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Captive Insurance
Annual 2024

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Unit 23, Metro Business Centre, Kangley Bridge Rd, London, SE26 5BW

Publisher: John Savage
johnsavage@captiveinsurancetimes.com

Publishing Director: Justin Lawson
justinlawson@captiveinsurancetimes.com

Office Manager: Chelsea Bowles
accounts@captiveinsurancetimes.com

Group Editor: Karl Loomes
karlloomes@blackknightmedialtd.com

Deputy Editor: Carmella Haswell
carmellahaswell@securitiesfinancetimes.com

Reporter: Diana Bui
diana@captiveinsurancetimes.com

Reporter: Jack McRae
jackmcrae@assetservicingtimes.com

Junior Reporter: Clelia Reka Frondaroli
cleliarekafrondaroli@assetservicingtimes.com

Junior Reporter: Klea Neza
kleaneza@blackknightmedialtd.com

Designer: James Hickman
jameshickman@blackknightmedialtd.com

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As we delve into the complexities of captive insurance, it becomes increasingly clear that asset management should not merely be an afterthought; rather, it ought to be a continuous discussion woven throughout the entire process of forming and managing a captive.

The articles within this Asset Management Captive Insurance Annual highlight pivotal insights into the regulatory landscape that captive insurers navigate, particularly the recent amendments to Solvency II and the challenges posed by the Australian regulatory environment. Understanding these frameworks is essential for captives aiming to operate successfully and leverage opportunities for diversification.

In today's dynamic market, sophisticated asset management strategies are paramount. Captives must evaluate their unique risk profiles and embrace trends such as sustainable investing and adherence to environmental, social, and governance (ESG) criteria, which enhance their reputational standing and meet stakeholder expectations. Furthermore, balancing liquidity, security, and profitability is critical as captives assess their investment portfolios amid market volatility.

The exploration of alternative risk management structures, such as discretionary mutual funds (DMFs), demonstrates that innovative solutions can offer captives the flexibility and reduced regulatory burden they need to thrive.

As we move forward, fostering ongoing dialogue among industry stakeholders will be vital in refining asset management strategies and adapting to emerging challenges. Captive owners and asset managers are encouraged to remain proactive, utilising the insights from these articles to effectively manage their assets and navigate the complexities of the insurance landscape.

John Savage
Publisher
Captive Insurance Times

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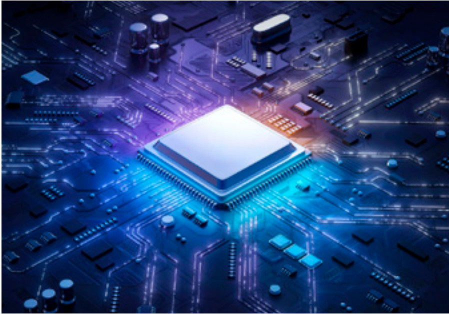

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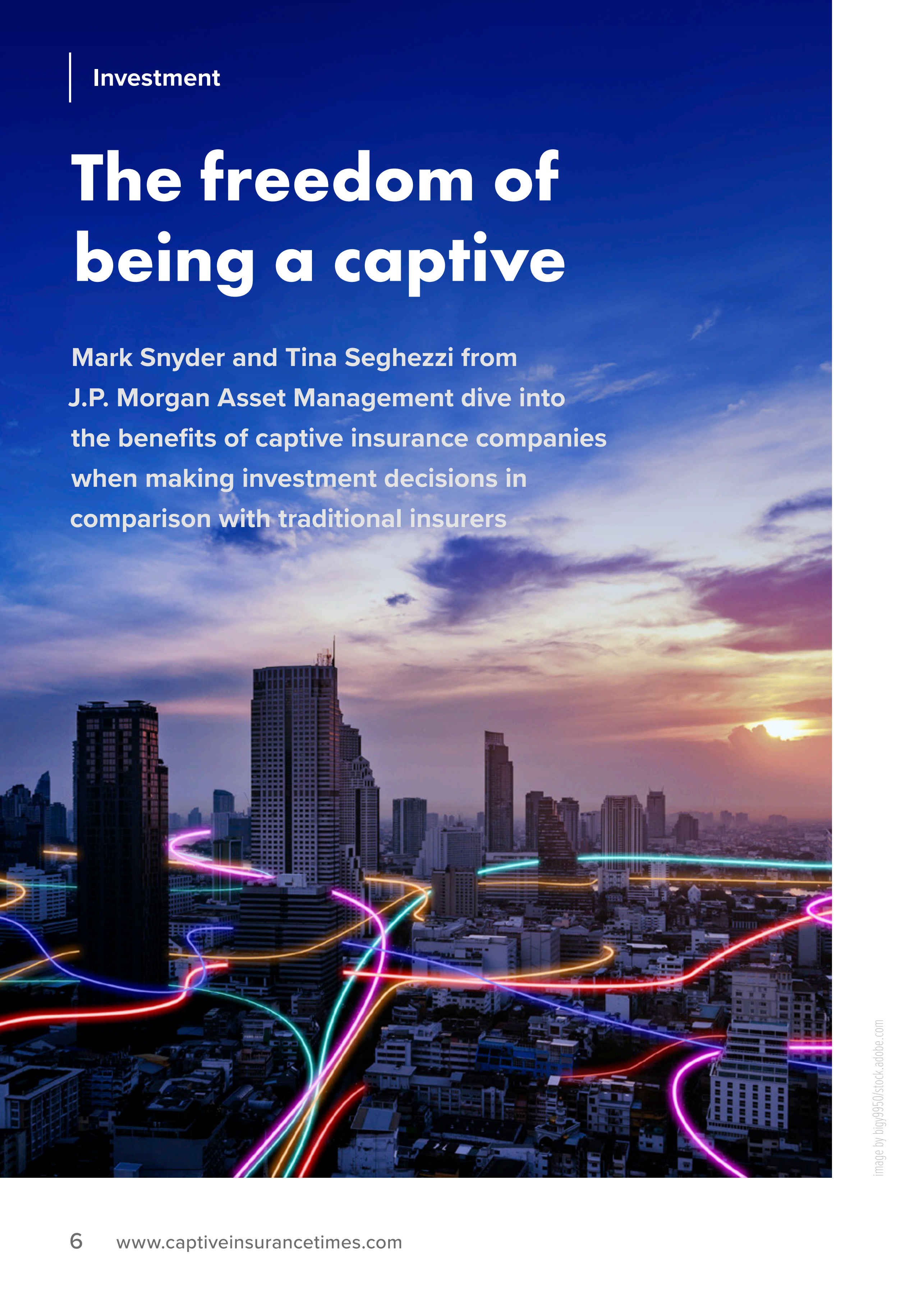

