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The essential guide to alternative risk transfer

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A BROADER REACH

IDEAS ABOUND FOR HOW CAPTIVES CAN SCALE NEW

EDITOR'S VIEW

Raising the limits

SO TO NOBODY'S great surprise the US raised its debt limit by up to $2.4tn, averting the possible financial disaster media outlets had been so excited about.

The bill's signing came just 10 hours before Washington's deadline, following posturing and brinkmanship (sorry, "drawn-out talks") between Republicans and Democrats.

Obama urged Congress to look to boost the economy with measures to create jobs and increase consumer confidence. The president didn't mention captives during the speech, or even later at his birthday bash, but they were clearly on his mind, or at least should have been.

The US' resulting situation calls not just for compromise but also ingenuity, something captives continue to exhibit, as shown by Rentokil Initial's captive (*page 18*). The company's recent consideration of employee benefits, environmental liability and expanded personal accident liabilities is mirrored in the US by companies' growing interest in integrated disability management programmes (*page 15*).

The cover feature broaches the perennial issue of what can and should be written into a captive, and how far its utility can extend (*page 23*). Such matters are arguably of greater pertinence during economic hardships, when a company's need to function within its means but "think outside the box" is particularly pronounced.

However, the problem is perhaps less about a lack of ideas and knowledge and more about inadequate communication to the wider corporate bodies. This issue is perhaps best expressed by David Spruance, director of risk management for Republic Services: "Risk managers often deal with theory, which isn't necessarily tangible, so corporate boards do not get to see what those benefits are."

Meanwhile, Dublin's captive industry becomes even more pertinent to EU-orientated companies as Solvency II implementation nears. It domiciles captives of an impressive number of "household" companies, and is leading the way in captive-based corporate governance. However, it is arguably less flexible and open to new applications than Malta (*page 20*), which has benefited from re-domestications between the domiciles.

Matthew Broomfield
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Investment strategy for volatile markets

Investment advisers and insurance company executives have a golden opportunity to improve the efficiency of investment portfolio management and reporting

by ***Tom Cifelli, managing director and editor at CaptiveExperts.com, part of the Crusader International Group***

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 programmes. 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. The current 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 advisers 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 authorising domicile's statutes. In every US state, the investment restrictions are lengthy, requiring most insurance companies to invest primarily in US 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 four component parts totalling nearly 200 pages. The trend is towards 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

"Pure captives with full service investment advisors and active investment committees have the highest probability of navigating today's turbulent financial market waters"

organisation 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 US 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 organisations 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 favour 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."

Most states within the US that have enacted specific captive statutes have added provisions exempting some captives from the general insurance investment restriction statutes. For example Vermont, Arizona and South Carolina, three leading US captive domiciles, have adopted similarly worded statutes based on the NAIC model act. Their statutes essentially ensure 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.

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 US or EU 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.

We expect the new Federal Insurance Office (FIO), created as part of the 2010 Frank-Dodd Act in the US, to facilitate further uniformity in insurance company investment restriction and reporting requirements for US-based captives. The new FIO will hopefully also focus on making US 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 advisers 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 adviser 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 US and the EU today, investment advisers, 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 US 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 US and EU financial reform agendas.

Captive insurance investment management services

Many large investment advisers recognise smaller captives are not well served by their current investment adviser 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 $7-10m in investable assets. These larger firms have significant upfront 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 specialised 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,

> "All insurance companies, particularly captives, should push for preservation of current exemptions from investment restrictions and lobby to prevent any increased investment reporting requirements"

formerly a wealth manager at Wachovia Securities now part of Wells Fargo Advisers in Charleston, South Carolina, offers customised individually selected bond and equity investments for several US and offshore captives starting with as little as $250,000 to invest. Richard Oxford, MBA, an investment adviser 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.

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 $1,600 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.

Looking at the private sector for clues on future yield trends, we are seeing new signs of 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 US political polarisation convincing most economists that a US 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 over the next several years, you would experience increasing average yields on investments while minimising 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 the current dismal yields on short maturities, the leading institutional investment managers are utilising 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 analyse industry sectors and individual companies within industries. 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

Specialised 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.

Bond ETFs (exchange traded funds), such as iShares Investment Grade Corporate Bond Fund, are increasingly popular. This particular ETF, as of 25 July 2011, had more than $14bn 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 0.15% for the above referenced ETF).

Fixed income ETFs are revolutionising 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 a 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 US 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.

Captive investment committees should consider a defensive approach