Module G Unit 13

INVESTMENTS AND LOANS

Purpose

At the end of this unit the participant should be able to demonstrate an understanding to as the reasons why insurance companies invest their funds, the options for investment and the factors which should be considered when determining investment strategy.

Assumed knowledge

A general understanding of how insurance companies operate and the solvency model issued by the GFSC. See Unit 6B and the appendices.

Summary of learning outcomes
1. Explain why insurance companies invest their assets
2. Describe the type of investments insurance companies typically hold
3. Explain why it is important for the (re)insurer board to understand the impact of accounting on a “Mark to Market” basis
4. Explain why solvency is an important consideration when considering the class of asset in which to investments

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13.0 WHAT IS THE SOURCE OF AN INSURANCE COMPANY ASSETS?

An insurer's assets will be derived from:

- Original share capital paid in by the shareholder
- Current years premium income
- Claims reserves
- Unearned premium reserves
- Retained profit from prior years of trading

13.1 LIQUIDITY

An insurer must consider its liquidity requirement at all times. Liquidity is a measure of the insurer's ability to settle its operating expenses and claims payments as they arise. These payments will be built into a cash flow forecast with an estimate of when claims are likely to be settled through the financial year. The cash flow forecast will be based upon past experience but should also allow a reasonable buffer for variability as claims settlement amounts and dates cannot be known with certainty in advance.

The cash flow forecast determines how much cash needs to be maintained readily available in short term (between one and six month) bank deposits. The balance of the insurer's assets are potentially available for investment if the board choses to invest those funds.

13.2 WHY DOES AN INSURANCE COMPANY INVEST ITS ASSETS?

There are several reasons why the board of an insurer would consider investing the assets.

a) Investment returns can make a useful contribution to cover the operating costs of the company and can enhance the overall profitability of the company

b) The opportunity to diversify assets reducing concentration list

c) As a hedge against claims and general expense inflation

d) The board should be seeking to achieve a matching of its assets against its liabilities. When an insurer writes insurance policies that have claims with a long tail (claims that take a long time to settle, typically seen on liability policies) then investment returns become more important.

   Claims can remain open, albeit reserved, on the books of the insurer long after the payment of the original premium and or the expiry of the insurance policy. Claims that remain open for long periods of time can be subject to the effects of inflation and so the value of the insurer's liability can increase over time. If the assets of the insurer are not invested in a way that seeks to achieve an investment return that will equal claims inflation then there will be a mismatch of its assets against its liabilities and this can lead to problems with solvency and the insurer's ability to settle those claims in full.

13.4 WHY NOT LEAVE ALL THE FUNDS IN CASH DEPOSITS?

There are several disadvantages to leaving all the funds in bank deposits.

a) The level of investment return (interest) payable on bank deposits are likely to be insufficient to cover much of the impact of claims inflation. Interest rates do tend to rise in times of high inflation, due to efforts by central banks to suppress the economy and bring inflation under control, but over a sustained period of time the growth in the asset base of the insurer will most likely fall behind the growth in the value of the claims.

b) Bank fixed deposits normally suffer interest rate penalty clauses if the duration of the deposit needs to be broken to settle a claim. This is why liquidity management and prudent cash flow forecasting is so important.

c) Opening a number of deposit accounts with different banks in order to ensure that, the best interest rates can be obtained, but also importantly to provide diversification and a spread of credit risk between those financial institutions is an onerous task for the Insurance Manager to undertake. The process of opening multiple bank accounts is very time consuming due to the Know Your Client (KYC) and Anti Money Laundering and Financing of Crime and Terrorism (AMLFCT) due diligence work the banks have to undertake.

13.5 MONEY BROKERS

There are investment managers that provide money broking facilities and this can assist with the problems highlighted in 13.4 b) and c) above. Money brokers, for a modest fee of perhaps 0.05% of the funds placed with them, can access multiple financial institutions and can place funds with them in the form of financial instruments such as Certificates of Deposit (CD) or Floating Rate Notes (FRN).

The insurer will enter into a formal agreement with the money broker and the money broker will conduct the KYC/AMLFCT due diligence work on the captive and its owners. The financial institutions they deal with will then accept an introduction from the Money Broker to the insurer as the ultimate client with no further or limited due diligence.

Due to the volume of funds being managed by the money broker for multiple clients they can negotiate better interest rates from the institutions than the insurer could obtain directly.

CD and FRN are treated as cash or cash equivalents for solvency purposes as they are highly liquid and can be converted to cash very readily without financial penalties being incurred.