The freedom of being a captive

Mark Snyder and Tina Seghezzi from J.P. Morgan Asset Management dive into the benefits of captive insurance companies when making investment decisions in comparison with traditional insurers

image by bigy9950/stock.adobe.com

When it comes to investment strategies, traditional US-based insurers face a host of external constraints, including regulatory restrictions, capital requirements, and conservative liquidity mandates.

While captive insurance companies also operate under specific limitations, they enjoy a degree of flexibility that makes comparisons with more heavily regulated traditional insurers less useful, particularly in the context of asset allocation. Interestingly, the regulatory and rating agency constraints imposed on traditional insurers can sometimes push them to take on more risk than their less restricted captive counterparts, even when aiming for the same return targets.

This dynamic is particularly relevant when examining property and casualty (P&C) insurers, which are most representative of the typical captive insurance model and will serve as the primary focus of this analysis.

Earnings volatility

Public P&C insurers prioritise strategies that minimise earnings volatility. Most fixed income and loan asset classes, held at amortised cost on the statutory balance sheet, only contribute to US Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS) earnings through interest income in the absence of impairment or realised gains. Below investment-grade fixed income (defined as NAIC 3.A or lower) is held by P&C insurers on the statutory balance sheet at the lower of fair value and amortised cost.

On the other hand, changes in fair value for alternatives and public equity typically affect GAAP or IFRS earnings. These assets, typically held at fair value on the statutory balance sheet, experience fluctuations in their statement value due to market fluctuations. Given this divergent accounting treatment, insurers are largely indifferent to the volatility of investment-grade bonds and mortgage loans, whereas they are extremely sensitive to the volatility of public equity and alternative assets.

Tina Seghezzi
Analyst, Global Insurance Solutions
J.P. Morgan Asset Management

Mark Snyder
Head of North America, Global Insurance Solutions
J.P. Morgan Asset Management

Capital requirements

Capital requirements are another factor that impacts investing. Alternative assets and equity usually have higher regulatory and rating agency capital charges than traditional assets. Insurers can incorporate these capital charges into their asset allocation decision framework by computing a cost of capital and a capital-adjusted expected return for all asset classes.

The cost of capital accounts for asset class-level capital charges, target risk-based capital (RBC) ratio, assumed diversification, and an insurer's own cost of capital. An illustrative example is shown below:

	Expected Return	Cost of US P&C RBC Capital	Capital Adjusted Expected Return
Bond Rated A	5.28%	0.08%	5.20%
Bond Rated BBB	5.43%	0.13%	5.30%
Diversified Hedge Funds	5.00%	1.20%	3.80%
OECD Infrastructure Equity	6.80%	1.20%	5.60%
Real Asset Leasing to IG Counterparties	7.70%	1.20%	6.50%
US Large Cap Equity	7.00%	0.90%	6.10%
Private Equity	9.70%	1.20%	8.50%
Direct Lending	8.50%	0.41%	8.09%

As of July 2024 *Source: J.P. Morgan Asset Management, Bloomberg*

Alternatives must have significantly higher returns to offset their higher capital cost, but given that capital charges are not differentiated based on underlying risk, traditional insurers are incentivised to invest in the alternatives with the highest return, which often correlates with the highest risk.

This means that private equity is much more prevalent in the US insurance industry than presumably lower-risk real asset and hedge fund investments.

Liquidity requirements

Traditional insurers also often maintain extremely liquid portfolios beyond what is necessary given their liabilities because of requirements from rating agencies and other stakeholders, such as lenders.

