Artex | Alternative Risk

Delivering Successful Captive Outcomes: The Importance of the Investment Management Process

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Putting one's own capital at risk is a fundamental pillar of a captive insurance company. While the assumption of risk requires proper management of a company's liabilities, it is often overlooked that the asset side of the balance sheet is of equal or greater importance. The scale of capital required upon the inception of a captive, and the uncertainty around the timing and magnitude of future claims, are as critical to the success of a captive as those related to a captive owner's risk assumption appetite. Consequently, the management of this capital and the corresponding investment decisions is a key function within a captive's operation, as well as being a primary driver of the long-term viability and, ultimately, the profitability of the program.

Understanding the traditional commercial insurer's business model sets the stage for a deeper appreciation of the unique benefits and considerations of a captive's asset management strategy.

Simply stated, insurance companies make money through two primary sources:

- **Underwriting Income:** earned premium remaining after losses and administrative costs
- **Investment Income:** earnings from an increase in the value of investments (interest, dividends, capital appreciation)

While traditional markets must first rely on experienced underwriters and actuaries for the selection and pricing of insured risks, it is how the resulting premium dollars are invested that ensures adequate reserves and cash flow to meet current and future claims payments. In addition, investment returns generated on unused premiums can deliver a substantial source of profit and shareholder returns.

What is a captive?

A captive is a licensed, regulated insurance company owned and controlled by its policyholders that is designed to provide insurance. The captive manages a loss fund; accrues investment income on premiums; pays losses to the policyholder from the loss fund; and returns underwriting profit to the policyholder(s). These are the same functions that commercial carriers perform, but it is common for mid- to larger-sized companies to self-fund insurance by forming a single-parent captive. Captives traditionally are formed to handle property and casualty coverages, however, can be utilized for a range of additional insurance purposes, including medical stop-loss.[1]

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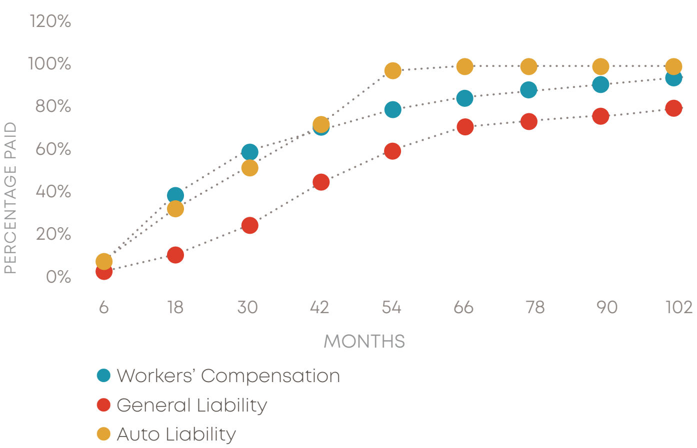
total net income generated by investment income, not underwriting gains[1]

THE BENEFITS OF THE CAPTIVE APPROACH

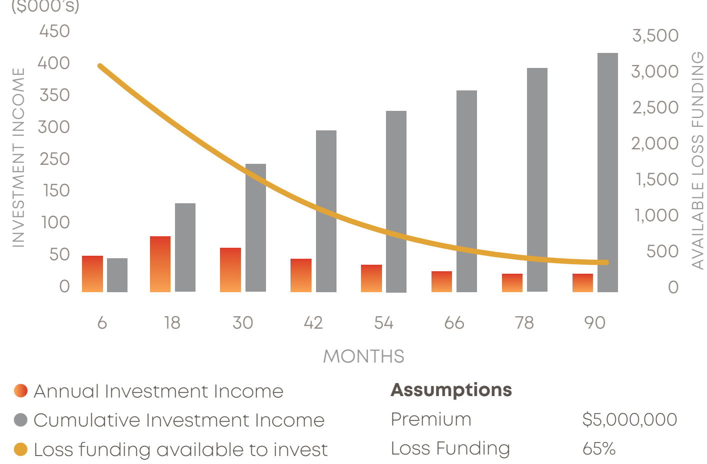
One of the primary drivers for managing risk through a captive is the increased ownership and control an organization has in their insurance program. This is especially true for the investment management function of an insurance company as captives provide the ability to not only manage risk, but also to potentially capture additional benefits from putting their own capital to work. For instance, loss funds can be invested immediately and grown until needed for future claim payments, which can take several years to develop as highlighted by the sample loss emergence patterns shown below:

SAMPLE LOSS EMERGENCE PATTERNS[1]



Therefore, depending upon the types of coverages incorporated into your program, the opportunity for investment income can be significant. And unlike traditional insurance markets, the investment income generated on these reserves stays within your program. The impact of loss emergence patterns on the accumulation of investment income is illustrated by the hypothetical sample analysis and graphic below:

EFFECT OF LOSS EMERGENCE PATTERNS ON INVESTMENT INCOME



Assumptions	
Premium	$5,000,000
Loss Funding	65%
Fixed Costs	35%
Business	WC/GL/AL
Investment Return	4%

As shown, earnings from these investments can, over time, be considerable and are a major motivating factor in the continued existence of a captive due to the ability to lower the total cost of risk. However, improperly managed investments can have significant negative consequences in the form of additional costs to the sponsor as well as jeopardizing the survival of the captive. Because of this, it is critical to understand and manage this risk-return paradigm through a sound investment management program.