Using a money broker helps resolve issues 13.4 b) and c) above but it does not address the issue identified in a) as the enhanced interest rates achieved, whilst welcome, are generally not sufficient to address the problem of claims inflation.

13.6 INVESTMENTS OTHER THAN FIXED DEPOSITS, CDS OR FRNS

Large insurance companies will hold a very substantial pool of assets often running to billions of pounds. They will have very sophisticated investment strategies implemented by their own investment management teams and or in conjunction with large investment management firms.

The type of investments they might hold include:-

1) Cash, CD’s FRN’s
2) Government and Corporate bonds
3) Equities (shares in companies)
4) Property
5) Commodities including gold
6) Currencies
7) Derivatives

Most captives, being relatively modest in size, adopt conservative investment strategies and are most unlikely to invest in anything other than 1) to 3) above. 4) through 7) are beyond the scope of this course.

We have already discussed 1) and will now consider 2) and 3).

13.6.1 Corporate and Government Bonds (Bonds)

Bonds are an instrument through which Companies and Governments (the bond issuer) borrow funds over a given period of time.

When the bond is first issued it will be issued at a given price (principal value), for a given duration (maturity date) and with a coupon which is the amount of money that the party holding the bond will receive each year until the bond’s maturity date. Generally the coupon will be fixed at issue but in some instances will vary over time (some bonds have a clause whereby the coupon increases if the issuers rating is downgraded for example).

Bonds are rated by Rating Agencies such as S&P Global Ratings (previously Standard & Poor’s) and Moody’s. The higher the rating, the less risk there is of the bond issuer either failing to honor the coupon payments or in the worst case being unable to repay the principal value of the bond on its maturity. “AAA” is the highest rating and any bond with a rating less than “BBB” will typically not be considered by a captive board as they represent too much of an investment risk. Ratings AAA through BBB are known as ‘investment grade’ and BB and below are known as ‘high yield’ or sometimes ‘junk’ due to their higher probability of default.

Bonds issued by Governments, also known as sovereign bonds (for example Gilts (UK) and Treasuries (US)), almost always have a higher rating than those bonds issued by companies from that nation.

There is a global and highly liquid trading market on which such bonds can be bought and sold once issued. The price at which the bond can be traded will be influenced by, amongst others:

- the interest rates that are available in the currency of the bond
- the risk associated by lending to the company.
- expected inflation rates
- expected economic growth

If the yield on the bond is rising, perhaps because interest rates are moving, or the perceived risk of the issuer has increased, the price of bond will fall, potentially below the price at which it was issued. If the bond were to be sold at that point, a capital loss would be crystallised and incurred by the bond holder (the captive). Conversely, if yields are falling, the price of the bond will increase, and a profit could potentially be realised by selling the bond above the purchase price. In both cases though, the captive would suffer from reinvestment risk, and may not be able to achieve the same return in a different bond.

It is quite typical for a captive to purchase bonds with the intention of holding them to their maturity date as they are considered a longer term investment strategy than cash and, if the cash flow forecasts are accurate, should not be required to be sold before maturity. An exception to this might be if the profit available on selling the bond is such that it makes sense for the insurer to take that profit and invest the proceeds elsewhere.

13.6.2 Equities

Equity markets offer much improved investment returns over the long term when compared to 1) but also increased volatility and risk. If a captive decides to invest in this class of asset it might only do so for a modest percentage of its total assets and will employ the services of an Investment Manager (see Unit 17c for more information on Investment Managers) to assist in the selection of equities and to acquire, hold and monitor their performance.

Equities will provide investment returns by way of dividends and also through movements in the underlying price of the shares.

It must be remembered that the price, and therefore the value of the shares, can go down as well as up and so the insurer must be prepared over the short term to accept and absorb significant losses as well as profits on such investments.

In the worst case scenario, a company in which the insurer purchases shares, could go into liquidation and it is not impossible for 100% of the value of the investment to be lost. However, by diversifying the shares held, the concentration risk to the captive is reduced.

Equities issued on the world's major stock markets are normally very liquid and can be bought and sold every working day at the current market price (see 13.6.3). Clearly, if the shares are of a company that is in financial distress they may not be so easy to sell and the level of loss can increase rapidly.

13.6.3 Mark to Market

In the case of both Equities and Bonds it can be a requirement of the accounting policies which will apply to the captive that the value of the Equity or Bond held is recorded at the market price for that instrument on the day that the insurers accounts are prepared as opposed to the purchase price.

This is called "Mark to Market" and often deters captive boards from investing in these instruments as the accounts may show an unrealized loss on the investments at a particular point in time. This may be the case even if the captive intends to retain the investment, until its value returns to the price at which it was bought or higher for Equities, or until the maturity date of the Bond at which point the issuer has to pay to the bond holder the principal value.

