Captive Insurance Company Investment Management and Strategy for Today's Volatile Markets

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Summary: This article explores captive insurance company investment restrictions, investment regulation trends, large and small insurance investment managers, and portfolio investment strategy considerations warranted in the continuing aberrant global economy.

Introduction

Insurance company investment regulation is governed by two over-riding primary principles – preservation of capital and liquidity. Return on investment needs more consideration by regulators, especially in this prolonged central bank engineered low interest rate environment.

Each captive is unique and warrants a custom investment policy. Increasingly smaller pure captives are part of a private corporate group business plan integrated with estate and wealth transfer programs. In these situations, insurance company management teams should give long-term return on investment heightened consideration.

In today's uncertain environment, all insurance companies need increased attention to their investment portfolio strategy. Today's central bank engineered artificially low interest rate environment could cause unexpected, and unprecedented, principal losses on traditionally conservative portfolios. Pure captives with full service investment advisors and active investment committees have the highest probability of navigating today's turbulent financial market waters. Other captives and traditional insurance companies with restricted portfolios structured to match investment maturities to liabilities are at greatest risk of losing recent portfolio gains. Defensive adjustments are indicated. So is lobbying to expand allowable investments particularly with global reform initiatives already underway.

Background on Domicile Specific Investment Restrictions and Reporting

An insurance company's investments are governed by its authorizing domicile's statutes. In every U.S. state, the investment restrictions are lengthy requiring most insurance companies to invest primarily in U.S. guaranteed investments. Other securities are limited to a small percentage of total admitted assets.

The National Association of Insurance Commissioners (NAIC) "Investment of Insurers Model Act" has 4 component parts totaling nearly 200 pages. The trend is toward increased granularity of regulation; not a positive development for operating efficiency or competitiveness. While the NAIC is not technically a regulatory entity, but merely a non-profit organization whose members are the commissioners, directors, superintendents and other state officials who regulate the insurance business within the 50 states, the District of Columbia and the four U.S. territories [1], its model investment act is designed to bring increased uniformity between the states. By requiring states to adopt some of its model laws as a condition of NAIC accreditation, the NAIC has become a de-facto regulatory body. To complicate matters, the National Conference of Insurance Legislators also proposes regulations often in variance with NAIC proposals, evident by recent variations in how these organizations propose addressing multi-state reinsurance premium tax allocations.

In February 2009, the NAIC's CEO Therese Vaughan issued a policy brief comparing the NAIC's ongoing efforts to increase insurance regulatory uniformity with the European Commission's adoption of its

Solvency II initiative. "In Solvency II, Europe is relaxing its investment restrictions in favor of a prudent person approach to investment regulation. In the United States, investment regulations vary across the states. In general, states maintain a blend of rules-based and prudent person approaches to investment regulation, with most assets required to be invested in high quality instruments, but a small amount (the basket) permitted to be invested outside those restrictions." [2]

Most states within the U.S. that have enacted specific captive insurance company statutes have added provisions exempting some captives from the general insurance investment restriction statutes. For example Vermont, Arizona and South Carolina, three leading U.S. captive domiciles, have adopted similarly worded statutes based on the NAIC model act. Their statutes essentially provide that a pure captive is not subject to restrictions on allowable investments, except the commissioner may prohibit or limit any investment that threatens the captive's solvency or liquidity. They all added one significant provision regarding self-dealing by requiring prior approval of the state insurance department before a captive insurance company may loan to or invest in its parent or affiliate companies. [3]

Notwithstanding an express exemption from insurance investment restrictions for pure captives, many state regulators expect captives to follow the conservative investment limitations unless their approved business plans and investment policy specifically allows broader investment discretion including increased weighting in equities and lower grade investments. Most offshore domiciles not part of the U.S. or E.U. have more relaxed investment restrictions and less cumbersome regulatory compliance requirements. We anticipate states desiring to increase their share of captive business to continue with regulatory reforms focused on captive operation efficiency and flexibility. [4]

We expect the new Federal Insurance Office (FIO) created as part of the 2010 Frank-Dodd Act in the U.S. to facilitate further uniformity in insurance company investment restriction and reporting requirements for U.S. based captives. The new FIO will hopefully also focus on making U.S. domiciled insurance companies more globally competitive and expand investment discretion, even if contingent on an insurance company having corporate governance that includes an active investment committee with one or more independent experienced members.

