

# Hang on to your assets

An overly conservative and non-proactive approach to managing captive assets could lead many group/company shareholders to question the efficacy of a captive

by **Clive James**

Even before the collapse of Lehman Brothers and the start of the latest credit crunch there were already signs of a shift in the way the assets of captive companies were being managed. The past 12 months have re-emphasised the conservative style in which captive assets have been managed, together with an increased level of governance on local boards. We are seeing and recognising that the flexibility of managing captive assets is gradually being eroded.

A key issue for captives' assets is the security required by the 'fronting' insurers. Invariably these are letters of credit (LoCs) or trust arrangements. Both of these forms of security apply even more conservative asset policies than most regulators and these inhibit the captives even further in their quest for investment returns. One of the few solutions to avoid the security issue, outside of direct writing, is to obtain a rating, but even this will increase the operating expense of the captive as well as potentially adding investment restrictions expected by the rating agency.

While it is important that the management of assets is in line with the exposures and retention limits within the captive in my experience it is rare that the captive has a true asset/liability matching for programmes as you would

see for general and long-term insurers. Generally, even the guidelines for investment managers are very limited. Even now, those captives who have had an element of equities in their portfolio will have seen their value fall off over the past 12 months, which has resulted in a flight towards fixed-income securities.

The question is whether the highly conservative nature and potential inflexibility of the captive's assets will impact their objective for their corporate shareholders. Today there is an ever-increasing emphasis on the measurement of return on capital. So, how does a CFO view a return on captive's assets of below 2% when the IRR of the corporate can be over 10%?

Who is driving these conservative asset programmes? Is it the regulators with their growing concern around asset allocations within the current volatile market? Or is it the new breed of non-executive directors (NEDs) sitting on captive boards whose tasks include the minimising of risk within the captive? Is it the captive manager who, in many cases, 'polices' the regulations and has to provide strong corporate governance policies as part of their role?

To my mind, it is certainly not the shareholder or its representatives on the board who embark on a conserva-

tive asset campaign for their insurance subsidiary. In the current environment many CFOs and treasury departments of corporations naturally want the assets of all their subsidiaries to be working hard and achieving an expected corporate IRR.

I recall sitting in many board meetings where the shareholders' representatives would have a different view and philosophy on the captive's assets to the local board members. In an ideal world many corporates would prefer to have the monies return to group treasury to manage internally, to maximise their own capital. Although there are a number of captives who mirror the treasury function in the offshore environment, this can be extremely difficult as the goals of the captive are normally quite different to that of the parent.

Let's take a look at the main players and determine who plays the major influence in this area.

## Regulators

As usual within the captive world there is a difference between the onshore and offshore domiciles and their regulations. The offshore environment increasingly has more control over the assets of captives. In the past it was relatively flexible and the issue of loan-

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backs, or purchasing corporate paper of the parent company, was allowed and sometimes without approval. Today the asset allocation restrictions make any form of loanbacks increasingly difficult.

However, within the onshore environment, especially in the US, the loanback of a proportion of the captive's assets is seen as 'normal' and essential for the running of the company. There may be tax issues on loanbacks as well as potential longer-term regulatory tightening up. However, this form does give increasing flexibility to the captive owners.

#### Non-executive directors

The role of the NED has changed quite substantially over the past five years. Today the NED has to fully understand the risks of the captive and must be critical in determining the captive's business plan as well as understanding the regulations within which the captive operates. In today's climate part of the NED role is responsible for making sure that the area of asset management is being run properly. Investment sub-committees are now commonplace.

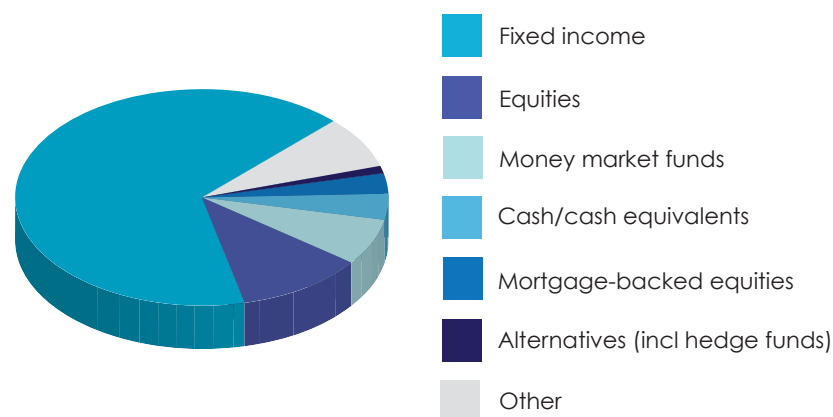
#### The manager

The manager has an influential part to play in the asset management side of the captive, but will always stop short of being the investment advisor. Consequently the board will take into consideration the manager's knowledge of the 'local' financial market, regulations and potential opportunities, but the board will make the final decisions.

#### The shareholder

Representatives of the shareholder on the board are having to wear two 'hats' as they want the best interests

Typical captive portfolio by asset class



Source: Captive Review Asset Manager Survey, October 2009

of the captive while working within group corporate goals. This can lead to potential conflicts – and I have sat at many boards where this is an issue. Therefore, and not for the first time, the actual objectives of captives can be at odds with the group treasury policy and, therefore, the parent company has to rethink its strategy on its investment into the captive.

Looking forward, asset allocation is certainly not going to get any easier with Solvency II on the horizon and with domiciles looking for 'equivalence' if they are not in the EU. The concern is that captives will be viewed as cash cows by the parent company and may feel that they can use the capital better in other parts of their organisation. Producing an IRR for a captive is not easy as there are so many 'qualitative' measurements which are tangible and this is a key issue for determining the objectives of current, and potential new captives.

Historically, a simple solution was loanbacks and until recently this was acceptable, although limited, for many domiciles. However, regulators were getting more nervous about the exposures of a given captive even if it was purely underwriting the assets of the parent. For the offshore domiciles the potential of a captive with insufficient assets is unthinkable, so for them to have control over the assets is essential.

Can captives be more aggressive in their approach to managing their assets within the current regulatory asset allocations or should captives keep the minimum exposure and release any surplus assets for a better IRR? I still believe that many captives still do not fully match assets to liabilities which

would maximise their objectives and get closer to the corporate overall IRR.

There is such a demand for conservative assets allocation that many captives do not apply a long-term investment strategy for their long-tail risks. This is not good for the short or long term, as many will question the efficacy of a captive if it is too conservative.

As a result of this conservative strategy there is now an increasing pressure to 'release' the assets by selling off outstanding liabilities through converting the liabilities into a loss portfolio transfer or even selling the captive itself to interested parties. Also, there are now a number of innovative captive reinsurance structures and techniques that allow the monies to be released back to the parent.

There is now a fear that the current environment of managing assets will significantly affect the viability of existing captives, as well as limiting the potential growth of new captives. The concern is that the lack of asset flexibility will ultimately move the risks from the captive back to the corporate balance sheet.

This goes against the long-term philosophy of captives. I believe the strategy and business plan of the captive needs to take a longer-term view of its asset management to improve its return on capital. Therefore, a more proactive approach is necessary on asset allocation and matching assets to liabilities to secure acceptable returns. This is the only way that a captive can satisfy its risk appetite and increase its retention limits and provides the opportunity to expand the insurance programme rather than looking to reduce or sell off its liabilities. CR