Like any P&C insurer, captive investments should reflect the nature of their liabilities in terms of cash flow timing and uncertainty about cash needs.

However, captives presumably have a better understanding of the risk in their liabilities and specific liquidity needs.

This, combined with the absence or presence of only reduced rating agency liquidity limits, should allow captives to invest through a more tailored approach in illiquid investments compared to a traditional onshore P&C insurer.

Constraints that impact investments

Below are the key aspects where captives are (typically) less constrained than traditional insurers.

Artificial constraint	How captives compare to onshore insurers
Concern about earnings volatility	Captives are not forced to favour IG fixed income to avoid earnings volatility
Capital requirements	Captives can look at assets on their own terms without having to haircut alternative and public equity due to higher capital charges
Overly conservative liquidity requirements and lack of transparency related to liabilities	Captives can invest more in illiquid investment strategies

As of July 2024 *Source: J.P. Morgan Asset Management*

Portfolio comparison

Because of these differences, captives can and should invest differently than a traditional insurer and should take a customised economic approach that can account for their superior understanding of their parent's liabilities, focussing on total return diversification and efficiency.

Our Multi-Asset Solutions Portfolio Management team reviewed the traditional allocation below and devised a more risk-return-efficient allocation that aligns with their current views and outlook for the year.

As illustrated below, tweaking a traditional portfolio to lean more into certain areas of alternatives and public equity leads to a portfolio with a moderate return and a lower volatility.

Asset Class	Traditional Allocation	Model Portfolio Allocation	Difference
Real Estate	2.2%	4.0%	+1.8%
Private Equity	6.5%	0.0%	-6.5%
HY Private Credit	1.0%	11.0%	+10.0%
IG Private Credit	6.6%	0.0%	-6.6%
Public Equity	2.0%	5.0%	+3.0%
Securitized	20.0%	27.0%	+7.0%
HY Corp	4.0%	10.0%	+6.0%
IG Corp	26.5%	25.0%	-1.5%
Gov't Related/Municipal Bonds	15.0%	0.0%	-15.0%
Treasury	13.4%	13.0%	-0.4%
Cash & ST	3.4%	5.0%	+1.6%
Total	100.0%	100.0%	

As of July 2024 *Source: J.P. Morgan Asset Management, S&P Global*

A few key differences to call out include the 5% allocation to equity in the model portfolio compared to the original 2% allocation in the traditional portfolio. Additionally, in real estate, the portfolio extends to a 4% allocation versus. the traditional minimal 0.1% allocation.

Metric	Traditional Allocation	Model Portfolio Allocation
US P&C RBC	3.07%	3.40%
Expected Return	5.69%	5.95%
Default Adj	-0.08%	-0.16%
Market Yield	5.78%	6.10%
Investment Volatility	3.09%	2.93%
Asset Duration	2.99%	2.14%
% Illiquid	16.30%	15.00%

As of July 2024 *Source: J.P. Morgan Asset Management, S&P Global, Bloomberg*

Our Insurance Strategy and Analytics team ran both the traditional and model allocations, utilising their optimisation tools to output the above metrics. As seen in the table above, the key metrics display a model portfolio that is achieving a slightly stronger expected return (at 5.9%) while experiencing a reduced investment volatility (at 2.93%). We can attribute this specifically to the reallocations we detailed above, while also branching out of vanilla fixed income areas such as IG Corp and Municipals. Additionally, note that while the model portfolio has a slightly higher P&C capital charge, the RBC requirements would not necessarily be relevant for a captive. Though the model portfolio has a smaller allocation to illiquid assets than the traditional portfolio, there is flexibility to increase this allocation significantly if it is consistent with our tactical views.

While initially unclear throughout the first half of 2024, we now believe that the pace of economic growth is moderate, and the Fed would consider beginning easing before the end of the year, as long as inflation continues to cool sufficiently. This environment supports a risk-on tilt in portfolios, particularly an overweight to public equities — an approach the model portfolio emulates. Furthermore, the case for alternatives can be made for the unpredictability associated with 2024, as alternatives have demonstrated inflation resilience in the past, alongside improving returns. In particular, expected returns for real assets, such as real estate, infrastructure, and transportation, as well as private credit, are expected to be higher in 2024. In the model portfolio, diversification is highlighted, and a moderate return is achieved by dabbling in the aforementioned alternatives and public equity while keeping volatility low. This is an opportune time for captives to take advantage of their edge over traditional insurers and adopt a slightly altered approach while navigating these more flexible limitations. ■

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Gary Greene
Managing director
Wellspring Financial Solutions

Unleashing potential of direct indexing for captive insurers

Gary Greene, senior vice president and managing director at Wellspring Financial Solutions, delves into the strategic advantages of direct indexing for captive insurers, offering insights on how this approach can enhance investment portfolios

How does direct indexing differ from traditional index-based investments like exchange traded funds (ETFs) or mutual funds, and what unique advantages does it offer captive insurers in terms of portfolio customisation and risk management?

Direct indexing represents a significant evolution in investment strategies, providing investors with greater autonomy, control, and potential tax advantages compared to traditional mutual funds or ETFs.

