulatory filings and other information received by the department from Delaware-domiciled micro captive insurance companies.

The DDOI responded to the summons with the state's confidentiality statute, Section 6920 of the Delaware Insurance Code, which provides immunity from subpoena and disclosure of confidential documents relating to the licensing of captive insurance companies.

In addition, the section prohibits either the commissioner or DDOI from disclosing such documents without the express approval of the relevant captive.

Section 6920 allows an exception to this immunity if the law enforcement agency (in this case, the IRS) agrees to hold the confidential information consistent with Section 6920. The DDOI offered to disclose the relevant information under this exception, which the IRS refused.

DDOI's motion was denied by the lower court, leading to the current appeal.

The brief describes that the district court's decision "negatively impacts the insurance industry on a nationwide scale".

The brief continues that confidentiality measures are in place for both traditional and captive insurance companies to promote the solvency of insurance companies, as well as protect the proprietary information belonging to these insurers.

Citing the McCarran-Ferguson Act, which expressly provides states with the power to regulate and tax the business of insurance, the amicus brief argues that Congress did not intend for the IRS to be able to subpoena a state insurance department for confidential information under this legislation.

In a statement, DCIA concludes: “It is the hope of the captive industry coalition that the appeals court will overturn the district court’s decision, which is contrary to the intent of Congress and undermines not only Delaware’s authority to regulate the business of insurance, but also insurance regulations across the country.”

### **BRIM: Captives have a “higher value proposition”**

Companies of all shapes, sizes and industries are evaluating their alternative risk financing strategies in response to the continued hard market conditions, according to a session at the Barbados Risk and Insurance Management (BRIM) conference. Michael Serricchio, managing director at Marsh Captive Solutions, noted the heightened interest around captives, whether companies are returning to feasibility studies from a few years ago, revisiting dormant captives, or expanding their current active captives.

This was affirmed by Patrick Ferguson, senior vice president at Marsh Captive Solutions, who added that commercial insurance premiums have increased year-on-year while capacity declines.

“The reality is that, at this point in time, a captive provides a higher value proposition to a company than it would have two or three years ago,” Ferguson said.

With this increased utilisation of captives, it was noted that property insurance was the most popular coverage written by Marsh-managed captives in the first half of 2021, followed by directors’ and officers’ (D&O), trade credit, surety, third-party and cyber.

Cyber in particular was highlighted as a key emerging risk, with Ferguson noting US\$63.5 million in total cyber premium in captives under management. This marks a 13 per cent growth in the number of captives writing cyber year-on-year, and a massive 127 per cent increase over five years.

Serricchio added that, as a low frequency, high severity risk, there are several different possibilities of how captives can provide innovative policies for cyber, including a policy to reimburse retention, quota share or limit for layer within a risk transfer programme, a policy for excluded coverage (such as ransomware), or a policy for excess limits.

He noted that a key indicator of a captive’s value in providing flexible, customised insurance solutions is the growth in coverages that were not written by captives a decade ago. These emerging non-traditional risks are demonstrating steady increases in net premiums written, particularly medical stop-loss (81 per cent), cyber (54 per cent) and D&O (50 per cent). The latter has become particularly prominent over the last six months, Serricchio added, especially following the recent amendment of the Delaware Insurance Code allowing corporations to use captives for D&O liability insurance.

D&O and cyber are the top two coverages written in cell facilities formed in recent years, Ferguson noted, although protected cell formations still see traditional risks such as property and liability.

Serricchio added that third-party business continues to increase, with 19 per cent of

Marsh-managed captives writing third-party coverage and premium growing by 85 per cent over the past five years. He noted that third-party risk is advantageous as it allows for risk diversification, and provides an opportunity for the captive to generate profits for its parent with a higher potential for building up surplus.

The session concluded that, among the current market conditions (rising interest rates, inflation, war, pandemic), captive owners should constantly evaluate their risks and captive portfolio to consider how ESG and the interest rate environment affects their captive.

Noting that captives have traditionally excelled at governance (‘G’), they should now focus on environmental (‘E’) and social (‘S’) by viewing climate issues in the context of sustainability, portfolio impact and resilience, and by allowing organisations flexibility and control in addressing the people risks that impact their business, such as employee benefit and engagement programmes, and board diversity.

### **CICA: Corporate governance is “foundation” of a captive**

Corporate governance forms the foundation on which a captive is built, observed Sean O’Donnell, director of financial examination at the DC Department of Insurance, Securities and Banking, in a session at this year’s Captive Insurance Companies Association (CICA) International Conference.

O’Donnell added that, from a regulatory perspective, “everything flows from corporate governance. If there is good corporate governance in place, then the

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captive is likely to be successful in the long run”.

Although it was noted that corporate governance helps a captive through difficult times, rather than prevent them entirely, O'Donnell outlined the two main components of corporate governance frameworks. The first is literal, which refers to adherence to the corporate documents, bylaws and statutes of a domicile.

The second component, he continued, is the all-encompassing involvement and awareness of a captive's management team in the operation of the captive to ensure it properly follows its business

plan, as well as laws and regulations, in its processes. Conversely, Joe Holahan, partner at Morris, Manning & Martin, highlighted that, from an attorney's perspective, the two fundamental components of corporate governance are substantive and procedural.

Substantive refers to the directors' and officers' (D&O) fiduciary duties to the company, such as due care and loyalty, while procedural is designed to ensure a captive's chain of authority is properly followed as ascribed by statutes and internal processes, and that decisions made on behalf of the captive ultimately derive from the owner.

Robert Donohoe, president and CEO of Lone Star Alliance Risk Retention Group (RRG), added that from the corporate side of running an RRG, implementation is a significant aspect of corporate governance.

Establishing a culture of accountability, transparency and discipline is crucial to ensure that processes in place allow the captive to follow its original guidelines and laws as a company, he noted.

“Corporate governance does not work with just a chief compliance officer or CEO. It is a common understanding of the mission and goals of the company, and a commitment to carrying it out. The



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procedures, protocols and principles in place must allow staff to instinctively follow those rules,” Donohoe added.

Discussing the consequences of bad governance, O’Donnell warned that captives may have difficulty obtaining D&O coverage as a result of reputational risk to the captive’s owners and management. Such a reputational crisis could also lead to loss of service providers, reinsurers and other business partners.

Donohoe agreed that poor governance can create a loss of credibility and trust, whether internally within an organisation or among regulators or outside investors,

as well as causing a significant loss of time. In extreme cases, O’Donnell noted that fines may be imposed following repeated egregious displays of poor corporate governance.

Echoing the potential for severe practical consequences, Holahan noted that, in some cases, serious corporate governance problems can arise in otherwise well-managed captives — programmes that are financially successful and have high member satisfaction.

He pointed out that this can sometimes mask other problems that may look inconsequential compared to ensuring

the captive remains solvent and members remain happy — “that is the trap”, he warned.

It is worthwhile, therefore, to invest time now in sound corporate governance practices to avoid serious evolved problems down the line which can cause a detrimental economic impact. Donohoe added that the most effective way for a captive to prepare for such a crisis is to “establish and executive a game plan. Keep on the right path, and you will avert crises down the road”.

Concluding the session, O’Donnell recommended that applications submitted

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to regulators should demonstrate that a captive is working with good service providers to develop a robust corporate governance programme. Ensuring this is an important consideration when forming a captive goes a long way in setting up the structure for success (whether in financial, regulatory or governance terms) in the long run.

**Canadian blockchain captive group signs fronting agreement**

Decentralised finance captive insurance provider SuretyBlock has signed a fronting agreement with Fortress Insurance to enable the former to enlist and serve trade associations, organisations and event organisers across western Canada. Fortress Insurance is a western Canadian insurance

provider licensed in British Columbia, Alberta, Saskatchewan and Manitoba.

As a subsidiary of Ocean Falls Blockchain Corp (OFB), a Canadian blockchain technology company, SuretyBlock’s first decentralised product using blockchain technology to pool and distribute funds, Eagle1, is planned for launch in April 2022.

Eagle1 is an insurance platform for the golf industry — including golf associations, golf courses and tournament organisers — designed to make it easier, quicker and more efficient for unique, customised hole-in-one prize pools and payouts to be obtained and issued on golf courses and driving ranges.