Insurance company investment advisors and management companies historically have limited their involvement to assuring client compliance with new laws and regulations, verses being proactive in the regulatory reform process. A senior official with a global asset manager said he expects increasing costs if insurance companies are required to do solvency analysis and reporting. He added new regulation may also require investment portfolios to be even more conservative. Jeff Sims, CPA, a former senior investment officer with an insurance consortium and now an investment advisor with Madison Scottsdale, agrees that surplus assets should be allowed to be invested in equities, but that the allocation should be based upon surplus strength and that regulations limiting such investments to a percentage of total assets, as opposed to surplus, ignore this very important distinction.

In both the U.S. and the E.U. today, investment advisors, insurance company executives and even insurance management service providers have a golden opportunity to be proactive and improve the efficiency of investment portfolio management and reporting. All insurance companies, particularly captives, should push for preservation of current exemptions from investment restrictions and lobby to prevent any increased investment reporting requirements. There is no significant reason not to allow full investment discretion (as is given pure captives in most U.S. states) with respect to excess capital and with respect to surplus for all types of insurance companies. This would over time increase return on investment portfolios; strengthening insurance company solvency which is the main objective of both the U.S. and E.U. financial reform agendas.

Captive Insurance Investment Management Services

Captives usually start out with straightforward and simple investment approaches. As captives grow, the traditional view is they should have more targeted approaches aligning investments with scheduled liabilities and balancing this consideration with investment diversification and return objectives. Depending on the type of captive, they may also require specialized investment accounting reporting. This requires expertise not generally found within smaller insurance companies or many investment managers.

Experienced insurance investment advisors bring a suite of analytic resources to help improve investment returns while maintaining compliance with specialized regulations and reporting requirements. These institutional investment managers not only design, manage and report on individualized insurance company investment portfolios, but have internal resources to serve as de-facto senior investment officers for clients. They usually require $10 million or more in minimum investment and charge a declining scale asset based fee for services. For smaller insurers who do not have access to these large asset managers, many of these services can be purchased from third party providers at an additional cost.

Examples of some larger full service investment management firms with insurance industry expertise include AAM, Wellington, Madison Scottsdale and Dwight. [5] They offer individual investment selections based on each insurance client's particular needs. Dwight focuses exclusively on fixed income investments; the other large investment managers blend equities and other instruments in client portfolios where appropriate. AAM focuses exclusively on insurance investments, with around $15 billion of insurance company assets under management. Wellington Management has $675 billion under management of which $84 billion is insurance company assets. Madison Scottsdale is a SEC registered investment advisory firm specializing in insurance investment management. These larger investment managers pride themselves on the range of services offered and their depth of insurance industry expertise. [6]

Many large investment advisors recognize smaller captives are not well served by their current investment advisor relationships. One commented on how hard it is to justify the impact of professional management fees on portfolio rates of return in today's low interest rate environment when an insurance company has less than $7 to $10 million in investible assets. These larger firms have significant up front and ongoing expenses connected to new clients because they offer such comprehensive investment management and reporting services. Another large investment manager focused on insurance industry clients is working on a specialized pooled fund targeting smaller insurance portfolios to address this gap in the market. One such managed product is already available with as little as a $250,000 investment discussed below in the last section of this article.

Smaller captives looking for investment management services without large investment minimums or percentage of asset fee based services do have options beyond the typical retail high net worth investment managers at most banks and brokerage firms. For example, Jeff Pratt, formerly a wealth manager at Wachovia Securities now part of Wells Fargo Advisors in Charleston, South Carolina, offers customized individually selected bond and equity investments for several U.S. and offshore captives starting with as small as $250,000 to invest. Richard Oxford, MBA, an investment advisor with the

Private Client Group [7] in Paradise Valley, Arizona, recently began offering similar individually selected and managed investment portfolio services for smaller captives, institutions and non-profits.

Modernizing Investment Portfolio Strategy for Today's Economy

The days of high investment returns on conservatively managed insurance investment portfolios seem long gone. The low interest rate environment of recent years however is no excuse for accepting poor relative portfolio performance, or for taking too much market risk. If you have been fortunate of late to experience meaningful gains in your portfolio (note the S&P 500 is up over 30%, Barclay's Capital High Yield is up 15%, Citigroup World Government Bonds is up 10%, and most investment grade bond funds are up 6% to 7% for the year ending June 30, 2011), do not let that blind you to the dynamics at work impacting your future investment portfolio return; there remains significant risk of market value loss should interest rates start rising particularly if coupled with continuing global economic weakness.