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CAPTIVE ASSET MANAGEMENT CONSIDERATIONS

No matter the life cycle of a captive, the primary goal of an investment portfolio should always be "Preservation of Capital." Put another way, the goal should be to minimize return volatility rather than maximize total return, while still generating a reasonable positive return over time. This is critical to a successful investment portfolio as it will enable the captive to reap the rewards of capital appreciation and income, while safeguarding the assets that are needed to pay out future claims.

The secondary goal is to generate a reasonable rate of return in line with the risk tolerance of the captive Board of Directors. One of the key considerations when determining the asset allocation of a portfolio is the life cycle of the captive. In the early years after formation, particular emphasis should be placed on the liquidity of the portfolio. A highly liquid portfolio will allow the captive to meet claim payment patterns that may have a higher level of volatility than in a mature captive. The Board may consider very low-risk assets during this period, such as certificates of deposit or money market funds. As a captive matures and builds its assets available for investment, the Board should consider whether a higher tolerance of risk is appropriate. At this stage, claim payout projections should be more accurate, allowing the incorporation of municipal and high-quality corporate bonds of a duration which aligns with projected claim payment needs. At the beginning of a captive's life cycle, the time spent by the Board on investment matters is naturally more limited in scope. However, as a captive matures, it can be seen that the investment function becomes a very important focus.

The understanding that risk is present in all types of securities and investment styles and that some risk is necessary to produce long-term results will allow the Board to craft an Investment Policy Statement ('IPS') to suit the captive's goals. A sound portfolio will aim to

capture positive returns on the upside, but also limit negative returns and downside risk. A mature captive may look to high-quality equities, or even real estate, to capture positive returns when the market is up, but these securities will generally never be the largest allocation of the portfolio. In broad strokes, most captives look to fixed income and cash assets to form the bulk of the portfolio, with mature captives also incorporating a smaller high-quality equity component.

Depending on the size of the portfolio, a Board will need to consider whether to employ passive or active management of the invested assets. A captive will usually engage a third-party investment consultant or manager to advise on portfolio structure and strategy. Actively managed portfolios bring higher fees; therefore, require a higher level of return to meet investment objectives. Captives seeking lower-cost options may choose mutual or indexed funds instead of active management.

A critical consideration in the development of an IPS is the regulatory restrictions that a captive may face. Most captive domiciles have investment guidelines and restrictions, and many require captives to obtain approval of their IPS before investing. Regulators need to have confidence that captives in their jurisdiction are investing in assets that ensure the preservation of capital. Furthermore, some captives may have banking restrictions that limit the scope of their IPS, such as collateral loan-to-value rates to support outgoing letters of credit.

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PUTTING THEORY INTO PRACTICE

Turning investment goals in an IPS into reality is an important fiduciary responsibility of a captive Board. To illustrate how a Board may fulfill this responsibility, let's look at a practical example. Artex has worked with a group of clients to streamline their investment function. In 2012, we brought a number of captive insurance companies with similar investment goals and risk tolerances together to form a private investors' fund, Group Advantage Investors Fund (GAIN), for their benefit. By pooling their assets, each individual captive was able to:

- Enjoy competitive investment management costs lower than they paid prior to joining the fund.
- Access top-tier active and passive investment managers which were unavailable to them prior to joining the fund due to high minimum investment requirements.
- Leverage economies of scale to incorporate new asset allocations and diversify the fund, thus providing returns in varying market conditions.

From inception through to the present date, GAIN has achieved its primary goal of preservation of capital with a reasonable rate of return, all while complying with multi-domicile regulatory and banking restrictions. GAIN has doubled the number of investors since its launch and assets under management have grown through capital appreciation and additional subscriptions by more than 500% since inception. The founding investors have seen their investment management costs reduce by about 45% compared to their cost structure prior to joining GAIN.

Group Advantage Investors Fund, LLC
GAIN

2012–2022

2x	**500%**	**45%**
INVESTORS	INCREASE IN ASSETS UNDER MANAGEMENT	REDUCTION IN INVESTMENT MANAGEMENT COSTS

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CONCLUSION

While captives provide an avenue to capture underwriting profit and investment income, they also come with the inherent risk of owning the associated liabilities on their balance sheet. Therefore it is critical that captive assets be managed relative to their liabilities and the risk tolerance appetite of the captive. Captive owners need to recognize they are the stewards of their capital, and must be prepared to face market volatility and economic uncertainty.

The global financial crisis in 2008 highlighted the increasing importance of this reality and having a structured and disciplined investment process for insurance investment management. In addition, a recent shift in the current market environment to one characterized by heightened inflation and increasing bond yields, make the investment decision management process even more critical to ensure assets are structured in a prudent manner with proper income generation and liquidity in place.

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THE ART OF RISK

At Artex, we believe there is more to alternative risk management. As a trusted leader and provider of diverse (re)insurance and ILS solutions, our global team operates at the intersection of art and science—where creative thinking meets expertise and superior outcomes are made. That's how we're able to fully understand our clients' needs and deliver the most comprehensive solutions available.

Established in more than 35 domiciles internationally, we're here to help you make empowered decisions with confidence, reduce your total cost of risk and improve your return on capital. At Artex, we believe in finding you a better way.

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