Commenting on the agreement, Kevin Day, president of SuretyBlock and chief

technology officer at OFB, says: “A company as well-established in the Canadian market as Fortress Insurance coming on to support our project is a major achievement.”

“We are excited for the future of SuretyBlock and the new captive insurance opportunities made possible by today’s emerging technologies.”

Shafeen Mawani, president and CEO at Fortress Insurance, adds: “Fortress has a long-standing goal to collaborate with and explore new insurance product niches and insurance programmes.”

“The concept and technological framework of SuretyBlock is something new and exciting and we are happy to explore this adventure with their team.” ■



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# En-Core!

Ian-Edward Stafrace of Atlas Insurance PCC shares how the active non-cellular core of their EU protected cell facility can help rapidly incubate risks, giving more time to assess and set up a cell

Risk managers and insurtech innovators in Europe are increasingly looking to cells to tackle common challenges.

In particular, Malta's cell growth continues to outpace standalone captives.

In 2021, insurance-carrying cells grew 16 per cent, outnumbering captives and non-domestic insurance undertakings.

An EU protected cell company (PCC) with an active core can provide many more solutions than traditionally understood, as it can also more rapidly underwrite risks through its core.

### Shared substance and resources

Malta is the only EU member state with insurance protected cell legislation, providing cells with direct access to the European Economic Area single market.

Atlas also provides access to the UK market and is one of the first PCCs to submit a branch application to the UK Prudential Regulation Authority. While the application is being processed, Atlas writes new business in the UK under the Temporary Permissions Regime.

With their shared economies of scale, Maltese PCCs provide substance and resources. They give confidence in being onshore in the EU, without a standalone company's complexities, costs and time, potentially also saving capital.

Insurers are increasingly expected to have adequate on-the-ground staff and key function holders.

PCCs can significantly help address substance as cells form part of a broader single entity that provides shared board, governance and key functions in Malta.

The well-capitalised active core of Atlas PCC is focused on the traditional non-life domestic insurance business in Malta, where Atlas retains around 20 per cent market share.

It has multiple branches and offices, naturally providing ample substance to the PCC.

### Regulatory timelines

Owing to increased resources, the Malta Financial Services Authority (MFSA) has improved timelines for well-produced cell applications, with risks falling firmly within its appetite, especially if approached beforehand. MFSA are very responsive and actively engage with promoters in each application. Insurance management companies and PCCs can help guide the application and regulatory exchanges.

Setting up a cell is faster than a standalone company due to the core capital, broader governance structures and resources already present in the PCC. However, you would not expect a cell or captive to be approved within days, as might happen offshore.

Rigorous compliance, due diligence process and solvency capital assessment aligned with EU regulations are required, especially in direct writing, when other stakeholders and consumer compliance may need to be factored in.

### Active core incubation and fronting

A practical example of how an EU PCC with an active core can rapidly incubate risks, giving more time to assess and set up a cell:

A global captive manager had a client with a US captive that wished to set up a protected cell to cover its EU-based risks.

As discussions progressed with Atlas, it was clear in December that there would not be sufficient time to licence a cell for its 1 January renewal.

As Atlas was already passported to all the countries where the risks were situated for the required classes of insurance, it underwrote the renewal through its core, reinsuring back to the US captive. Atlas provided a quick solution within a couple of weeks during the holiday season whilst allowing much more time for the setup of a cell to be considered within the same PCC.

***“An EU PCC with an active core can provide many more solutions than traditionally understood”***

### Accelerated pilots

Atlas hosts multiple insurtechs. On occasion, startups with promising models do not have sufficient data or capital to set up a cell. They may have reinsurance lined up or are willing to run a contained pilot to help them attract investors and better estimate projections. Through its core, Atlas has assisted insurtech ventures in micro-testing parametric and other business models, for example, using blockchain smart contracts to automate underwriting and claims processes.

From Atlas' experience helping prospective cells test their concepts, it is clear that market tests can attract investors, venture capital and other funding, further enabling scaling up of the business.

The non-cellular core can provide a sandbox facility that improves time-to-market and the gaining of actual market data. Business plans and projections can then be revised based on experience. If tests are unsuccessful, such also allows a low-cost exit without detriment to consumers.

Business underwritten by the core needs to fit within the PCC's risk appetite. Typically, an assessment identifies risks that can adversely affect the projections, particularly volatility in results and exposure to potential events or claims tail.

The interests of customers or other third-party stakeholders need to be reviewed where applicable, together with local compliance requirements where risks are situated. Reinsurance counterparty risk and mitigations such as collateral are also assessed.

### Brokers and global captive managers

The Atlas PCC team has built expertise in this sector, assessing and implementing various direct third-party, reinsurance and captive cells. It is also further developing the solutions it can offer through its non-cellular core.

Atlas is independent yet has excellent relationships with brokers and insurance management companies. In addition to the cells and schemes it hosts and manages directly, it also hosts business for clients of various leading global captive managers providing advisory and outsourcing support.

Brokers in the middle market are increasingly interested in such solutions. They are becoming more proactive when the hardened market rightly causes their most significant clients to question their risk financing.

The collaboration with such brokers is mutually beneficial. Brokers are closer to their customers in their countries and provide compliant local services in their language.

Adequately resourced and experienced PCCs like Atlas continue to foster sustainable innovation, providing new solutions to emerging challenges. ■



**Ian-Edward Stafrace**  
Chief strategy officer  
Atlas Insurance PCC Ltd

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# Can't make head nor long-tail

Industry professionals discuss how a captive can be used to provide coverage for the long-tail risk of workers' compensation, and how the COVID-19 pandemic has impacted this market

*Rebecca Delaney reports*



Workers' compensation refers to the provision of benefits to workers who suffer injury or illness while on the job. This can take the form of medical treatment for work-related conditions, cash payments to replace lost wages, temporary total disability benefits, or vocational rehabilitation benefits, according to the US Social Security Administration.

Agnes Hoeberling, CEO of InterCare Holdings, explains: "Workers' compensation is a type of insurance coverage that is required for all businesses to cover their employees when they are injured on the job or become ill from their job. Benefits include payment for lost wages from time off work to recover from the injury or illness, medical treatment, disability benefits from permanent impairment, money for retraining, and death benefits."

Before workers' compensation laws were introduced in the US, an injured worker had no other option but to bring a tort suit against their employer to prove employer negligence caused the injury. Although it was unlikely that employees would recover damages, employers also disliked this system as they were at risk for substantial and unpredictable losses if the employee's suit was successful.

Therefore, both sides favoured the introduction of state programmes on the basic principle that benefits would be provided to injured workers without regard to fault, while in return employers would face limited liability.

Although the Employers' Liability Acts mitigated the defence of contributory negligence, it fell to the states to take responsibility for designing and administering workers' compensation programmes.

Across states, programmes vary in terms of who is allowed to provide insurance, which injuries and illnesses are compensable, and the level of benefits. State laws generally require employers to obtain insurance or to prove they have the financial ability to carry their own risk.

Jason Wheeler, vice president, national sales and account management, CorVel, notes: "Almost all states require that employers have workers' comp insurance. A majority of employers buy workers' comp insurance coverage through private insurers or state-certified compensation insurance funds."

Owing to the fragmented, state-based nature of workers' compensation programmes in the US, there is no central data source, although organisations such as the Workers Compensation Research Institute collect statistics, benchmarks and the medical price index on a state basis.

However, it is recognised that medical costs are often the most significant expense for companies in terms of workers' compensation. Therefore, it is fundamental for a company to have sufficient tools in place to help mitigate medical costs for claimants.

Statistics compiled by the US Department of Labor and Bureau of Labor reveal that the most significant losses arise from productivity, as employees must take time off work from an incident. The top private industry occupations with the highest number of injuries and illnesses are labourers, truck drivers, janitors and cleaners, nursing assistants, and general maintenance and repair workers.

A Fitch Ratings report examining trends in workers' compensation insurance in June of last year identified that workers' compensation underwriting performance continued to remain strong in 2021 owing to recent reductions in claims frequency and further recognition of material reserve redundancies.