Unlike these conventional vehicles, where you invest in a fund that holds a basket of stocks, direct indexing involves purchasing the individual stocks that comprise an index. The portfolio's weightings closely mirror those of the index, but with key differences that offer distinct advantages.

One of the primary benefits of direct indexing is the ability to engage in tax-loss harvesting. Investors can selectively sell individual stocks at a loss to offset capital gains elsewhere in their portfolio. Traditional fund structures, which pool gains and losses, do not offer this powerful tool for tax liability management.

Portfolio customisation is another significant advantage. While mutual funds and ETFs expose investors to all of the fund's companies or sectors, direct indexing allows for the exclusion of specific stocks or sectors. This customisation is particularly beneficial for captive insurers, who can align their portfolio more closely with their specific risks, goals, or preferences.

Moreover, direct indexing allows for tax lot customisation. Investors can choose specific tax lots to sell when rebalancing or adjusting their portfolios, offering another layer of tax efficiency. Additionally, unlike mutual funds, direct indexing avoids triggering capital gains at the fund level, which can further enhance tax efficiency.

For captive insurers, these benefits are particularly valuable. The ability to tailor a portfolio to match the insurer's unique risk profile, while also managing tax exposure more effectively, makes direct indexing a compelling choice. This strategy allows insurers to realise potential tax benefits that would be inaccessible within the traditional fund structure.

For instance, if the value of certain stocks within an ETF declines, the fund is unable to harvest those losses individually. However, with direct indexing, the investor can sell those underperforming stocks at a loss and replace them with others that have similar characteristics — such as swapping Home Depot for Lowe's or AT&T for Verizon — thereby releasing losses that can offset gains in the current or future years.

What role can direct indexing play in helping captives manage their unique risk profiles, particularly in aligning investment strategies with underwriting exposures and claim payment patterns?

Direct indexing is a useful tool for captives because it allows them to tailor their investment strategies to closely align with their specific balance sheet risks and cash flow requirements. Much like any insurance company, captives need their investments to reflect the unique risks they underwrite.

Direct indexing, through customisation, enables captives to manage these risks effectively. For instance, we can design portfolios to steer clear of, or restrict, investments in areas significantly linked to the captive's underwriting risks. If a captive insures supply chain risks from a particular country, it may limit investments in that country to mitigate exposure.

Similarly, it helps manage counterparty risk by avoiding or limiting investments in companies that are directly or indirectly associated with the captive or its parent company. This might include avoiding investments in direct competitors of the parent company, thereby ensuring that the captive's investment strategy does not inadvertently increase its overall risk exposure.

How does the tax-loss harvesting potential of direct indexing translate to the captive insurance context, considering the specialised tax treatment of captives?

Direct indexing's tax benefits are among its most valuable features, particularly for mature captives with equity investments. Typically, captives pay taxes on their investment income and capital gains.

When a captive sells a fund or ETF, it is required to pay taxes on the collective gains of the underlying fund holdings. However, any potential tax benefits from the underlying holdings that have declined in value are forfeit.

This is fixed by direct indexing, which lets captives get those losses directly from individual securities in a portfolio. This is a better way to balance out gains and lower overall tax obligations than investing in a fund or ETF.

In what ways can direct indexing facilitate ESG integration for captives looking to align their investment portfolios with corporate values or stakeholder expectations?

Direct indexing offers a highly customisable approach that aligns well with ESG mandates. Unlike traditional investment methods, direct indexing allows captives to hold individual company stocks, providing the flexibility to tailor their portfolios in line with specific ESG criteria.

For instance, captives can exclude companies that do not meet their corporate values or stakeholder expectations, or they can screen the entire index for particular ESG metrics before making investment decisions.

Furthermore, numerous direct indexing managers currently provide options specifically linked to ESG-focused indices, simplifying the process for captives to incorporate socially conscious investing into their portfolios.

How might direct indexing strategies be tailored to address the often longer investment horizons of captive insurers compared to traditional property and casualty companies?

Direct indexing is an equity-based investment strategy, making it particularly well-suited for captives with intermediate to longer-term investment horizons. I typically recommend this approach for captives that possess ample surplus or are managing longer-tail risks. The extended timeline allows these captives to fully leverage the benefits of direct indexing, such as increased customisation and potential tax efficiencies, aligning well with their long-term financial objectives.

What technological infrastructure is required to effectively implement and manage a direct indexing strategy for captives, and how does this compare to traditional investment approaches?

Captive investors who opt for direct indexing through a professional money manager typically won't need additional technological infrastructure. However, challenges may arise for captives that do not use an automated accounting system, such as Clearwater Analytics. Direct indexing often leads to a portfolio comprising several hundred securities, which can create significant accounting complexities. In contrast, traditional investment approaches, with fewer securities, are generally easier to manage without the need for sophisticated accounting tools.

How can direct indexing be utilised to manage concentrated positions or sector exposures that may arise from a captive's parent company or industry focus?

All companies face counterparty, sector, and geopolitical risks, but recognising these risks is just the first step; taking action to hedge or mitigate them is where the real challenge lies. Captives, due to their

relatively small size compared to commercial insurers, often have a more limited selection of investment vehicles. This limitation often leads them to use funds or ETFs to achieve necessary diversification, sometimes at the expense of exposing their balance sheet or parent company to certain risks.