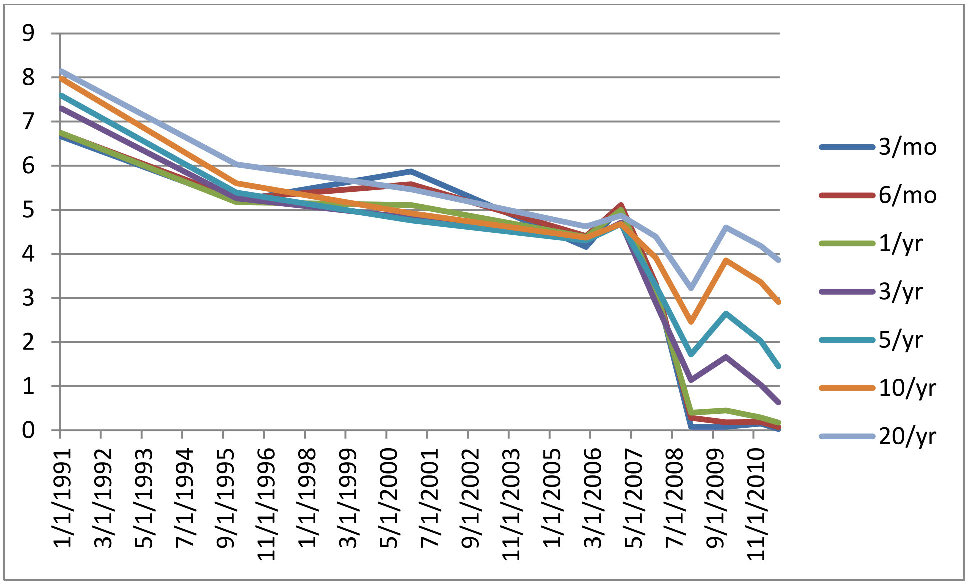
For several years running, many economists have been predicting interest rate yield curve increases for one reason or another that as of June 2011 has not yet manifested. ***"Everybody's concerned about rising interest rates today, but we do not see a rapid ratcheting up of rates anytime soon. Our portfolios are designed to allow repositioning as needed,"*** said one senior investment officer with a global asset manager.

No one living has experienced such widespread aggressive and prolonged government and central bank intervention keeping interest rates low trying to stimulate economic growth without igniting an inflationary inferno. There is now more consensus than ever that higher interest rates and inflation are inevitable. A stagflation period could of course reverse recent widespread investment gains potentially for both equities and fixed income investments.

Consider the following two charts. Does anything look aberrational to you since the onset of the global economic crisis in 2007 that should impact current investment portfolio strategy?

US Treasury Interest Rate Yields (extracted from the Treasury website)

Date	3/mo	6/mo	1/yr	3/yr	5/yr	10/yr	20/yr
7/19/2011	0.03	0.07	0.17	0.63	1.45	2.91	3.86
1/3/2011	0.15	0.19	0.29	1.03	2.02	3.36	4.18
1/4/2010	0.08	0.18	0.45	1.66	2.65	3.85	4.6
1/2/2009	0.08	0.28	0.4	1.14	1.72	2.46	3.22
1/2/2008	3.26	3.32	3.17	2.89	3.28	3.91	4.39
1/2/2007	5.07	5.11	5	4.71	4.68	4.68	4.87
1/3/2006	4.16	4.4	4.38	4.3	4.3	4.37	4.62
1/2/2001	5.87	5.58	5.11	4.82	4.76	4.92	5.46
1/2/1996	5.2	5.25	5.17	5.26	5.39	5.6	6.03
1/2/1991	6.66	6.73	6.74	7.3	7.59	7.97	8.14



Key considerations derived from the above data include:

- For 15 years prior to the recent economic crisis, short-term interest rates (1 to 5 years) on U.S. Treasuries ranged between 4% and 7%, emulating domestic inflation and economic growth rates
- For the past several years, short-term rates have held in the 0% to 2% range, below the approximate 3% rate of underlying inflation and GDP growth
- Yield curves throughout the 20 year maturity range were relatively flat for the 15 year period prior to the recent global economic crisis
- Yield curve spreads, especially in percentage terms, is quite wide today between short, medium and longer terms as compared to the 15 years before this post-crisis era

Some internal economic forecast conclusions of some of the large insurance investment manager teams shared in newsletters follow:

- ***"We have not changed our outlook, believing the US economy in the second half of 2011 will be more robust … Moreover, our commodity price outlook remains consistent with GDP growth in the US of slightly less than 3%."*** Elizabeth G. Henderson, CFA, July 12, 2011 AAM Corporate Credit View.
- ***"A measure of the attractiveness of an asset is its ability to produce a positive return net of expected inflation … on an earnings basis, many equity markets are yielding between 6% and 8%, which compares favorably to expected inflation … In terms of other asset classes with the potential to outpace inflation, U.S. high yield bonds fit this bill."*** Evan Grace, CFA, Third Quarter 2011 Wellington Management Asset Allocation Outlook.