Maggie Jaltorossian, senior vice president of the workers' compensation division at InterCare Holdings, explains: "Businesses are experiencing flat or slightly reduced rates because of the decline in claim volume from the COVID-19 pandemic, except for some specific industries like healthcare, retail and public entities with first responders."

She adds: "Since the COVID-19 pandemic, we have seen an increase in inquiries into captive programmes and pools. The top workers' compensation concerns continue to be the rate adequacy, the long-COVID impacts, rising medical costs and benefits, retaining and attracting talented claims professionals and shifting of workforce and workplace, as well as mental health and wellness."

In this current environment, David Dougherty, captive producer at Atlas Insurance Management, notes that from a carrier perspective, there will likely be a push to write more guaranteed cost or low deductible coverage, because this provides a larger piece of the underwriting profit for the carrier.

He continues: "On the flip side, insureds will look to take more risk on their workers' compensation coverage to gain a premium savings. This is especially true for those insureds who are performing well; their strong performance should give them confidence to take on more risk."

### Captives and workers' compensation

In workers' comp coverage, captives offer to fund the deductible and take the working layer of risk, which reduces traditional insurance costs while giving the beneficial owners the opportunity to use risk management practices to achieve a higher underwriting profit. Jaltorossian notes that, while smaller employers generally cover their workers' compensation through primary insurance policies, a growing number of medium-sized companies are joining programmes and exploring the feasibility of group captives. Larger companies tend to self-insure, or else have large deductible programmes and purchase excess policies.

Wheeler says: "Workers' compensation is a great line to have in a group captive as it is the most predictable line of coverage. It also has a longer-tail, where interest can be earned, although not as much today as other years."

"Management of workers' compensation injuries is essential, first to get the employee well and back to work. Second, to ensure that the care provided is appropriate and cost-effective. Captives are highly incentivised to invest in outstanding care and case management for injured workers because they are the ultimate payer," he adds.

Affirming the advantages of captives for workers' compensation coverage, Dougherty notes: "A captive offers control over claims and the insured's data, stability of overall insurance costs, and predictability of cash flow by pre-funding losses."

He adds that a captive can be employed to reimburse an insured's large workers' compensation deductible, with pre-funding losses providing the captive with the ability to establish reserves.

"Captives allow an insured with good workers' compensation performance to benefit from that performance by sharing in the underwriting profit. Workers' comp can be a premium driver, so for those insureds who already have a captive in place, adding

this coverage can help offset the performance of other lines in the captive, making it more of a self-levelling ship.”

Hoerberling notes that captives also allow greater flexibility in domiciliation, both onshore and offshore, as well as having a captive manager that is responsible for the finance and administration.

“There is more flexibility on investments — more choices on the investment portfolio and, depending on the investment portfolio, may also generate a larger return. The tax advantages are also more considerable, and there is a heightened focus on loss prevention,” she adds.

Furthermore, Hoerberling contends that larger employers with large deductible programmes can benefit from using a third-party claims administrator (TPA) to focus on expedited claims management.

This is affirmed by CorVel’s Wheeler, who explains that TPA services can include customised provider networks, utilisation and bill reviews, and ancillary benefit management to oversee total spend and utilisation. TPA services also encompass pharmacy benefit management to provide visibility into prescriptions, reporting and trending, and case management with visibility to risk scores, clinical modelling, adjustor notes and documents.

“There are many positives to an unbundled TPA and loss control programme in a captive. The captive can limit the TPA authority to settle claims or increase reserves. This is a whole new dimension for the insureds to have a say in, and understanding of, why a claim is being settled at a particular amount. Depending on the captive structure, there will, or should be, peer pressure not to have the worst losses in the programme, since the other captive members will share all the losses. This peer pressure is a good thing, as it focuses management on preventing losses and managing their claims,” Wheeler explains.

This loss control is highlighted as a key advantage of captives, with most group captives employing standard safety operating procedures (SSOPs). Since being part of a workers’ comp captive does not guarantee lower premiums or dividends, losses must be reduced.

“Most group captives will engage loss control experts that specialise in their industry. Working with the loss control experts, the insureds

will come together and develop best-in-class SSOPs. The purpose is to reduce losses and get more employees home safely every day,” Wheeler affirms.

## Challenges

However, there are obstacles in using a captive for workers’ comp, particularly for COVID-19-related claims. Logistically, it is extremely difficult to prove claims by healthcare workers that contracted the virus at work. Some states are forcing carriers to accept compensability for these claims, which for large employers could cause a significant amount of claims and liabilities.

Wheeler says: “The primary risk is that the employer, through the captive, can potentially hold huge risk involved in a major workers’ comp loss. Captives can be costly to establish and incur ongoing costs to be maintained.”

He continues that there are several other cost and tax considerations: “If you decide to self-insure using a captive, the best long-term strategy might be to invest heavily in safety and loss control. Essentially, the more you invest in safety, the higher chance that you will incur fewer losses that you, as the captive owner, may have to pay.”

A captive can mitigate these challenges through robust capital management, which begins with the company considering whether they want to keep a large portion of their event risk on the balance sheet and allocate the required capital, or allocate the risk capital through insurance premiums and retain the passive risk demanded by the insurance providers.

Noting other challenges that may arise, Dougherty adds that carriers are beginning to use workers’ comp coverage to write other property and casualty lines. He explains: “A carrier may provide more aggressive workers’ comp rates to write the general or auto liability lines, which could lead to the traditional market offering rates that are competitive enough that a captive may not make financial sense.”

Jaltorossian points out that, as with any programme, results are likely to fluctuate unless properly managed. For a captive to offer a cost-effective solution, therefore, it must be structured

to allow policyholders to participate in the profits of their own risk as well as the cost, and be able to pay claims and secure future losses.

“To fully realise the value of a captive programme, policyholders must be in it for the long-term due to the fluctuations in risk, loss costs and investment return. Over time, the risk and cost balances itself out and there is greater return on the investment. All things considered, if policyholders are aligned in their risk control, loss prevention and underwriting policies, over time they should realise an investment income,” Jaltorossian explains.

### The challenges of long-tail risk

*CorVel's Wheeler highlights the two most significant challenges in using a captive for workers' comp to be the following:*

**Closing out an underwriting year:** workers' comp has a long-tail, meaning it may take years to close a claim based on the injuries.

The captive should wait to release underwriting profits until all claims are closed and the possibility of claims reopening has passed.

**Collateral:** since most group captives are unrated, the fronting company will need to have a letter of credit or cash securing the unearned premium and loss reserves.

The amount of collateral is generally between 30 and 35 per cent of the premium collected for each of the programme's first three years.

This is because the fronting company is ultimately responsible for paying claims, so must maintain collateral equal to the underwriting year's ultimate expected loss.

**“To fully realise the value of a captive programme, policyholders must be in it for the long-term”**

### Evolution

Looking at the future of workers' comp coverage, it seems inevitable that the ongoing effects of the COVID-19 pandemic will include clarification around the inclusion or exclusion of infectious diseases and pandemic coverage.

Atlas' Dougherty affirms that US states may follow suit of Tennessee and Washington in passing laws to extend workers' compensation presumptions around infectious diseases and public health emergencies.

“These presumptions allow for employees to claim workers compensation more easily from infectious disease with the burden of proof falling on the employer to prove the disease was not contracted at work,” he explains.

He adds that the COVID-19 pandemic has spurred growth in telemedicine, citing that eight per cent of all primary care visits were done through telemedicine in 2021. Digital healthcare has transitioned to the best practice for employers seeking to reduce their workers' comp claims costs.

Wheeler reflects: “There have been several disruptions to the workers' comp market during the pandemic. Specific very risky industries — where workers' comp costs can be very high and so often used captives — may have seen an economic downturn and lower workers' comp costs. All these issues factor into deciding whether to use traditional insurance or self-insure using a captive.”

“The overall drive for more control and better management of injured workers is anticipated to make captives an attractive option. The cost benefits of captives versus third-party insurance premiums continues to hold,” Wheeler concludes. ■



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# Calling the shots

Kate Miller of London & Capital and Jack Meskunas of Oppenheimer discuss the importance of investing captive assets and finding the right asset manager to ensure a captive operates efficiently and effectively

*Rebecca Delaney reports*

Asset management has a fundamental role in ensuring a captive achieves its objectives, as financial assets are central to how a captive insurance company manages insurance risk.