Captives can track an investment index with minimal tracking error and customise it to mitigate non-market-driven risks through direct indexing. For instance, if a captive's parent company or industry focus exposes it to specific companies or industries, we can tailor direct indexing to mitigate these concentrated positions, thereby providing a more targeted approach to risk management.

"All companies face counterparty, sector, and geopolitical risks, but recognising these risks is just the first step; taking action to hedge or mitigate them is where the real challenge lies"

In the context of a hardening insurance market, how might direct indexing provide captives with additional flexibility in managing their investment portfolios to support potential increases in underwriting activity?

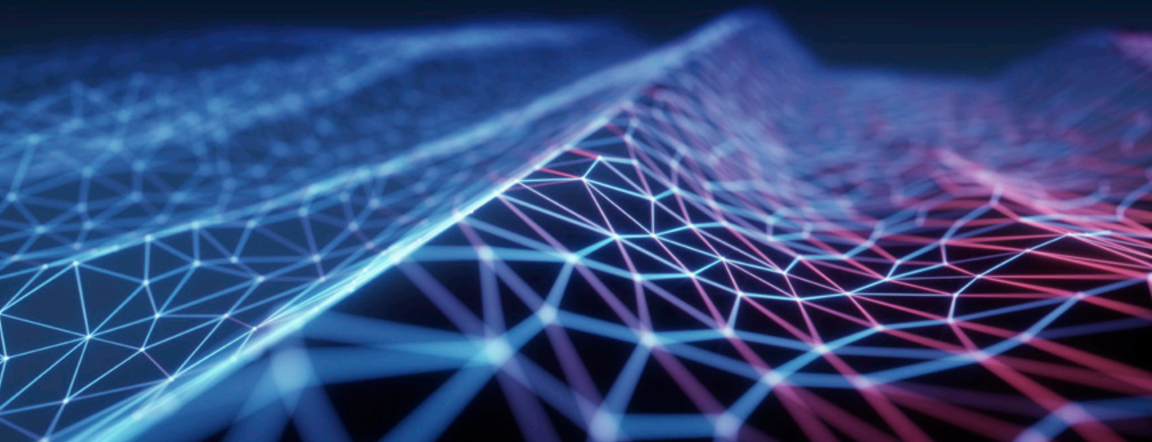
Direct indexing can offer captives a unique advantage by potentially generating higher after-tax total returns on their investments. Using this strategy allows captives to keep funds that they would have otherwise paid in taxes. The balance sheet immediately receives these additional dollars as excess surplus, allowing captives to leverage them in various ways. Captives can use this surplus to lower future premiums, increase retention, or expand their coverage offerings, thereby enhancing their ability to manage increased underwriting activity in a challenging market environment.

What are the key considerations for captive managers when evaluating the cost-benefit trade-off of implementing a direct indexing strategy versus more traditional investment approaches?

The key considerations for direct indexing are quite similar to those for traditional investment approaches. Direct indexing is primarily an equity-based investment strategy, which means that captives must assess whether they have the risk capacity, risk tolerance, and investment timeline to support equity investments. While direct indexing is a modified passive approach and may incur slightly higher costs compared to traditional passive investing, these costs are generally minimal. In my experience, the benefits of direct indexing, such as greater customisation and potential tax advantages, often far outweigh these additional costs. ■

Keeping in line with IFRS 17

AM Best's Christie Lee and Mahesh Mistry outline implications of the International Financial Reporting Standards 17 on captive insurance operations



What is IFRS 17, and why is it crucial for captive owners to understand its implications for their operations?

Christie Lee: International Financial Reporting Standards (IFRS) 17 is a market-value-focused accounting standard for insurance contracts based on discounting future cash flows.

The standard also acknowledges profit throughout the duration of the services provided under the contract. This new reporting standard necessitates significant modifications to accounting principles, rules, presentations, and financial disclosures for insurance companies regarding the valuation and reporting of insurance contracts. It also aims to bring greater transparency and comparability, especially with non-insurance sectors.

IFRS 17 implementation will impact captive (re)insurance companies that publish financial statements in accordance with IFRS accounting standards, including those based in Hong Kong. If a captive does not report under IFRS, but its parent company does, the captive may still be required to perform IFRS 17 valuations for consolidation purposes.

How does the implementation of IFRS 17 affect the valuation and reporting of insurance liabilities for captives, particularly in relation to the discounting of cash flows and the inclusion of a risk adjustment?

Mahesh Mistry: IFRS 17 enables different measurement models for reporting purposes. The general measurement model (GMM) requires a split of the insurance contract liability into a present value of future cash flows and a risk adjustment, with the remaining amount being the contractual service margin.

The premium allocation approach (PAA) mandates the division of incurred claims into a present value of future cash flows and a risk adjustment. For captives, which are largely non-life insurers, the impact of discounting and the removal of implicit margins may be in part offset by creating an explicit risk adjustment.

