Module J Unit 17A

SERVICE PROVIDERS – BANKERS

Purpose

At the end of this unit the participant should understand the matters to be considered by an insurer when choosing its bankers and operating bank accounts

Assumed knowledge

None

Summary of learning outcomes
1. Describe the key criteria that will influence the choice of bankers.
2. Describe how a cash management company can assist with opening of bank accounts.
3. Explain the importance of diversification to reduce risk.
4. Explain why insurance managers personnel are usually a signatory on every money transaction made by a captive insurer.

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17.0 CHOICE OF BANK

The choice of bank to be used by the captive will be influenced by a number of factors which are discussed below:

17.0.1 Parent company influence

Whilst the captive board makes its own decisions selecting which banks it utilises, it is common practice to consider any banking relationships that the parent company has as these relationships can be leveraged in both opening and operating the accounts of the captive.

17.0.2 Rating of the bank

All captive funds held with the banks will attract a capital loading under the solvency calculations and the better the rating of the institution from agencies such as Moody's and Standard and Poor the lower the capital loading that will apply. If an offshore bank is appointed, care should be taken to understand whether it is a branch, or a separate subsidiary of the parent bank as differing credit ratings may apply.

17.0.3 Local presence

There is no requirement to hold cash assets with a bank that has an establishment in the domicile of the captive but it is generally found to be helpful as the Insurance Manager will normally have an established working relationship with the personnel of any locally licenced bank and this can be helpful if assistance is needed for any unusual transactions. It might be that only funds required for imminent liquidity/cash flow are placed locally with the balance placed elsewhere.

17.0.4 Diversification

It is important for the board to consider diversification of its exposure to the credit risk of the banks. Essentially it is not considered prudent to place all the cash assets of the company with a single bank. There will often be pressure to place very large sums with the bank(s) with which the parent organisation has the strongest relationships. This needs to be carefully considered and the board should not lose sight of the fact that a particular bank credit limit which makes sense for the parent company at say £25m or even £50m might well exceed the entire cash assets of a captive. This could lead to 100% of the captive's funds being placed with one bank which may not be ideal. Good practice suggests, where possible, the maximum amount placed with a single bank should not exceed 50% of cash and investments.

17.0.5 Cash Management

An option that can assist, with the issue of diversification, is the appointment of a Cash Management Company (CMC). This is an organisation that specialises in managing the cash assets on behalf of the captive. The CMC will open a trading account in the name of the captive with a custodian organisation. The custodian is often a well-recognised bank.

The CMC and the captive board then agree a list of banks with whom the captive is happy to trade with (due to their acceptable credit rating). A management agreement is put in place that sets out the parameters of what the CMC may do with the funds that the captive place in its care and it will also address the custody issues.

The agreement will determine which financial institutions may be used, the maximum duration of any investment and the maximum amount and/or percentage of the captive's funds that may be placed with each institution.

The CMC then approaches all of the approved institutions and obtains offers from them to sell to the captive either Certificates of Deposit (CD) or Floating Rate Notes (FRN). These are highly liquid instruments that behave very much like a cash deposit but usually offer slightly better rate than deposits.

Such an arrangement has four key benefits:

I. To set up this arrangement the CMC undertakes the Know Your Customer (KYC) / Due diligence (DD) and Anti-Money Laundering (AML) Anti-Financing of Terrorism (FCT) on the captive. Once completed they can use its relationships with the banks to trade in the CD's or FRN's. This enables the captive to obtain diversification without the administration of account opening procedures and maturity dates.

II. Instant diversification amongst the approved institutions and no administration for the Insurance Manager.

III. An improved return (not guaranteed but usually achieved) on what can normally be achieved by bank deposits. This is usually the case even net of the CMC fees.

IV. Some of the CMC also have the facility to offer Security Interest Agreements as discussed in Unit 9

17.0.6 Charges and Letters of Credit

The need for Letters of Credit (LOC's) to provide security to fronting insurers is discussed in Unit 9. The ability and willingness of banks used by the captive to issue LOC's is an important factor in the choice of bank. In particular the charges for such LOC's can vary quite significantly so it is worth enquiring what these are and comparing them with other banks when making the decision which banks to utilise. This is true even if fronting and security is not an issue when the captive is first incorporated as it might later become a facility which is required.

17.0.7 Electronic banking

It is now pretty much a given that the captive will require electronic banking to be available to provide ease of making payments, viewing account balances and undertaking reconciliations.

17.0.8 Currency

The captive may need to operate bank accounts in a number of currencies and the banks selected need to be able to offer services in the currencies required.

17.0.9 Account opening requirements

Due to AML/KYC regulations the opening of bank accounts has become more difficult and drawn out. The Insurance Manager should be aware of the particular requirements of each bank, be ready to provide the required documentation and anticipate the timeline for opening an account and any possible delays in doing so.

17.0.10 Bank mandates

Captives usually adopt quite onerous bank mandates with different levels of signing authority according to either:

I. To whom the payment is to be made
II. The amount of the payment

- It is usual to have representatives of the Insurance Manager as a signatory on every payment except those when it is the payee. This ensures the Insurance Manager always know what transactions are taking place and it can effectively oversee them to ensure they are appropriate, properly authorised and the captive will remain solvent after the payment.

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- There is usually a list of regular payees for the captive where two signatures of the manager are required for payments. These might be the GFSC, Auditors, Data Protection Authority, Guernsey Registry, Reinsurers, Brokers, the parent company, fronting company or loss adjustors.

- Outside of the agreed list above it is usual to require both the signature of a representative of the Insurance Manager and one Director (typically the local Independent Non-Executive Director).

- For payments over a given amount, to be pre- determined by the board, it might be that there is a requirement for the signature of the Insurance Manager representative plus a director representing the parent company on the captive board.

Not all banks will/can accommodate these complex mandates so it is worth knowing their position on variable mandates before entering into the process of opening an account.

Please see Appendices Unit 17A a typical bank mandate and signing authority for a captive. This is just an example as there are a number of ways they can be structured.

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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. Give two reasons why is it important to know and consider the rating of a bank? 2. Give two reasons why a (re)insurer may wish to use more than one bank? 3. How many signatories are recommended on any bank transaction? 4. It is recommended you look at the structure of a typical bank mandate shown in the appendices.

Summary of learning outcomes
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