One global asset manager newsletter cautions that it is important to consider the degree to which investors are attracted to equities by dint of low expected returns elsewhere. It states that if bond yields are low due to poor expected economic growth, and stock prices are rising for relative-value reasons not supported by fundamental growth, we may be setting up for a deeper valuation correction down the road. Continuing investor uncertainty is moderating this flight for returns; safety always takes precedence in volatile political and uncertain economic times.

Some portfolio managers are making significant defensive adjustments within client portfolios - shortening average maturities and increasing risk to maintain yields. Others continue matching maturities to actuarial reserve schedules irrespective of the exposure to potential prolonged periods of total negative portfolio returns should interest rates rise in coming years. Just because rates have not risen in recent years, despite several years of such expectation, does not mean they won't soon. Gold reaching an all-time high breaking $1600 an ounce for the first time ever in July 2011 could be a leading indicator of meaningfully higher inflation and interest rates around the corner.

US Senate minority leader Mitch McConnel on July 18, 2011 stated during the Cut, Cap and Balance debate on the senate floor that ***"two years of reckless spending and debt has brought us to the point of crisis."*** While market observers today are focused on these macro government created events, underlying fundamentals suggest short-term and intermediate rates should begin rising regardless of whether governments govern more responsibly in the future. If the U.S. government debt is downgraded, a steeper yield curve is anticipated according to Stephen Walsh, CIO with Western Asset Manager interviewed live on CNBC July 25, 2011. Mr. Hoogendoorn of BDO Capital Markets predicts a U.S. downgrade impact on yield curves should be muted, noting years ago when Japan's debt was downgraded yields actually went down due to overriding market factors.

For an alarming view of one potentially disastrous scenario, consider the testimony of representative Ron Paul, a very popular Texas Republican and candidate for President of the U.S., on the floor of Congress July 19, 2011 during the Cut, Cap and Balance debate ceiling debate:

> ***"We will default because the debt is unsustainable ... this is a huge problem ... to increase the debt limit causes another type of default, by the destruction of the currency ... today's interest rate is 9% ... right now we are in the early stages of higher inflation."*** See, http://www.youtube.com/watch?v=xqfm0zrRs9Q.

Looking at the private sector for clues on future yield trends, we are seeing new signs more industries reviving, suggesting a pulse is returning to the developed industrial economies notwithstanding continuing government mismanagement. The case for rising interest rates over several years now seems compelling, especially with increased U.S. political polarization convincing most economists that a U.S. debt downgrade is unavoidable regardless of whether debt ceiling defaults are avoided in coming years.

Your captive investment committee should consider a defensive approach. Shortening average maturities, and laddering your portfolio to have periodic maturities to reinvest at the longer end of your portfolio, working capital permitting, is indicated. If interest rates rise the next several years, you would experience increasing average yields on investments while minimizing exposure to declining bond and yield driven investment prices. You can always extend maturities for slightly higher yields later; the probability of long bond yields declining further seems low.

To address today's dismal yields on short maturities, the leading institutional investment managers are utilizing medium and lower grade bond and convertible instruments to improve yield and total portfolio returns. To the extent permissible, some are using dividend yielding stocks. They are not simply yield shopping however. Internal financial analysts with these larger investment managers independently analyze industry sectors and individual companies within industries. [6] They look for industries expected to outperform the market, then they select the strongest companies based on their proprietary credit reviews. This helps them outperform the market.