Lee: In addition, under IFRS 17, insurance contract liabilities will incorporate the net effect of insurance receivables (an asset item) and insurance payables (a liability item); these used to be shown as separate items in assets and liabilities. This netting of receivables and payables within (re)insurance contract assets/liabilities would reduce total assets and total liabilities of a captive's balance sheet.

What are the key differences between the GMM and the PAA under IFRS 17, and why might captives prefer to adopt the PAA for their insurance contracts?

Lee: The GMM is the default measurement model for evaluating insurance liabilities. Life insurance contracts or long-duration contracts typically use this more complex implementation. The PAA, on the other hand, is a simpler way to do accounting. It can be used to report liabilities for insurance contracts that cover one year or less, or for short-term contracts that cover more than one year but where the PAA result is not likely to be significantly different from the GMM result.

Captive insurers adopting IFRS 17 are most likely to use a measurement model that reflects the profile of their product composition. In most cases, this will be the PAA approach.

In what ways does IFRS 17 change the treatment of reinsurance commissions for captive reinsurers, and how might this impact their key performance indicators?

Lee: Under IFRS 17, the revenue key performance indicator (KPI) for insurance services replaces the gross premium. For captive reinsurers, under IFRS 17, ceding commissions on inward reinsurance that are not contingent on claims are not part of insurance service revenue. Insurance service revenue would exclude this as an investment (ie deposit) component.

The shift in reporting treatment for these commissions is one of the biggest conceptual changes in the transition to IFRS 17. This approach could potentially reduce the denominator of combined ratios for a captive reinsurer operating under IFRS 17. When coupled with the discounting effect in the numerator of combined ratios, the new standard requires a significant educational effort to help management understand how to read and interpret KPIs going forward.

How does IFRS 17's requirement for more granular data affect captives' operational processes and IT systems, and what strategies can captives employ to address potential data gaps, especially for legacy contracts?

Mistry and Lee: Some captives may have encountered issues with legacy data, which might not be available or need additional work to prepare. To ensure the successful implementation of IFRS 17, captives would have needed to invest in new data systems and processes, resulting in increased management expenses.

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However, we expect most captives that have adopted IFRS 17 or are in advanced stages of implementation will have incurred the majority of investment in systems by now, so these costs should largely have been absorbed. Additionally, many captives have received support from their captive managers regarding IFRS 17, which has partially reduced their expense burden.

The cost should not have created significant pressure on operating performance but may result in management expenses ticking up a little.

Given the global variation in IFRS 17 adoption timelines, how should multinational corporations with captives in different jurisdictions approach the consolidation of financial statements under the new standard?

Lee: IFRS 17 took effect on 1 January, 2023, although some jurisdictions are adopting the standard over the next three years. IFRS 17 is generally applicable to all entities that issue insurance contracts and report under IFRS accounting standards.

While these changes will affect insurance companies operating in most jurisdictions, some significant markets, such as the United States and Japan, are not IFRS reporting jurisdictions. Some insurers who are not reporting under IFRS may opt to adopt it for comparability. While Bermuda, the Cayman Islands, Vermont, Utah, and Delaware are the top five captive domiciles, these jurisdictions do not require the compulsory adoption of IFRS 17. Bermuda and Cayman Islands permit the use of IFRS, but they are not required.

However, captive insurers face certain challenges. If a captive does not report under IFRS, but its parent company does, the captive may be required to perform IFRS 17 valuations for consolidation purposes.

For those who need to adopt IFRS 17 in the near future, there is a varying level of readiness for its implementation among captives.

What are the potential implications of IFRS 17 on captives' pricing strategies, and how might it influence decisions regarding risk retention versus transfer to the commercial insurance market?

Mistry: Given that captives are generally a risk management tool for the parent, as with commercial insurers, there should not be any impact on pricing structures. Additionally, the economic view of the balance sheet is likely to remain unchanged. There will be an effort to understand new terminology, definitions and KPIs under IFRS 17. To date, we have not seen any evidence of captives altering strategic objectives as a result of IFRS 17.

How does IFRS 17 impact the calculation and interpretation of key financial metrics for captives, such as combined ratios, return on equity, and solvency ratios?

Lee: AM Best expects to evaluate net/net and net/gross combined ratios calculated for IFRS 17 reporters. IFRS 17 ratios should be more comparable across the IFRS 17 universe, at least when comparing similar ratios such as the net/net, than was previously the case. Discounting should diminish normal variations between lines of business. However, combined ratios will remain subject to interpretation for individual insurers. Comparisons across accounting standards will require careful interpretation. Indeed, the need for interpretation will grow when comparing combined ratios that use IFRS 17 data with those from other accounting standards, including US GAAP.

In light of IFRS 17's focus on contract grouping and cohorts, how should captives approach the aggregation of insurance contracts, especially when dealing with multi-year or complex risk transfer arrangements?

Mistry: Those captives that are already producing financial statements under an IFRS 17 basis would have

undergone a comprehensive review of their portfolios and identified appropriate cohorts and groupings for the reporting standard.

This would have included a review of multi-year contracts and complex risk transfer, most likely under the GMM approach.

Captive managers would discuss such decisions with the board of directors and, of course, auditors.

