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.

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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, Meskunas 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.

Meskunas 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

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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. ■