A Capital Question

The last ten years have been something of a lost decade for the investment portfolios of niche insurers such as captives and mutuals. The recession of 2009 and the ultra-low interest rate environment that has persisted in its wake, has translated into precious little opportunity to generate meaningful returns. Given the arid investment landscape, many management boards put the thought of investing to one side and placed captive assets in bank deposits or loaned the money back to parent companies. However, as interest rates continue to creep up and corporate governance regulation tightens, boards need to be able to demonstrate they have reviewed all options and come to a well-informed decision on how best to invest their assets.

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Kate Miller, Head of Institutional Business at London & Capital and Insurance Consultant, Malcolm Cutts-Watson, discuss the options.

By their very nature insurers have a conservative risk profile. Capital preservation is key in order to ensure sufficient cash flow to pay claims as they fall due and to protect the value of the assets. The irony is that, despite this conservative bias, the default option over the past decade has been to loan insurance assets back to parent companies or put the cash in the bank, both of which can carry significant risk.

However, the introduction of the Solvency II regulatory regime for EU-based insurers in 2016, and the enforcement of risk-based assessments in other territories, has served to concentrate minds on risk management. The collapse of several parent companies, most recently Carillion, has also caused pause for thought on the prudence or otherwise of lending to parent companies, many of which are unrated and run on thin cash cushions. When Carillion went into liquidation in January 2018 the company's £1.5 billion debt burden included a loan from its Guernsey-based captive. The courts subsequently deemed the loan irrecoverable and found the captive had failed to satisfy the balance sheet and cash flow aspects of the applicable solvency test under Guernsey law i.e., the own capital solvency assessment, which must include the directors' view on the company's current and projected solvency.

The failure, however, was attributed to the insolvency of Carillion rather than to the captive's board of management in handling its financial affairs. The fact that the captive was in wind down, retained sufficient funds for day-to-day operating purposes and was established years before Solvency II came into play perhaps helped to exculpate the directors. Continued on page 2...

REGULATORY LANDSCAPE: SOLVENCY II AND RISK-BASED ASSESSMENTS

Since January 2016 EU-based insurers are subject to the Solvency II regime. Insurers based in other jurisdictions that serve EEA domiciled corporates are indirectly affected by Solvency II and most have introduced their own risk-based rules. The regulation consists of three pillars, all of which affect insurers' asset allocation decisions:

1

Pillar I governs the calculation of capital reserves to protect against default with the riskiest investments attracting the most onerous charges. At 45-49% the capital charge for loan backs is among the highest, making it a poor option for maximising capital utilisation.

2

Pillar II relates to the management of potential risks and governance. In addition to adhering to robust risk metrics, insurers must demonstrate a detailed decision making process.

3

Pillar III covers reporting and disclosure obligations including the need to publish a detailed annual report and risk assessment. (and the ability to look through fund structures to the individual component investments.)

However there is no doubt that board members, either under Solvency II or a risk-based assessment, are being held to much greater account than was previously the case. Boards must evidence their decision-making process and if they do not have sufficient knowledge to make an informed decision then they must seek the necessary training and assistance to enable them to carry out their duties.

Education, in fact, is key, says Miller who in previous roles has acted as an advisory chief investment officer. She recommends that any management board who are considering moving capital into an investment portfolio for the first time ask their investment advisor for training on the options and risks before making any decision. "It's like learning to ride a bike; you don't rush onto a dirt bike before navigating with stabilisers first.

Putting money in the bank or loaning it upstream has the comfort of the familiar while on the other side trepidation sometimes creeps in once talk turns to duration matching assets with liabilities, ensuring adequate liquidity and understanding and mitigating against interest rate and counterparty default risk. An investment advisor should be able to help navigate this"

Once the investment strategy is agreed, guidelines are devised and a process should be established to monitor the results and ensure proper reporting is in place. This provides a solid basis on which to assess the policy's success. It may well be that after considering all angles, a parent company loan is still considered the best of the available options. The importance lies in being able to demonstrate that other options were actively considered.

Some of the issues to consider when looking at options for a captive's capital:

- The captive's liability profile
- Capital provisions
- Liquidity requirements
- Regulatory landscape
- Risk appetite

Regulators are also increasingly interested in captives writing third-party business, either explicitly (such as extended warranties) or implicitly (employers liability), and apply more stringent criteria where there is a need to protect insureds unconnected to the captive's parent.