The appearance of investment losses (even unrealised) in the accounts of the insurer is often unnerving for the board and if the adverse movement in price is large enough could impact solvency. This situation can be managed by carefully considering how much of the insurer's assets to invest in Equities and Bonds and by ensuring that the board understands and is expecting some volatility in prices in the short term.

13.6.4 Risk versus Reward

The board needs to consider and determine its appetite and capacity for risk versus reward.

When writing long tail business, an investment strategy that is only focused on cash or cash equivalents such as CDs and FRNs, will present very low investment risk but will also deliver a low reward. This brings with it the complication of investment returns not matching claims inflation.

If the board decides to invest in Equities and or Bonds it needs to acknowledge the increased risk of losses and the mitigation of such risk through careful selection of the investments with highly rated Companies or Governments and typically by delegating responsibility for implementing the investment strategy to a regulated investment manager (see Unit 17c for more information on Investment Managers). In addition, ensuring the investments are well diversified amongst a number of entities as well as considering the insurer's liquidity requirements will assist in managing the risk side of investing.

The most appropriate strategy should be decided by each board (and reviewed at least annually thereafter) according to those factors discussed above and the particular portfolio of insurance business held.

There is no one correct formula but a mix of Cash, Equities and Bonds can be designed in an effort to find the optimum strategy balancing both Risk and Reward.

13.7 LOANS

A very significant level of captive assets in Guernsey are invested by way of a loan back to the parent organisation. This is allowed under the Law and Regulations but there are implications for solvency which are discussed in 13.8 below.

Loans made to the captive's parent organisation have the following positive and negative features to be considered by the captive board: -

Positives:

a) It is likely that the interest rate that the captive will receive will be superior than on fixed deposits

b) It is likely that the interest rate to be paid to the captive will be lower than the rates which the parent organisation would have to pay in the market to borrow money so that is of benefit to the group

c) The duration of the loan need not be fixed and there do not have to be any penalties imposed if the loan is recalled earlier than expected. Indeed, it is normal practice to draft a loan agreement that states that the loan is repayable upon demand by the captive

d) The perception at the parent company level is that the captive is assisting the parent with its financing requirements as well as its insurance programme, so this is should enhance the captive's reputation within the group

Negatives:

a) It is likely that the interest rate that the captive will receive will only be marginally better than a cash deposit so it does not address the problem of claims inflation

b) The captive is exposed to the credit risk of the parent organisation. This is likely to be significantly higher than most financial institutions that the captive would otherwise place its cash with. The amount of the loan might also exceed the amount that the captive would normally place with a single financial institution further increasing the risk of the captive. This will have bearing on the captive's solvency calculations as discussed in 13.8.

c) The loan needs to be formally documented and at terms which are arms-length. The interest rate paid to the captive cannot be artificially high but it should equally be high enough to take account of the extra credit risk associated with such a loan over that of a fixed deposit with a well rated financial institution

d) If the parent is unable to repay the loan when asked to do so the captive may be unable to settle claims and if these are with a fronting insurer this would create a significant problem for the captive and its board. If the parent is the insured, then a right to offset (where balances due to the captive are offset against claims payment due to the insured) clause may protect the captive

e) Unless the parent organisation has a credit rating there will be a significant impact on the solvency margin calculations of the captive as discussed in 13.8

Loans to the parent can be useful and valuable part of a captive investment strategy but the board needs to be careful about the level of assets invested in this way. Parent company representatives on the captive board may have a conflict of interest when considering loans to parent.

LENDING BY INSURERS *(supplement added 6 March 2023)*

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Many Guernsey-licensed insurance companies extend loans to other companies in their group. Those lending activities are potentially subject to regulation under the new Lending, Credit and Finance (Bailiwick of Guernsey) Law, 2022. This briefing considers the impact of the Law on that lending activity.

Introduction

Parts of the Lending, Credit and Finance (Bailiwick of Guernsey) Law, 2022 ("**Law**") came into force on 1 January 2023. The Law introduces new licensing regimes for lending, credit and finance activities and provides UK-style consumer protection for retail and home borrowers. The Law replaces the registration regime under the Registration of Non-Regulated Financial Services Businesses (Bailiwick of Guernsey) Law, 2008 ("**RNFSB**"). This brings the Bailiwick into line with the latest Financial Action Task Force recommendations for the combatting of money laundering and terrorist financing and demonstrates the Bailiwick's commitment to compliance with international standards.

