FEATURE

Captive Boards and Investing: What You Need to Know

The Directors of captive Boards have fiduciary duty to effectively handle the claims made against the company, but they also have a fiduciary duty to make the best possible decisions in the management of the companies' assets. Captive Board Directors don't often have any expertise, or a lot of interest, in insurance asset management. This leads many Directors to concentrate on the liability side of the captive, putting little or no time into the company's investments.

That is a mistake. A captive Board needs to be active in the development of an investment policy, be well-informed about hiring an investment manager, must look deep into asset allocation, and above all be on top of getting the most out of the captive's investments each year.

WRITTEN BY KARRIE HYATT

BUILDING AN INVESTMENT POLICY

No captive should be without an investment policy. An investment policy helps define a captive's investment goals by clearly stating long-term objectives and the investment structure needed to meet those objectives. A well-developed investment plan will also help the investment manager to meet to the needs and interests of the captive. It's important to have an investment policy in place before hiring an investment manager, otherwise that person is likely to bring in their own biases, which may not necessarily align with what the captive is looking for.

Another important part of creating an investment policy is to approach it from an enterprise risk management (ERM) viewpoint. So often an investment plan is created separately from the rest of the business. "Investment decisions are usually done in a silo rather than by correlating them to activities on the liability side of the balance sheet," said Carl Terzer, principal of CapVisor Associates, LLC. "Often we see captives that don't properly define their investment objectives and risk tolerances. They don't correlate their investment risk with their liability risk as proper use of ERM and Asset Liability Management (ALM) techniques would require."

When building an investment policy, a generic, boilerplate plan won't serve. The most basic objective, 'to earn as much money as we can with as little risk as possible', is near-sighted. It doesn't take into account the different types of assets being invested nor does it pertain to the different risks associated.

The captive's Directors, "Should articulate their objectives and their risk tolerance in their investment policy statement by portfolio segment," continued Terzer. "The liquidity component of their portfolio is used to play current claims and their operating expenses. That segment has a unique investment objective: that of preservation of principal. You can't afford a loss there because it basically has to be cash or cash equivalents. Then you have the reserve component. It's actuarially determined how much you need to "reserve" to be able to pay your claims. That reserve is usually invested in investment grade, or very high-quality bonds. Whatever is in excess of the liquidity and reserve components, that is your surplus which typically receives most of your risk budget allocation and can be invested in a variety of risk assets."

The captive's investment policy needs to be built around the three parts of the portfolio—liquidity, reserve, and surplus. Each of these parts needs to be given a different investment objective because each one has a different risk tolerance.

While one investment policy might seem hard to put together, three can be daunting to a Director with little experience in finance or insurance. But with the advent of computer modeling, the creation of a highly specialized investment plans is easier than ever. With the help of an investment consultant, the captive can have access to hundreds of investment strategies that can be modeled to find what mix of risk tolerance best fits the captive's needs.

SELECTION OF THE ASSET MANAGER

While a captive is an insurance company, and risk and claims are the bread and butter of an insurance company, successful asset management is what keeps the company moving forward. With a specialized investment plan in place, the captive Directors need to work with an investment manager who has a deep understanding of investing for the needs of an insurance company.

Not all asset managers are alike. There are those that specialize in wealth management or pension management. There are those that best understand investing for individuals and those who specialize in company assets. To haphazardly choose an asset manager based on the recommendation of a colleague or choosing one that other captives use, is not the most diligent way to choose a manager. Captives usually form because standard insurance doesn't work for the owners, so why use a standard asset manager?

Captive Directors need to make sure they understand the difference between wealth management and insurance asset management. They need to consider how involved they want to be—whether they are going to be monitoring their investments quarterly or if they are more interested in where they will end up in three to five years. An investment manager that is unfamiliar with insurance assets, specifically those of captives, will not be able to help determine the best way to allocate available assets.

Directors need to select their manager based on what their needs are and how, specifically, the manager can meet those needs. There are more than 3,000 investment managers in the U.S. with, according to Terzer, 20,000 investment strategies to choose from. To find the best manager for the captive, there are several national databases, such as OSN and ENVestNet, that can compare investment managers based on a selection of criteria.

In addition to an investment manager, hiring an investment consultant or advisor can help bypass any conflicts of interest that may come up if the investment manager is also the captive's investment advisor. Working only with a manager presents several potential problems.

The first is that the investment manager will set their own benchmarks, which is not helpful to Directors trying to understand the success, or set-back, of their investments. Another issue is that a manager won't recommend an investment product that could send their business elsewhere, but as a client the captive Board will never know that without an additional advisor.

Without a third-party advisor or an investment-wise Directors, one thing that a Board can do is ask the right questions. A good way to do this is to pick five key metrics, that are understandable to the members of the Board or related directly to the captive's investment policy. These can help the Director's ask the right questions to determine the adequacy of

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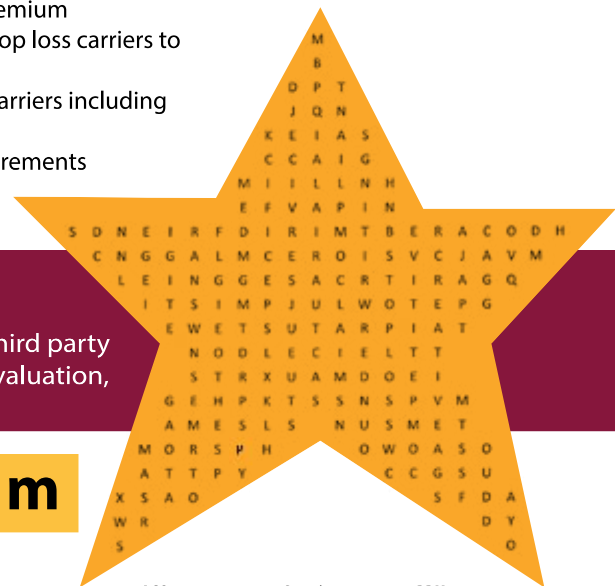

