Module J Unit 17C

SERVICE PROVIDERS – ASSET MANAGEMENT

Purpose

At the end of this unit the participant should understand the limitations of an insurance manager with regard to asset management, the roles of a Cash Management Company and that of an Investment Manager.

Assumed knowledge

An understanding as to the reasons that (re)insurance companies investment funds. See Unit 13.

Summary of learning outcomes
1. Explain the limitations of asset management services offered by insurance managers.
2. Describe the role of and benefits of a Cash Management Company
3. Describe the role of and services provided by an Investment Manager
4. Explain factors to be considered when choosing an Investment Manager

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SERVICE PROVIDERS – ASSET MANAGEMENT

17.0 ROLE OF THE INSURANCE MANAGER VS INVESTMENT MANAGER

Insurance Management companies typically do not offer investment expertise in house although they may employ treasury management staff. Their task will normally be to manage cash deposits as directed by the board. The board will determine which banks have satisfactory credit ratings and create an approved list of institutions (often with assistance / the approval of the captives Parent Group Treasury department) , to determine the maximum amount to be deposited with each institution and the duration of any deposit within a range typically between 1 and 12 months. The Insurance Manager will then be delegated to place the deposits with those institutions, having considered the cash flow/ liquidity requirements of the captive which will also have been considered by the board when determining duration.

Insurance Management companies are typically not in a position to be able to advise the captive on investments and so external expertise should be sought. If the parent company Treasury team is unable or unwilling to provide this service then there are a host of asset managers able to help. Investment Managers will typically be engaged by an insurance company to manage investments outside of cash and cash equivalents.

17.0.1. Cash Management / Money broker

In some cases, the captive board will decide that a Money Broker, or Investment Manager that specialises in cash management (NB some call themselves Investment Managers but when looking after a cash only portfolio we will refer to them as a Money Broker), should be employed to look after the cash funds of the captive. The Money Broker will have access to multiple financial institutions where they can place cash deposits or purchase Certificates of Deposit (CD’s) or Floating Rate Notes (FRN’s) which are considered as cash equivalent instruments.

The advantages of using a Money Broker are as follows:

I. They have strong working relationships with multiple financial institutions and are able to readily assess where the best interest rates can be found on any day. For an Insurance Manager to obtain these rates daily is time consuming and it may have a limited number of institutions it can readily approach.

II. Due to the relationships they have with the financial institutions, only one Know Your Client (KYC) and Anti Money Laundering (AML) due diligence exercise on the captive is required to be undertaken on the appointment of the Money Broker. They are then able to place funds with all the financial institutions that the captive is happy to approve. Without a money broker, the Insurance Manager would need to work through an account opening process with each and every institution and this is a time consuming and slow process. This feature not only reduces administration but access to multiple financial institutions also helps to diversify the credit risk of the captive

III. The Money Broker is constantly monitoring the financial performance and market sentiment towards each financial institution. If it feels there is any question over the future security of that institution it will immediately flag that with the captive and propose the termination of any transactions with that institution in favour of another more secure institution. This market intelligence may not be available to the Insurance Manager

IV. Some Money Brokers, having recognised that captives often need to provide security/collateral to a fronting insurer, have created Security Interest Agreements (SIA). These SIA are acceptable to most, but not all, fronting insurers as an alternative to a Letter of Credit (LOC). The SIA costs significantly less than an LOC and provides the captive with greater control and flexibility as more fully described in Unit 9

A Money Broker can add value to a captive as described in a) to d) above. Their fees range from 0.03% to 0.05% on funds under management and they generally achieve an interest rate return (net of fees) higher than could be achieved by leaving the funds to be placed by the Insurance Manager.

17.0.2. Investment Manager

As discussed in Unit 13, often the return that can be obtained on cash is less than the rate of claims inflation. This can be a problem for an insurer of long tail business as the growth of the cash assets it holds is less than the growth in the cost of outstanding claims for which it has reserved on its books. This can lead to a mismatch between assets and liabilities on its balance sheet which in turn could lead to inadequate regulatory solvency.

In order to address such a mismatch the captive should consider investing in instruments other than the cash deposits, CDs and FRNs discussed above.

Investment instruments such as Government Bonds, Corporate Bonds, and Equities can provide a higher return than cash but bring with them a different set of risks and the need for professional management.

This professional management can be accessed through the appointment of an Investment Manager.

17.0.3. Choice of Investment Manager

When choosing a suitable Investment Manager, a number of factors should be considered, including:

I. Experience managing appropriate investment strategies, including asset liability matching
II. Reputation in their market
III. Past performance
IV. Demonstration of an understanding of the insurer's need to manage carefully the balance of risk vs return
V. Representation in the domicile (preferable but not essential)
VI. Fees
VII. Quality and timeliness of reporting. This is most important as the Insurance Manager will be relying upon the Investment Manager's reporting to enable the Insurance Manager to issue management accounts (and statutory accounts) to the accuracy and within the deadlines required by the insurance company board and its shareholder

17.0.4. Services expected of the Investment Manager

Provision of an investment strategy proposal based upon a sound understanding of the business of the insurer, its risk appetite, liquidity needs and desired return. They should also consider the regulatory status of the capital invested and how this will meet the necessary solvency requirements.

I. Custody of assets with an acceptable provider, to hold for the benefit of the insurer, assets that will be acquired as the chosen investment strategy.

II. The recommendation of a suitable benchmark against which the performance of the agreed investment strategy/portfolio can be measured. Getting an appropriate benchmark is key and should be given careful attention by the board at the outset. A benchmark can be a reference of performance created by independent agencies which the Investment Manager cannot influence. It enables the board to assess how the insurers investment portfolio is performing against a selection of similar investment strategies.

III. Upon appointment, the creation of a suitable investment portfolio

IV. Regular quality reporting of the make-up of the investment portfolio, its performance against the benchmark and its current valuation

V. Regular reporting on any changes to the investment strategy and guidelines that the Investment Manager feels should be considered by the board due to changes in the insurers business plan, economy, market performance, and performance of specific investments in the portfolio

VI. Regular compliance reporting to ensure that the Investment Manager is evidencing compliance with the investment mandate agreed with the board of the insurer

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. Why do Insurance Managers typically only manage cash deposits?
2. What are the key differences between the services offered by a Cash Management Company and those by an Investment Manager?
3. What is the purpose of agreeing a benchmark with the Investment Manager?
4. Why is the quality and timeliness of the Investment Manager's reporting to the insurance manager so important?

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