The inherent flexibility and customisable nature of a captive means that its investment portfolio must be carefully managed to ensure it is tailored to meet the captive's specific requirements, whether relating to solvency, liquidity, collateral, income or long-term value.

Kate Miller, partner and head of institutional business at London & Capital, notes that the objectives of a captive will vary according to how long it has been established. She explains that a new captive may wish to preserve capital in the first few years, as well as demonstrate a robust underwriting performance, before taking on investment risk.

Alternatively, captives insuring long-term risks will require a portfolio that matches their long-term liabilities with the assets on their balance sheet to optimise regulatory capital, prioritise sufficient claims cash flow and ensure they provide stable premiums, Miller adds.

"We have typically seen a whole spectrum of captive objectives, ranging from a simple short-term way to access reinsurance markets to an out-and-out profit centre. For all these challenges, your asset management strategy can become a core part of your business planning."

Miller continues: "Every captive should think carefully about how their assets can effectively be utilised and avoid default 'solutions', such as cash in the bank or intercompany loans. This process takes time and effort to properly engage with, but generates outsized returns for the captive."

With this in mind, Jack Meskunas, executive director of investments and captive insurance asset management advisor at Oppenheimer & Co, identifies that the most significant role of asset management in helping a captive achieve its objectives is one of guidance.

He explains that this is because, fundamentally, a captive is an insurance company formed to provide a service to the parent. Therefore, all other aspects are essentially ancillary to the captive's ability to provide insurance and pay claims in a timely manner.

***“By designing the investment portfolio to reflect the risks, liabilities, ethos and objectives of the captive, its owners and managers can make better informed decisions”***

Meskunas explains: “In order for that risk transfer to be complete, it must be backed by assets, which need to be managed correctly. If the assets are mishandled and funds are not available to pay claims, then you really have not transferred risk. So the asset manager can potentially, unwittingly or unintentionally, destroy the very insurance purpose of the captive by not managing assets properly.”

“Most of what I do is trying to inform and guide the captive owners and the captive management team to allocate the assets in such a way that they provide value added to the captive, a reasonable risk-adjusted rate of return and overall stability so that, at the end of the day, the captive owner and the captive managers do not have to worry about the investments,” he adds.

### Finding the right fit

With these unique objectives and asset management requirements compared to other insurance entities, captives can gain significant value from a partnership with a specialist insurance asset manager.

Miller says: “While captives may not have the in-house resources to develop and model a bespoke investment strategy, they should be able to lean on their outsourced asset manager to provide asset-liability matching studies, cash flow management planning, investment portfolio capital-efficiency modelling, and support for changes to regulatory or accounting reporting.”

An important aspect of asset management services that captives can particularly benefit from are portfolio reviews. Meskunas illustrates that in a recent portfolio review, he found that an offshore captive owning onshore mutual funds had mistakenly subjected themselves to withholding tax.

“Being able to pick that up and point out to the captive owner and the captive management team that their previous advisor had them in the wrong class of shares is a big thing. That review and analysis process on an ongoing basis is very important,” he explains.

In addition, captives, along with the wider insurance industry, are becoming increasingly aware of the impact of sustainable investing practices on both their investment portfolio and external environment.

Miller notes: “Asset managers can help captives by adapting best practice in ESG and making it relevant to the captive. For example, rather than applying a general ESG scoring methodology, asset managers can adjust the scoring to reflect ESG issues that are directly relevant to a captive.”

“By designing the investment portfolio to reflect the risks, liabilities, ethos and objectives of the captive, its owners and managers can more easily make sense of external risks and make better informed decisions from an investment perspective, as well as in general for the captive.”

### Investment

Investing captive assets is a cautious area, as the end goal is both to ensure sufficient financial resources are available for claim payments, and to protect the overall value of captive assets. Therefore, captives tend to prefer stable, low-risk investment vehicles and fixed income products, such as state-issued bonds, US Treasury bonds and treasury notes.

However, Meskunas identifies that the fixed income field is beginning to see more sophistication coming into captives. This includes a growing interest in the municipal bond space, as he notes that municipalities in the US are currently very financially healthy.

“This is partly owing to relevantly high taxes in states, and partly to do with multi-trillion dollar giveaways since the COVID-19 pandemic that have just stuffed the coffers of these municipalities. Subsequently, they are getting credit upgrades,” he explains.

In addition, larger captives on the equity side are now looking to invest in alternative assets such as hedge funds, Meskunus notes.

“Hedge funds have had a bad rap in some ways from a retail point of view, but in terms of smoothing performance and protecting against some of the wild swings we have seen in the market, these hedge funds have been able to provide a good rate of return and more stability.

“I would put all that under the heading of sophistication; they are getting a little more sophisticated, and more asset classes are being put into captive portfolios that typically were not there before.”

It is important to note that the balance of risk will inevitably evolve over time, whether in terms of the available lines of coverage, underwriting criteria, reserve development, levels of surplus volatility or regulatory requirements. Accordingly, successful asset management requires a diligent and collaborative approach to ensure portfolio solutions align with evolving risk agendas and company objectives.

With this natural progression, a captive must therefore employ tools to monitor its investment performance. Miller outlines that, in any investment management proposition, there are three undertakings: holding the assets, managing the assets, and reporting on the assets. When combined, this creates a “meaningful operational and counterparty risk” for a captive.

Meskunus points out that there is no shortage of tools or benchmarks; the issue lies in how to appropriately benchmark the performance of a captive.

“Oppenheimer alone publishes 70 different benchmarks; who knows how many there actually are. Captive owners and managers may say: “The S&P 500 did this. What did the captive do?” We then point out that the captive only has perhaps 20 per cent of their money in equities — so why would the S&P 500 be the benchmark for captive assets?”

## Regulation

In addition to measuring and managing captive portfolios, asset managers may also have some responsibility for communicating with industry associations, service provider networks and regulatory bodies in both onshore and offshore domiciles. The latter is particularly important as investment portfolios must be extremely mindful of regulatory regimes, actuarial and accounting considerations, capital requirements and organisation-specific financial aims.

## Performance measurement

London & Capital's Kate Miller highlights that investment performance measurement is both an internal and external requirement. Monitoring and evaluation of performance is crucial to understand how the portfolios will react to specific market conditions, such as rising rates, inflationary periods, stagflation and equity crashes.

After analysing and interpreting the data from investment performance measurement, reporting on assets to clients can take several forms depending on their specific needs:

**Strategic reporting:** this is specifically designed for the benefit of directors and senior management and includes asset allocation, portfolio risk metrics and scenario analysis, as well as audit-grade compliance monitoring

**Tactical reporting:** communications explaining the impact of significant macroeconomic events on the portfolio, including seminars and calls at the client's discretion to discuss performance with key stakeholders

**Regulatory reporting:** understanding the requirements of various regulatory regimes and providing all necessary investment information required to meet submissions



***“It is important to have deep insight into the nature of risk transfer inherent in the captive to understand how to better fit what you do in asset management with what the captive is doing in insurance”***

Although specific regulatory requirements vary according to jurisdictions, all captives are subjected to underlying principles of prudent investment. Miller notes that this takes the form of the Prudent Person Principle in Europe, and the Fiduciary Duty Principle in the US.

“The spirit of the approach is the same: to ensure insurers and captives invest in assets where the risks are properly understood, can be measured and are actively managed. Even though captives can outsource the operational, day-to-day management of the investment portfolio they cannot outsource the overall responsibility of prudent controls and oversight.”

Looking more specifically at jurisdictions, Meskunas adds: “In the case of captives, regulation usually starts with the domicile. Every domicile has its own regulations and requirements for the amount of capital and surplus. Many, but not all, domiciles have restrictions and limitations on what kinds of investments can be held by a captive.”

For example, collateral restrictions may limit captives in the type of assets they are permitted to invest in; to manage this process efficiently, a captive must precisely state its objectives and risk

appetite to the third-party asset manager, before agreeing on clear investment guidelines that satisfy the scope.