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Delaware Licenses 46 Captive Insurers in 2018

Conditional Licensing System Very Successful

Captive insurance formations faced a number of challenges in 2018, due to recent changes in tax law. Despite the headwinds, Delaware's having knowledgeable captive regulators continues to attract quality applicants. Delaware is the fifth largest captive domicile in the world, and 3rd largest in the U.S. It is only one of four captive insurance domiciles that is ICCIE (International Center for Captive Insurance Education) trained. Its captive insurers generate more than $12.5 billion of annual captive insurance premium.

We are committed to licensing captive insurers with sound business plans formed by reputable individuals. I thank my captive team for its hard work to make Delaware a leading captive domicile. I attribute 2018's success to the newly enacted conditional licensing legislation. Delaware is the first state in the nation allowing electronic filing of a conditional license. It permits the issuance of a conditional license to a captive insurance applicant on the same day as the application submission. Of the 46 licenses issued in Delaware, 30 were conditional licenses. It allows speed to market for issuing a license, while at the same time maintaining regulatory integrity and safety. It is only available to certain captive managers who satisfy specific standards set by the Department of Insurance. If an approved captive manager needs a captive insurance license by a certain date, then they are encouraged to seek a conditional license.

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an investment manager. It will take some research but can help determine how good a manager will be for the captive.

In choosing an asset manager, it comes down to understanding that captives are a unique niche—both in insurance and in investments—and will have specialized needs. A captive needs to hire advisors and investment managers that have a deep understanding of the insurance landscape and know how maximize investment yields while minimizing the risk.

STRATEGICALLY ALLOCATING ASSETS

Deciding on how a captive's assets are apportioned amongst various asset classes is, by far, "The most important decision a board will make. It accounts for more than 90% of the portfolio's long-term returns," according to Terzer. Captive Directors need to be knowledgeable about the different types of investments available and what the risk appetite of a captive should be.

A captive's investment strategy needs to ensure that cash flow will adequately cover any claims while yielding the best possible returns. Captive Boards must take forward action to determine the best mix of investments and not take the most obvious, and easiest, investment route. Many times, captive Boards go with fixed assets and bonds as the most responsible way of investing the captive's assets. However, this narrow view will only get so-so results. They may earn a solid 5% a year, but there are lots of other types of investments that are not as conservative that will have a higher yield. A multi-asset approach to investing will spread the risk and allow for better returns. Investments in equities, alternative credit, and property are solid ways to spread the investment risk.

Terzer believes that a "Board should not make an asset allocation decision without some kind of analytic foundation for making that decision." There are several approaches to doing this type of analysis, but one of the most useful is a Dynamic Financial Analysis (DFA).

Recommended by the Casualty Actuarial Society, a DFA is a computer simulation that looks at an insurance company's risk on an enterprise-wide scale rather than the traditional way conducted by actuaries that analyzes each risk individually. A DFA can be expensive, so might only be reasonable for a large captive. However, there are simpler systems that can aid small to medium-sized captives properly allocate their assets.

LEAVING NO MONEY ON THE TABLE

What an investment policy, the right investment manager, and strategic asset management together lead to is a Board that is proactive on the investment side of their captive. When a Board goes with a boilerplate plan, an investment manager that isn't a good fit, and develops their asset allocation on the back of a napkin, those Directors could be missing important opportunities—they could be leaving money on the table because investments have become an afterthought.

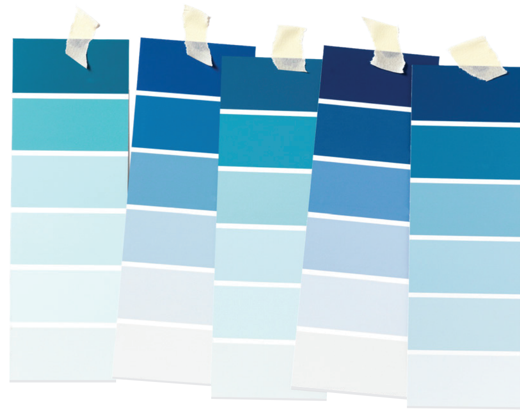
"[Directors] are never held accountable because no one knows how much money they've lost, or not earned by maintaining an inefficient asset allocation," said Terzer.

Investment management isn't just a one-time duty. Investments should be reviewed quarterly and the investment policy should be revisited once each year. The financial market can undergo a lot of changes in a year, as can a captive's liquidity and claims outlook, so the program needs to change with both internal and external conditions. A bad claims year with a loss carried forward means that it might be time to take some of the risk out of the captive's portfolio. After a few years, the surplus might be built up, so the investments could take on more risk.

What it comes down to is that investment risk is as important as liability risk and should be given equal consideration by a captive's Board. Unfortunately, there is no way to measure how much better a captive's investments could be doing if the Board were paying closer attention. ■

Karrie Hyatt is a freelance writer who has been involved in the captive industry for more than ten years. More information about her work can be found at: www.karriehyatt.com.

How do you choose, if all your choices look the same?



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