The Law will come into full effect on 1 July 2023 by which date any licences must be obtained. Lending, Credit and Finance Rules and Guidance 2023 ("**Rules**") and a notice of exemptions dated 1 February 2023 ("**Notice**") have also been issued by the Guernsey Financial Services Commission ("**Commission**") in connection with the Law.

Overview

The primary purpose of the Law is to regulate:

- the consumer credit and finance sector;
- financial firm business, this includes lending, guarantees and other activities previously regulated by the RNFSB;
- virtual asset service providers; and
- financial platform and intermediation services (such as peer to peer lending and crowdfunding).

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A detailed analysis of the legislation can be found here.

Exemptions and exclusions

The Law is wide ranging and seeks to regulate many financing activities which are commonplace in Guernsey and were previously unregulated. The exemptions contained in the Law and the Notice are extensive. They permit many of the activities previously carried on by Guernsey's finance sector to continue unaffected by the new regime and so are vital in understanding the true impact of the Law. It is common for Guernsey licensed insurers with significant assets to make loans to other members of the corporate group. Such intra-group lending is now caught by the Law. However, there are a number of exemptions which are relevant, as set out below.

Long-term insurers

Long-term insurers are exempt from licensing under Section 20(2)(a) of the Law.

Managed insurers

Section IX of the Notice exempts insurers which appoint a licensed insurance manager and whose lending is "one component of a holding structure of which the insurer forms a part (where the primary purpose of such a structure is to hold underlying assets, act as a corporate group or make one or more investments into underlying assets by equity or by debt, but the primary purpose is not to act as a lender to unconnected third parties)". Most insurers which appoint a manager and make loans to associated group companies will be exempt from licensing by this provision.

Lending to shareholders

The Notice exempts loans made to registered shareholders or beneficial owners. This would exempt any "upstream" loan made by a licensed insurer. However, it would not exempt loans made "downstream" to subsidiaries of the insurer or to related body corporates which are not shareholders or beneficial owners.

Lending to customers

Section 20(1)(g) of the Law exempts lending which is:

- made to customers of the main activity of the licensed insurer; and
- is not offered to the public.

This would exempt loans made by a captive insurer to group companies covered by the insurance policies issued by them. However, this exemption is unlikely to assist an insurer writing third party business nor insurers which write reinsurance business only.

Ancillary activity

Lending which is ancillary to the main activity of the insurer is exempt under the Notice. Section 20(1)(d) of the Law also exempts lending which is ancillary and directly related to the main activity of the lender. It is debatable whether lending is truly ancillary to insurance activity – the two activities are not necessarily related at all. Therefore some caution may be required when considering the scope of this exemption.

Applications

The Commission has published information on the application process alongside the application forms. Prospective licensees are invited to apply from 1 February 2023.

Fees will comprise annual fees for licensees and application fees, both of which are set out here.

There will be a 50% discount to the application fee for firms which submit high quality, complete application forms before 31 March 2023. The Commission does not guarantee that applications received after 31 March will be processed by 1 July 2023, when the Law comes into full effect.

13.8 SOLVENCY

The Guernsey Prescribed Capital Requirement (PCR), as set out in the GFSC solvency model applies varying levels of default risk to the investments held by a captive.

By way of example, if the funds are placed with the parent organisation that does not have a credit rating then there is a 45% capital risk charge applied. So the insurer must hold capital equal to 45% of the funds loaned to its parent.

If those same funds are placed on deposit with an "A" rated bank or invested in a portfolio of "A" rated bonds there is a capital risk charge applied of only 3%.

As can be seen a parental loan will put significant pressure on the solvency of the captive, particularly so if the loan represents most of the captive's investments.

When designing the investment strategy for a captive, the proposed strategy must always be tested in the GFSC solvency model to ensure that it does not create too much strain on the solvency margin of the captive. If Equities or Bonds are included in the strategy then the solvency model should be stress tested to see what level of investment losses can be sustained before the PCR is breached.

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Self-test questions
Answering these questions will remind the participant as to what has been learnt. Once completed, please check your answers against the relevant text. 1. What is liquidity and why does it matter? 2. Give two reasons why an insurance company invests its funds? 3. Why should an insurer consider both the risk and reward when choosing an investment? 4. Give two negative factors in relation to loans made to a captive's parent company? 5. Why does a large investment in a lower rated bond (say BBB) have an adverse impact on the solvency of a Guernsey insurer?

Summary of learning outcomes
1. Explain why insurance companies invest their assets
2. Describe the type of investments insurance companies typically hold
3. Explain why it is important for the (re)insurer board to understand the impact of accounting on a "Mark to Market" basis
4. Explain why solvency is an important consideration when considering the class of asset in which to investments