Miller advises: “This is rarely a case of simply writing down the investment assets that the manager can and cannot invest in. Instead, captives should work with their managers to ensure the guidelines provide sufficient latitude to operate with some flexibility in the investment market, whilst balancing and controlling the types of risk the portfolio is exposed to.

“Guidelines that are too restrictive may result in undiversified portfolios, and guidelines that are too wide may result in unintentional risk and regulatory breaches. This is an art, not a science, as every captive will need to strike the right balance for their business.”

Beyond this, an asset manager should also provide a captive with the necessary tools to monitor guideline compliance, such as training insurance managers on how to review and track this on a regular basis.

“Working with a manager that understands the regulatory landscape for captives across all major jurisdictions will go a long way to ensuring these requirements can be managed efficiently,” Miller adds.

This is affirmed by Meskunas: “The key step in managing the regulatory process efficiently is working with people with experience: knowing what is allowed for the various domiciles that you are asked to do asset management for; knowing what will be accepted; and doing what you can for the captive within the confines of restrictions, if any, that the domicile puts on asset management.”

He continues that this fundamental understanding, as well as a knowledge of what the captive is actually doing (such as what risk it is writing, whether risks are long-tail or short-tail, and the claims frequency), will then drive the need for liquidity, and in some cases the asset model that can be used.

“It is important to have that deep insight into the nature of risk transfer that is inherent in the captive to understand how to better fit what you do in asset management with what the captive is doing in insurance,” Meskunas concludes. ■



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Senior Vice President  
212-590-0976  
[donny.tong@truist.com](mailto:donny.tong@truist.com)

**Joseph Monaco**  
Vice President  
212-303-1746  
[joseph.monaco@truist.com](mailto:joseph.monaco@truist.com)

**Barbara Aubry**  
Senior Vice President  
212-303-4164  
[barbara.aubry@truist.com](mailto:barbara.aubry@truist.com)

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# 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



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



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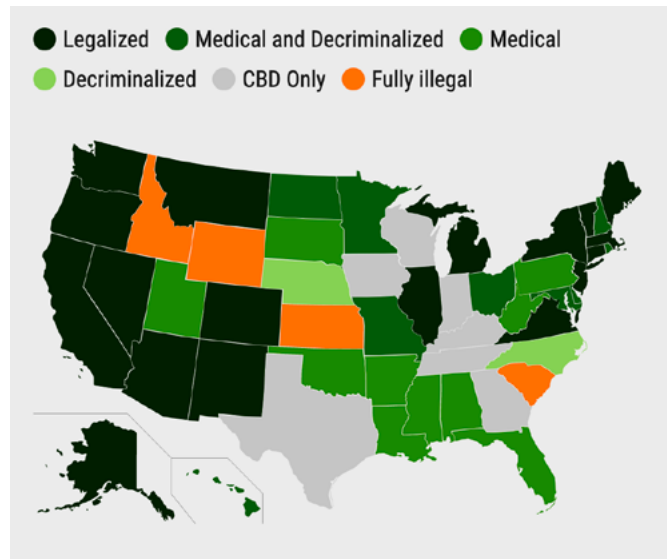
## American Cannabis Association - Group Captive Solution

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: Legalization of Marijuana in the United States*

*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.

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

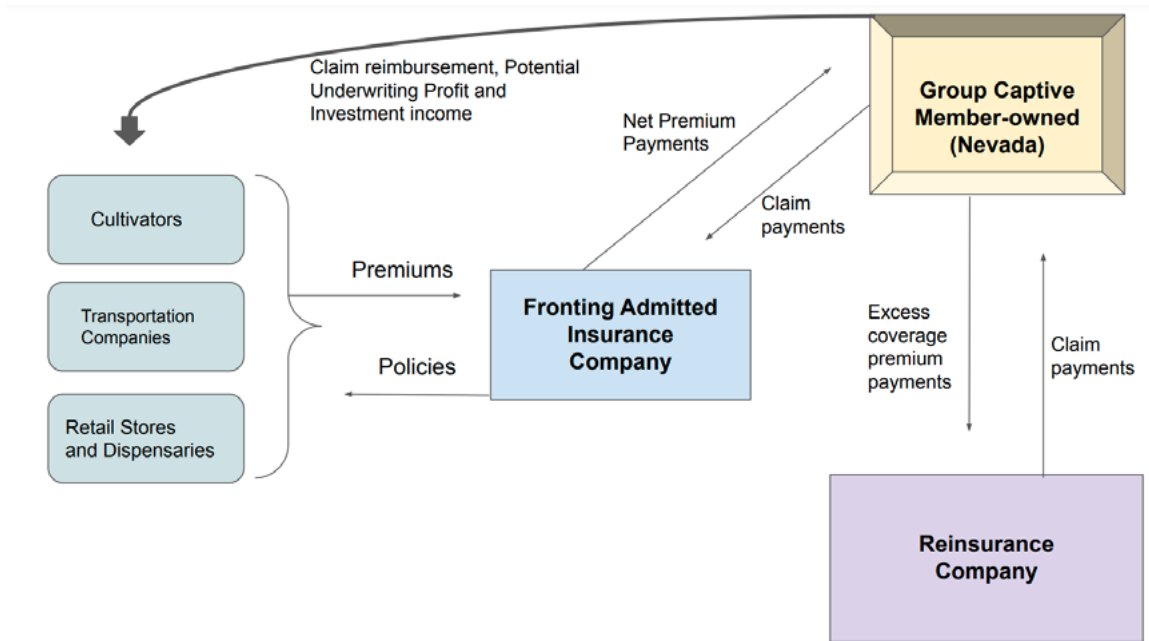
of a captive is that it provides coverage that would otherwise be unavailable in the commercial insurance market

*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.



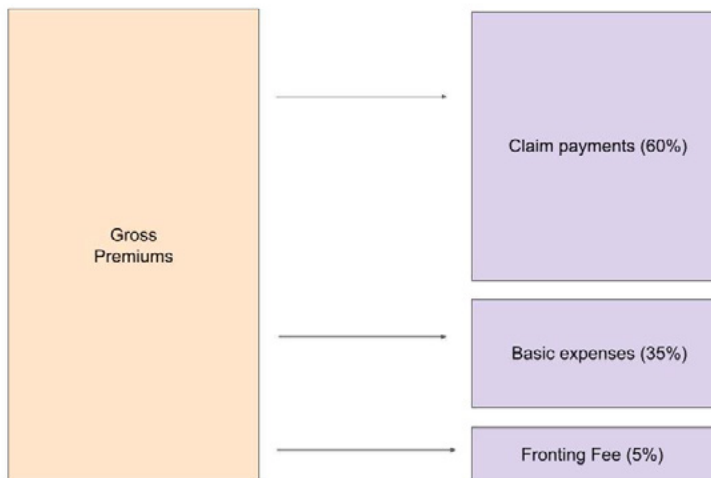
*Exhibit 2: Group captive structure*

**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**

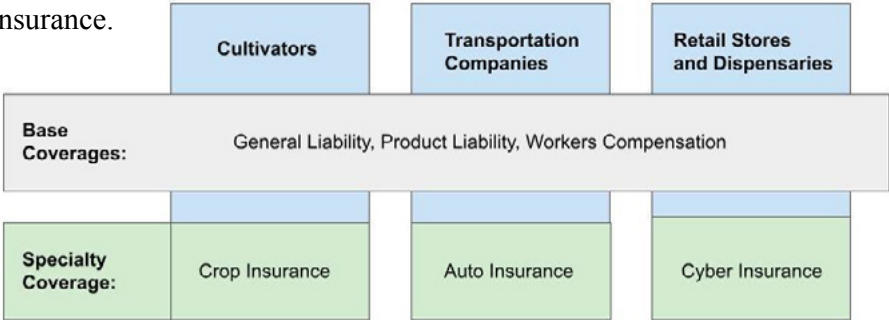
Loss prevention is a risk treatment that creates a physical action plan to prevent and control losses. Workplace safety throughout the entire cannabis supply chain is critical to lowering costs of risk for each business and in turn means fewer workplace injuries. A small portion of each member's premium 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.