FIXED INCOME IS DEAD… LONG LIVE FIXED INCOME!

The regulatory landscape is one part of the equation to which insurance boards must attend when deciding how best to invest captive assets. The other is the interest rate environment because insurers, due to their risk appetite, are confined for the most part to fixed income investments. Now after ten years, interest rates are finally rising, albeit at a glacial pace. To date the UK has hiked its benchmark rate only twice in the decade since July 2007, once in November 2017 and again in August 2018 to 0.75%. The European Central Bank and the Bank of Japan remain dovish with both banks continuing to pursue quantitative easing as inflation remains stubbornly below target. The Federal Reserve is the furthest down the path of policy normalisation, having raised rates in June for the seventh time since December 2015.

Risks of putting captive assets in the bank or loaning back to parents:

- Counterparty risk
- Foreign exchange risk
- Capital charges

So although we're far from the halcyon days of pre-2008 when 12-month deposits could garner a 5% return, the uptick has been enough to whet the appetite of return-starved captive managers, says Cutts-Watson. "The insurance market remains soft, and it's tough to make a significant underwriting profit with the focus on arm's length pricing, so with interest rates slowly moving higher we are seeing renewed interest on the asset side, whereas previously insurance managers were focused on the liability aspect of the balance sheet, the underwriting and reserving."

In seeking to leverage the rising interest rate environment, boards have two primary options; put the money in the bank or invest the cash. Although cash in the bank might seem like the safer of the two options, says Miller, that is not necessarily the case. "The most obvious danger is that corporate bank deposits are not covered by a compensation scheme. No-one would invest all their cash in one bond so why risk putting all your cash with a single corporate entity?"

Comparison for a Guernsey Captive

	Parent Company loan-back	Bond-only Portfolio	Stock and Bond Portfolio
Current Yield	0.7%	1.8%	2.3%
Annualised Return	2.1%	4.4%	4.9%
Annualised Volatility	0.0%	2.4%	3.7%
99.5% VaR	0.0%	-6.2%	-9.4%
Max Drawdown	0.0%	-3.4%	-8.7%
Spread + Eq Risk SCR	45.0%	1.5%	4.4%
Credit Rating	unrated	AA-/A+	AA-/A+
Key Risk:	Parent company default	Default/ Downgrade - Interest Rates	Mark-to-market

Miller stresses that it is vital for management boards to understand the risks of depositing cash in a bank are not just theoretical. She cites the example of one insurer with a “no risk” policy that kept its cash deposits in four Cypriot banks. “On top of the significant foreign exchange risk - despite having no foreign exchange liabilities - they had huge counterparty exposure that bit them hard during the last round of Cypriot bank haircuts in 2017, which shaved some $12 billion from depositor accounts.”

“So now they are in a paradoxical situation where an insurer with a no-risk policy is, in fact, carrying more risk than if they had placed all the money in an investment grade bond portfolio. That is not risk-free; it is more like playing roulette.”

THE FINAL WORD

The regulatory and investment landscape affecting insurers is changing. It no longer suffices to sign off on a parent company loan or keep assets in cash without undertaking rigorous due diligence and exploiting alternatives. Rather, boards need to educate themselves on the options for investment, follow a structured decision making process and clearly evidence the steps they have followed. With the right training it is not long before even the most cautious novice takes the L-plates off.

If you require further information or would like to discuss any issues in the paper please get in touch. We’d love to hear from you.

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Kate is our head of institutional business. Prior to joining Kate was a director at P-Solve, an institutional investment consultant. Kate worked with insurance clients setting investment strategy and objectives, strategic asset allocation and managing risk. In some cases she acted as an outsourced CIO. Prior to P-Solve, Kate was a consultant and chief operating officer at Meridian Investment Consultancy, advising general, captive, mutual and offshore insurance clients. Kate started her career as a fixed income investment manager at Credit Agricole, managing assets on behalf of insurers.

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Malcolm is acting in a consulting capacity for London & Capital having advised captive stakeholders on strategic, operational and governance matters across a broad range of industries and jurisdictions. He also advises governmental and regulatory bodies on legislative and regulatory change. Malcolm has served as a director for a variety of captive insurers and is an approved person in many captive domiciles. In 2017 he became an inaugural inductee into the Captive Hall of Fame which recognises the most influential figures in the captive industry over the past 50 years.

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