What synergies exist between IFRS 17 and Solvency II requirements for European captives, and how can these be leveraged to streamline implementation and ongoing compliance efforts?

Mistry: Captives still primarily use Solvency II reporting to manage their capital and maintain an economic perspective.

IFRS 17 will have little bearing on this. However, the Solvency II reporting infrastructure may be of use in preparing IFRS 17 reporting, including for discounting.

How might the enhanced transparency and comparability brought about by IFRS 17 influence parent companies' strategic decisions regarding the use and structure of their captive insurance operations?

Mistry: Global comparability remains a challenge for IFRS 17 reporters against non-IFRS17 reporters, which is the case for commercial insurers and reinsurers.

However, we expect greater convergence in reporting among IFRS17 reporters over time, which should add value and improve comparability. ■

Christie Lee
Senior director/head of analytics
AM Best Hong Kong

Mahesh Mistry
Senior director/head of analytics
AM Best London

Alan Taylor
Director
Avenue International

Cook Islands' approach to balancing privacy and transparency in captives

Alan Taylor, director at Avenue International, summarises the evolution of captive regulatory compliance in offshore jurisdictions and outlines the Cook Islands' approaches

Over the past two decades, the offshore landscape has changed considerably. 9/11 was arguably the catalyst for this. Following the catastrophic event, governments, and in particular the US, targeted the international transfer of funds as being the primary driver of terrorist activity. It was determined that more information was required to better understand the source of funds entering the banking system, the structures holding them and their owners.

The global financial crisis of 2009 followed, causing economic turmoil for many of the world's largest countries, resulting in enormous debt and the erosion of the tax bases needed to fund that debt and stimulate economies. In the ensuing years, EU and OECD members united to examine their tax laws and the reporting practices of their tax residents, with the aim of ensuring compliance with tax laws and growing the dwindling tax bases.

These events and their consequences have given rise to numerous measures, ostensibly intended to provide international standards for combating money laundering and financial crimes, including tax evasion, and the international exchange of financial information. However, it appears that these measures primarily targeted offshore financial centres, believing that restricting their activities would enable the EU and OECD countries to better control their taxpayers' activities.

International regulatory measures

The international regulatory measures introduced in recent years have significantly impacted offshore financial centres.

The Financial Action Task Force (FATF) Recommendations: The FATF has developed a comprehensive framework of measures that countries are to implement in order to combat money laundering and terrorist financing.

The FATF Recommendations provide an international standard that countries must adhere to. The FATF evaluates each country's Anti-Money Laundering (AML) regime against the recommendations and their specific circumstances.

The Foreign Account Tax Compliance Act (FATCA): The US requires all countries to automatically provide financial information held on US tax residents to the Internal Revenue Service (IRS).

The purpose of FATCA is to prevent US persons from using banks and other financial institutions outside the US to park their wealth and potentially avoid US taxation on income generated from such wealth.

The Common Reporting Standard (CRS): The OECD has implemented its version of FATCA, whereby all countries must agree and pass laws to ensure the automatic exchange of financial information held on tax residents of the requesting country. The CRS requires financial institutions to gather and share specific information with their respective tax authorities.

OECD Base Erosion and Profit Shifting Project (BEPS): The OECD has implemented a programme to address tax avoidance, primarily by multinational enterprises, and the shifting of profits to low or no-tax jurisdictions.

The BEPS project aims to equip governments with regulations and tools to combat tax avoidance and guarantee that the economic activity that generates profits is subject to taxation.

EU list of non-cooperative tax jurisdictions: In 2017, the EU notified more than 70 jurisdictions, mostly those regarded as no or low tax jurisdictions, that they would be blacklisted unless they amended tax laws that the EU regarded as harmful and preferential.

The EU also required those jurisdictions to be transparent with financial information and to have signed up to the OECD's BEPS project.

The imposition of these measures on offshore financial centres, such as the Cook Islands, disregards the costs and resources necessary for the implementation and maintenance of the mandated laws and systems, as well as the potential negative impact on their economies that depend on foreign investment and the autonomy to establish their own tax laws.

The Cook Islands' response

The Cook Islands is a small Pacific nation of 15 islands in the heart of the South Pacific. It has a resident population of around 15,000. Notwithstanding its lack of resources — financial and human — it had no choice but to comply with the onerous requirements stipulated by the world's most powerful nations.

It could not bear the thought of blacklisting, the ensuing reputational and economic harm, and the ensuing international isolation.

It has been an extremely challenging road for the Cook Islands to navigate. Still, it has progressed by committing to meet the standards demanded while preserving its ability to be innovative in enacting laws to meet the needs of its people and being responsive to its international client base, which requires certainty, continuity, and legitimate privacy.

Over recent years, the Cook Islands has received an outstanding Mutual Evaluation Report (MER) from the FATF, indicating it has one of the best AML/CFT regimes in the world.

The Cook Islands has incorporated the CRS and FATCA into its laws to promote transparency by automatically exchanging financial information with other jurisdictions, thereby aiding in the fight against tax evasion and other financial crimes.