*Exhibit 4*



**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.



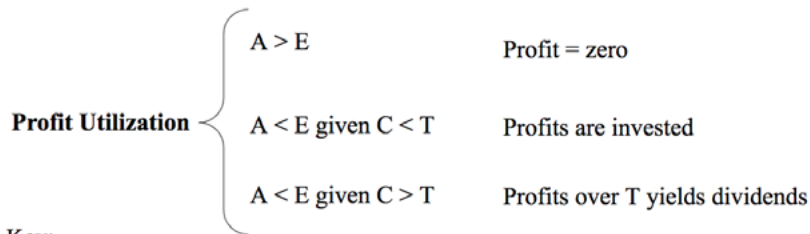
*Exhibit 5:  
Packaged policy*

**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.



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



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2021-2022

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# CICA STUDENT ESSAY CONTEST

Using Captive Insurance Solutions to Address Coverage Gaps



SAINT JOSEPH'S UNIVERSITY:

**Connor Thomson & Nicholas Vagnozzi**

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**CRAFT BREWERIES  
ASSOCIATION**

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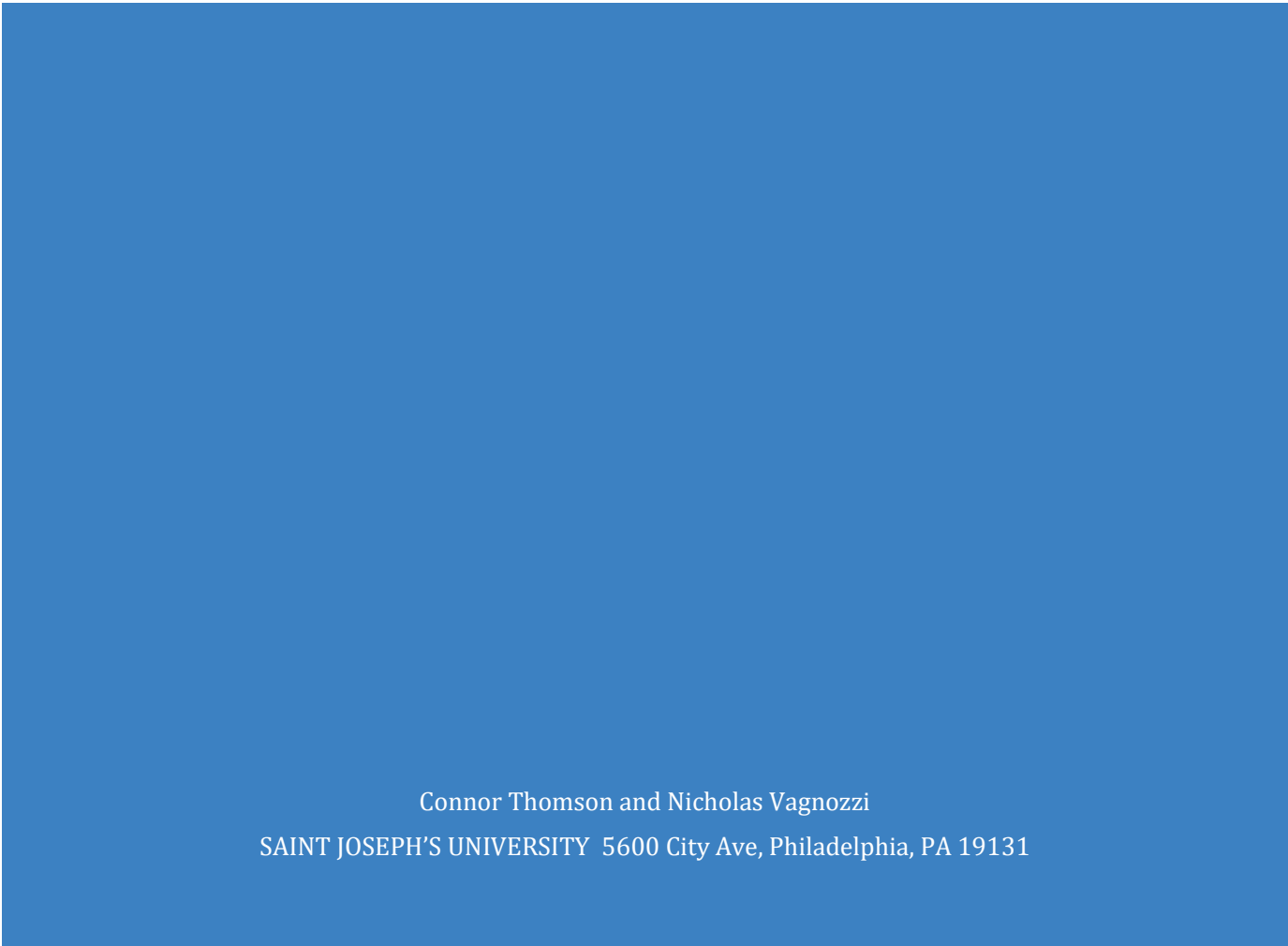


**CICA**  <sup>®</sup>





# 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

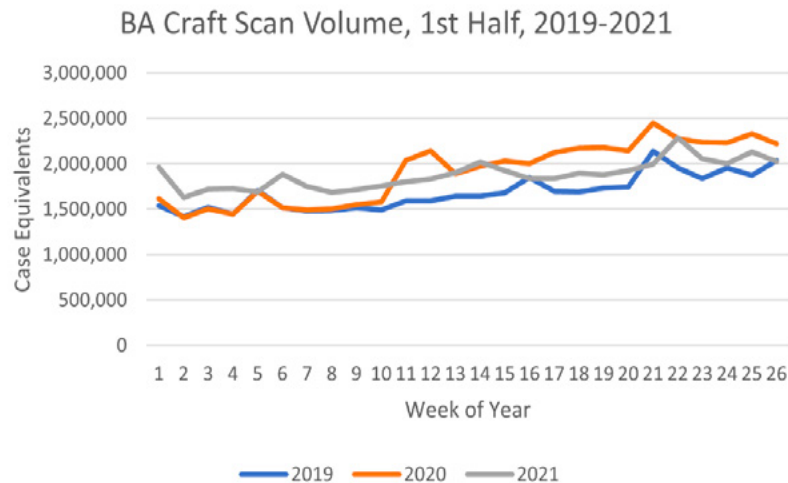
### *Craft Breweries Association*

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.

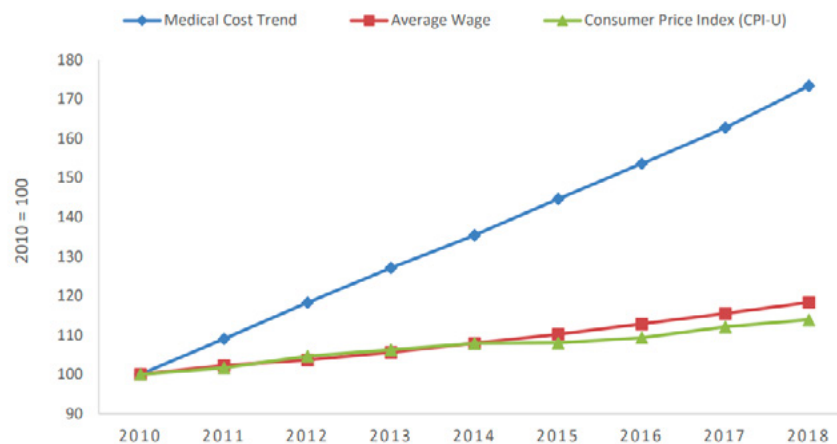
## ISSUE ANALYSIS

### *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

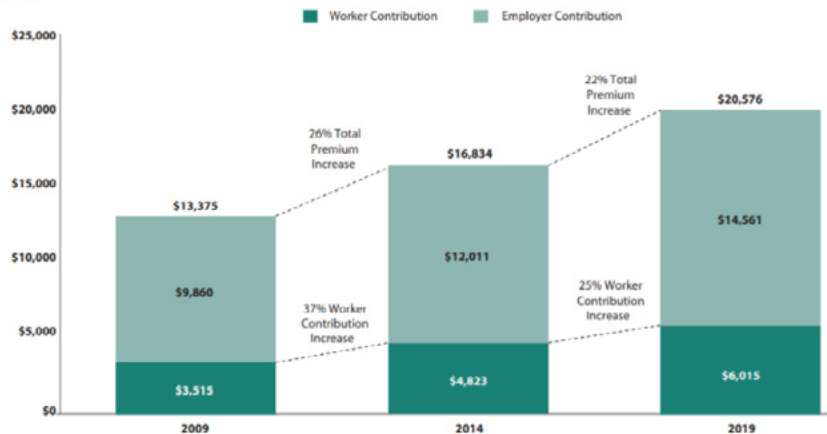


Government policies like Medicare and Medicaid have allowed private insurance companies to raise their rates, and our country is experiencing a growth in senior populations, chronic illnesses, and unhealthy habits. Americans’ physical and mental health standards are declining, generally speaking, and 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**