Other Investment Options and Strategies for Today's Volatile Markets

Specialized managed investment products are emerging targeting captives. Some captive managers with investment expertise have worked with asset managers to design investment funds that meet their clients' needs. For example, Lionheart Insurance Group and Crusader International worked with the New Jersey Princeton Advisory Group to create the Princeton Stable Income Fund. The fund was designed as an enhanced cash replacement for a portion of qualifying captive portfolios. This fund has an attractive yield (targeting 400 basis points above one month LIBOR) and relatively short average maturity to hedge against rising interest rates. It also invests a significant portion in variable rate securities. According to Mr. Simon Kilpatrick of Lionheart Insurance Group, the Princeton Stable Income Fund had a nearly 9.5% first year total return after fees with minimal volatility. [8]

Bond ETFs (Exchange Traded Funds), such as iShares Investment Grade Corporate Bond Fund, are increasingly popular. [9] This particular ETF, as of July 25, 2011, had over $14 billion of bond investments, more than 600 individual bonds in its portfolio, less than 1% of total assets invested in any one issue, an average weighted maturity of 11.88 years, and a 30 day SEC yield of 3.98%. One of the most attractive features of these bond ETFs are the low expense ratios (only .15% for the above referenced ETF).

Fixed income ETFs are revolutionizing the fixed income landscape. The greatest negative to these ETFs is the inability to control average maturity within the portfolio, and while the above referenced ETF has had a 6.59% one year, 8.3% three year and 6.75% five year average total return, there is greater risk now of a reversal in yield trends and corresponding downward pressure on market values of these managed products. Nevertheless, portfolios using a variety of ETFs in lieu of individual securities are likely to increase in coming years.

Unfortunately nearly all U.S. domiciles limit participation in managed products to a small percentage of admitted assets, usually 10%, regardless of the wide diversification or quality of the underlying investment assets. This is something the insurance industry should be more proactive about changing.

Conclusions

Relaxing investment restrictions to allow all insurance companies to invest a higher percentage of admitted assets, and all surplus, in high quality non-U.S. government backed investments should be sought by the insurance industry in this era of regulatory reform initiatives. Regarding managed products, a product prospectus allowing, and at times the actual portfolio having a small percentage of lower grade investment securities, should not disqualify these increasingly valuable and efficient products as allowable investments. For individually managed portfolios, investment grade corporate bonds should be on parity with U.S. government obligations as permissible investments. This would allow portfolio managers to take advantage of yield spreads between governments and investment grade companies with strong balance sheets without compromising principal preservation or liquidity. Additionally, increased allowance of equity investments should be considered for all insurance companies.

About the Author:

Tom Cifelli is Captive Experts Managing Director. He has over 20 years of legal, accounting, tax and financial expertise. Early in his career, Mr. Cifelli served as a municipal treasurer managing $100 million in investment restricted fixed income assets. During that time, he was a founding director of a Municipal Liquid Asset Fund, a managed product targeting restriction laden municipal and school investment portfolios that could not participate in general market managed products. Mr. Cifelli has since served as Chief Financial Officer and General Counsel with private and publicly traded companies. He also was the Managing Director of Investment Banking with a U.S. regional SEC registered broker-dealer firm.

References:

1/ Purposes and Procedures of the NAIC Securities Valuation Office, December 31, 2008.
2/ Therese M. Vaughan, *The Implications of Solvency II for U.S. Insurance Regulation*, March 2009, Insurance Reform Summit.
3/ Vermont Revised Statutes Title 8, Section 6010; Arizona Revised Statutes Title 20, Section 1098.10; South Carolina Revised Statutes, Title 38, Section 38-90-100.
4/ Nevada recently reformed its captive statutes seeking to attract new business but failed to address investment restrictions. See, *"State Looks to Regain Spot as Captive Insurer's Home,"* by John Seelmeyer, Northern Nevada Business Weekly, July 19, 2011, www.nnbw.biz.
5/ Large investment advisors provide sophisticated investment portfolio management services to help you establish good investment policies and procedures, improve portfolio yield, comply with investment regulation restrictions and reporting, and protect your investment portfolio from significant market value losses. For more information visit, www.AAMcompany.com, www.Wellington.com, www.MadisonScottsdale.com, and www.Dwight.com.
6/ Greg Curran with AAM shared that AAM's internal financial analysts do independent corporate credit reviews before selecting bonds verses relying on 3rd party reports and rating agencies.
7/ The Private Client Group's website is www.privateclientllc.com.
8/ Simon Kilpatrick, CFA and Executive Vice President with Lionheart Insurance Management, www.LionheartInsuranceGroup.com. Mr. Kilpatrick started his career as an institutional asset manager and financial advisor with Bank of Bermuda.
9/ As of July 25, 2011, according to www.iShares.com.