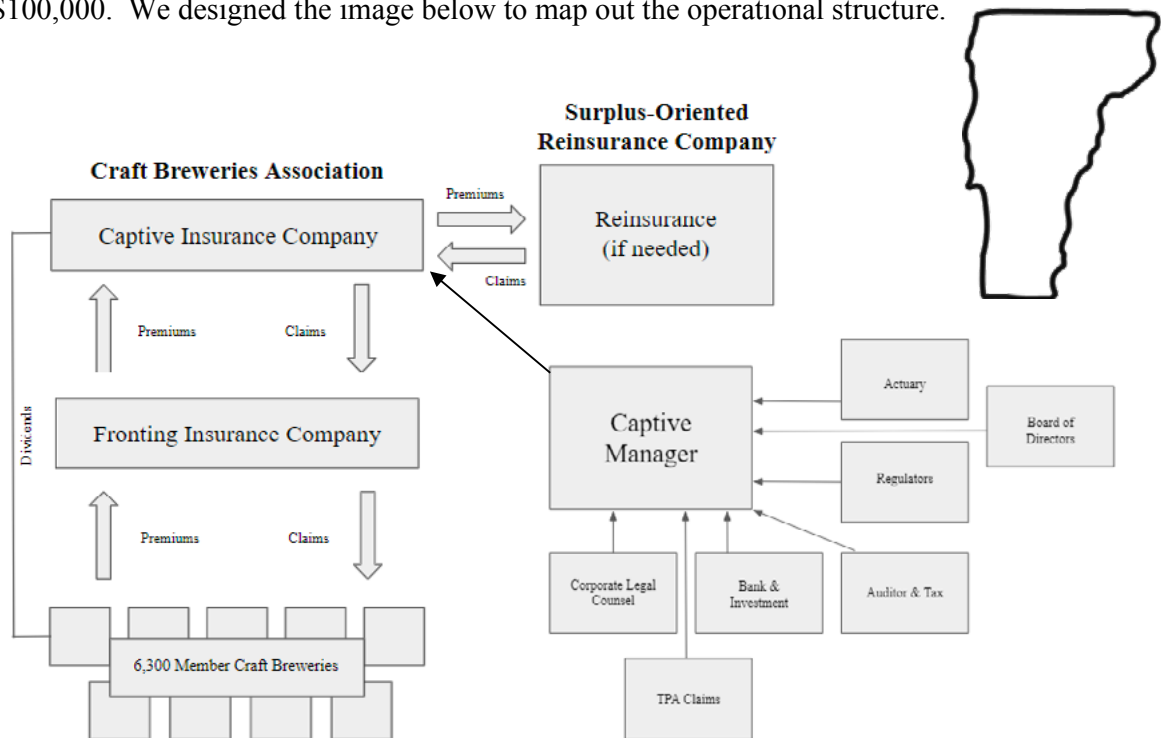
### *Why an Association Captive?*

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

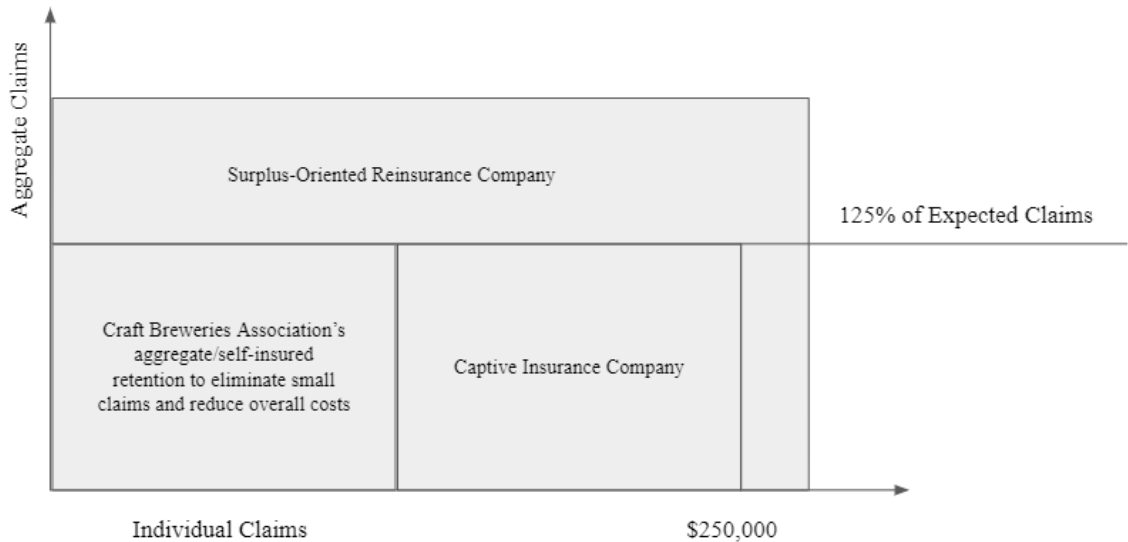
The group captive for the Craft Breweries Association will be domiciled in Vermont, US. Vermont is the largest national market for captive insurance companies because of its favorable corporate laws and robust regulatory environment. As of now, the minimum capital and surplus requirement in Vermont is \$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.

	<b>Gold Tier</b>	<b>Silver Tier</b>	<b>Bronze Tier</b>			
<b>Number of employees</b>	75+ employees	74-25 employees	24-01 employees			
<b>Geographic location</b>	E, NE, MW	C, Pacific NW	W, S, SW, SE			
<b>Age distribution</b>	51+ years old	50-30 years old	29-21 years old	*must be at least 21 years old to work in a craft brewery		
<b>Number of dependents</b>	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



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2021-2022

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# CICA STUDENT ESSAY CONTEST

Using Captive Insurance Solutions to Address Coverage Gaps



**BUTLER**

LACY SCHOOL  
of BUSINESS

BUTLER UNIVERSITY:  
**Katie Strohl & Blake Babec**

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BREWERY  
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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

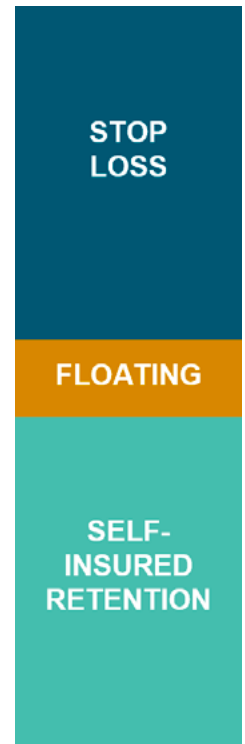
will be adding productive members that will not take more than their fair share of the pooled claim funds. So now we have established the benefits of larger membership in captives, but how do we manage such a system?

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 fallout 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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# Emerging Talent

## Greg Delleney

Chief analyst and assistant director of captives

South Carolina Department of Insurance



*“Greg Delleney is a fundamental part of the South Carolina captive division. He is not only the epitome of a captive insurance regulator, but his understanding of complex risk financing and transfer mechanisms is world-class. He is a team player who adds tremendous value, and we owe much of our success to what he brings to the table.”*

Joe McDonald, director of captives,  
South Carolina Department of Insurance

## Personal bio

I was born and raised in a small town south of Charlotte, North Carolina, but now I live and work in Columbia, South Carolina.

While I enjoy playing golf, boating and fishing when I'm not working, my favourite thing is spending time with my beautiful wife and our two daughters.

## Professional profile

I graduated from The Citadel in Charleston, South Carolina in 2010 with a degree in business administration with a concentration in accounting.

After graduation, I accepted a job with the South Carolina Department of Insurance regulating workers' compensation and medical malpractice insurance rates and policy forms.

From there, I made an internal jump to the captives division in 2014 and began working as a financial analyst. It was as a result of this move that I discovered something I really loved and was able to take several different roles, ultimately being promoted to chief analyst in 2020.

I am currently pursuing the associate in captive insurance designation.



### How did you end up in the captive industry?

After exploring opportunities to learn and grow in the insurance industry, I was exposed to the captive space and, like many others, I was immediately intrigued.

I quickly figured out that captives were much more exciting and a better fit for my skill set.

In 2014, I joined our captives division and haven't looked back! If you are in the insurance and risk management world, the captive space is where to be!

### What has been your highlight in the captive industry so far?

One of the things I am most proud of is when I was promoted to chief analyst at the department. In this position I am able to take a more visible and impactful role within our domicile promotion team. I also enjoy attending conferences and meeting people from all over the globe.

### What/who have been your influences in the captive industry?

I have been very lucky to have had several mentors in my career. One of the strongest influences on me was my late friend, co-worker and mentor, Jeff Kehler.

Jeff was truly one-of-a-kind and left a lasting impact on me. Jeff loved captives and the people in the industry.

His energy and positivity taught me how to interact with the industry and how to regulate the industry in a thorough, compassionate and effective manner.

### What is your impression of the industry?

The captive industry is cutting-edge, flexible and efficient. It is an exciting industry filled with people that implement unique and creative ideas.

*“Captives is an exciting industry filled with people that implement unique and creative ideas”*

### What are your aspirations for your career in the captive industry?

One of the most exciting aspects about serving in my current role is seeing new applications and kicking around new, innovative ideas for business plans for new captives, or to amend current business plans with a variety of captive managers and other service providers. Each captive is different and there is always something to learn.

I plan to continue to grow in the industry and learn as much as I can along the way. My main aspiration is to ensure that captives are regulated appropriately in South Carolina, and that I ensure the success of the growing portfolio of captive companies that call South Carolina home.

### What advice do you have for someone considering a role in the industry?

Take every day as a learning opportunity. Although you will have a hard time explaining to the general public what you do, it is a very exciting and niche space to work within the overall insurance community. If you choose this route, ask good questions and soak up knowledge like a sponge. There is so much to learn in this industry and so many great people willing to teach you! ■



### Zurich names Scherzinger head of US captives

Zurich North America has appointed Adriana Scherzinger as head of captives and sales execution for US national accounts.

In her new role, Scherzinger is responsible for managing the value proposition, performance metrics and key initiatives across Zurich's portfolio of single-parent and sponsored cell captive solutions within US national accounts and middle market.

She has more than 15 years of experience in insurance, with a focus on international corporate

business and reinsurance, including captive feasibility, fronting and management.

Scherzinger has served at Zurich Insurance for more than 10 years, most recently holding the position of regional head of international programme business for Zurich's commercial business in Latin America.

Before this, she was head of captive services for Latin America, and senior captive portfolio manager for the Middle East, Spain, Switzerland and Asia Pacific. ■

### The North Carolina Department of Insurance (NCDI) has named Lori Gorman as new deputy commissioner of the captive insurance company division, effective from 1 April.

Gorman has served at NCDI for 15 years, currently as assistant chief financial analyst within the department's financial analysis section of the company service group.

In this role, Gorman is responsible for monitoring the financial solvency of domestic and foreign insurers licensed in North Carolina, and served as a representative for the department on a working group with the National Association of Insurance Commissioners.

Before joining NCDI, Gorman worked in public accounting and in the insurance industry.

Commenting on the appointment, commissioner Mike Causey says: "Lori has an in-depth knowledge and understanding of the financial oversight that will complement the captive insurance company division.

"Her calm and personable demeanour will be an asset to the department and the industry."

Gorman succeeds Debbie Walker, who recently announced her retirement.

As part of the personnel transition, senior deputy commissioner of the company services group Jackie Obusek will assume senior leadership responsibilities in the captive insurance company division alongside her other current responsibilities.

**Renea Louie, chief operations officer of Pro Group Captive Management, will assume the position of chair for the Captive Insurance Companies Association's (CICA) 2022 board.**

In her role at Pro Group Captive Management, Louie is responsible for managing the day-to-day operations, including marketing, underwriting, accounting, audit, risk management, client acquisition and retention, regulatory compliance and corporate communications.

With extensive experience in the alternative risk transfer industry, Louie has served on the CICA board for the past four years.

Commenting on her upcoming term as chair, Louie says: "It is an honour and privilege to serve as CICA's 2022-2023 board chair. CICA's strength stems from our members, leadership and staff who are all passionate in serving the industry to create innovation, solutions and progress.

"The global pandemic has revealed to a much larger universe of business owners the power of captives, and the coming years will bring large growth for the industry. With growth comes new challenges, and CICA remains committed to providing the education, insights, perspectives and best practices in all facets of captive operations, guidance and leadership needed to thrive."

In addition, Nick Hentges, CEO of Captive Resources, has been elected as vice chair, while Mary Ellen Moriarty, vice president for property and casualty at Educational and Institutional Insurance Administrators (EIIA), has been elected as secretary/treasurer.

Returning CICA board members are Courtney Clafin, executive director of captive programmes at the University of California, Office of the President; Colin Donovan, president of STICO Mutual Insurance Company; Deyna Feng, director of captive programmes at Cummins Risk International; Heather McClure, chief risk advisor of Aon's US healthcare practice; Michael Scott,



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## Daniel Clements returns to TDCI

The Tennessee Department of Commerce and Insurance (TDCI) has appointed Daniel Clements as assistant director of the captive insurance section. Clements has extensive experience in risk-focus examination and regulatory control functions in both the private and public sectors, having most recently served as director for regulatory, audit and internal controls at AIG/Fortitude Re.

In this role, he was responsible for leading the regulatory efforts for a third-party administrator that oversaw 4.5 million insurance policies, as well as managing departmental reporting, developing corrective action and control projects, and reviewing referrals for suspected fraudulent activity.

Before this, Clements held the position of financial audit lead

analyst at Cigna Health, an insurance carrier. Clements previously worked at TDCI between 2016 and 2020 as examiner in charge of examinations of insurance companies, where he became familiar with Tennessee's captive insurance statutes.

Commenting on the appointment, TDCI assistant commissioner of insurance Bill Huddleston says: "Daniel's knowledge, experience, and understanding of the captive insurance industry combined with his belief in Tennessee's commitment to responsible regulation make him a natural fit as assistant director.

"I am confident that Daniel will play a crucial role in Tennessee's continued climb toward becoming the top domicile choice for captive insurance companies." ■

attorney at the Law Office of Allison & Mosby-Scott; and Michael Zuckerman, associate professor at Temple University.

The association also elected to the board Udo Kappes, head of property and casualty, employee lines and reinsurance at Airbus Insurance Risk Management, where he is responsible for the group-wide risk transfer of global property, liability, employee and financial lines of risk. Kappes also chairs the board of directors of the European Captive Insurance and Reinsurance Owners' Association.

Finally, Prabal Lakhnampal, vice president of Spring Consulting Group and chair of CICA's NEXTGen Young and New Professionals Committee, will begin his appointed term on the board.

### **PMA Companies has appointed Vince Perrotta as senior underwriting specialist within the specialty markets division.**

As a provider of workers' compensation, casualty insurance, and third-party administrator and risk services, PMA's specialty markets division works with alternative risk clients and brokers to form captive solutions.

In his new role, Perrotta will be responsible for working with PMA's distribution partners and clients, with a focus on underwriting the firm's growing captive book of business.

As a casualty underwriter, Perrotta has experience in the captive industry on a range of programmes, including single-parent and group captives, rent-a-captives and pure fronts. ■

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