The Cook Islands is a member of the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes as well as its BEPS Inclusive Framework. It has avoided being placed on the EU's AML/CFT blacklist by virtue of its MER report and the EU's non-cooperative tax jurisdiction list by amending laws to, among other things, remove the Cook Islands tax exemptions for companies incorporated under the International Companies Act 1981-82. The EU regards the Cook Islands as a cooperative tax jurisdiction.

The Cook Islands has always shown itself to be flexible, innovative, and understanding in meeting the needs of international business. An example of this is the enactment of the Captive Insurance Act in 2013. The Act provides for the licensing, regulation, and supervision of captive insurance business conducted outside of the Cook Islands by international companies, as well as certain captive insurance business conducted within the Cook Islands by companies incorporated under the Companies Act 1970-71.

Captive insurance business in the Cook Islands means the business of an international company insuring interests in its holding company or in companies that it is affiliated with or associated with, or which is organised within a group or agency relationship.

In passing the Act, the Cook Islands placed itself at the forefront of an industry in the Asia Pacific region that is continually growing and seeking strong, well-respected jurisdictions from which to establish and administer captive insurance structures. The Act contains features that, together with the benefits of doing business in the Cook Islands, provide strong technical and commercial reasons for organisations to incorporate Cook Islands captive insurance in their business plans.

Captive licencing in the Cook Islands

Features of a Cook Islands licensed captive insurance company (LCIC) include:

- The prescribed minimum share capital and surplus requirement for a LCIC is NZ$100,000 (US$61,000).
- Only assets prescribed in the Captive Insurance Regulations of 2013 will be admissible when determining the value of an LCIC's assets and its surplus.
- The Cook Islands Financial Supervisory Commission must audit and file an LCIC's annual accounts. A LCIC must establish and maintain a clearly defined risk management strategy commensurate with the size, nature, and complexity of the LCIC's business.
- Each LCIC must appoint an "approved insurance manager" who must be licensed under the Cook Islands Insurance Act 2008 or an external manager approved under the Act.
- Captive owners can be individuals, corporations, and unincorporated bodies, groups, and associations.
- The LCIC will only pay Cook Islands tax on income it sources in the Cook Islands.

Tax changes, CRS classification and privacy requirements

In removing tax exemptions for international companies, including LCICs, to comply with the EU's mandate, those companies then became subject to Cook Islands company tax on their worldwide income. This enactment kept the Cook Islands off of the EU's blacklist of non-cooperative tax jurisdictions but put at risk all of its international company business, including captive insurance. ■

The Cook Islands responded quickly, however, by commissioning a review of its corporate tax regime to find a solution enabling it to retain and further grow its international company business.

The Income Tax Amendment Act 2021, which changed the Cook Islands company residence test for taxation purposes from incorporation to location of mind and management, was the result of this review. International companies, including LCICs, are therefore able to structure their governance to have a majority of directors resident outside of the Cook Islands, thereby ensuring they are not tax-resident for Cook Islands tax purposes.

Given that the Cook Islands is a member of the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes, as well as its BEPS Inclusive Framework, and has passed laws to implement the CRS, it is imperative that each LCIC understands its CRS classification, as this will determine whether or not it has reporting obligations under the CRS. If so, it must comply with the Cook Islands CRS laws and regulations.

The Cook Islands exchanges the CRS information with its international CRS partners automatically on an annual basis. LCICs and all financial institutions in the Cook Islands, which include custodial institutions, depository institutions, investment entities, and specified insurance companies, must be CRS compliant.

Despite its commitment to meet its international obligations through compliance with EU, OECD, and FATF standards, the Cook Islands has been able to maintain its reputation for accountability and responsibility while continuing to be a safe haven for those seeking legitimate privacy for their personal affairs.

The ongoing global movement to establish transparency on financial matters suggests that we can no longer take the confidentiality and privacy of one's financial affairs for granted.

However, while governments should not be denied their rightful tax take and those profiting from crime should not be encouraged, there needs to be some comfort for those going about their lawful business that their personal information will not be available to those with no lawful need for it.

In this regard, the Cook Islands strikes a balance between fulfilling its international obligations and safeguarding an individual's right to legitimate confidentiality through its laws.

The Cook Islands does not have public registers for beneficial ownership of incorporated entities or trusts. The Commissioner of the Financial Supervisory Commission and the Financial Intelligence Unit do have investigative powers where there is reason to believe financial misconduct has taken place.

However, they will only share the obtained information in accordance with the law's provisions. Fishing expeditions will not be tolerated.

The Cook Islands' approach to meeting its international obligations while recognising and providing legitimate confidentiality for those doing business in and with the islands should give governments, institutions, businesses, and individuals globally great comfort when dealing with the jurisdiction and its financial services industry.

Notwithstanding the measures it has undertaken to ensure compliance with international regulatory standards, the Cook Islands has been able to maintain its reputation for innovation, accountability, and being a good international citizen without any significant impact on its business operations, in particular its captive insurance business.

International clients expect adherence to international standards and obtain comfort knowing the Cook Islands and its service providers continue to provide the highest quality service in a compliant and responsible manner. ■

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- [ ] DOMICILE
- [ ] FRONTING CARRIER
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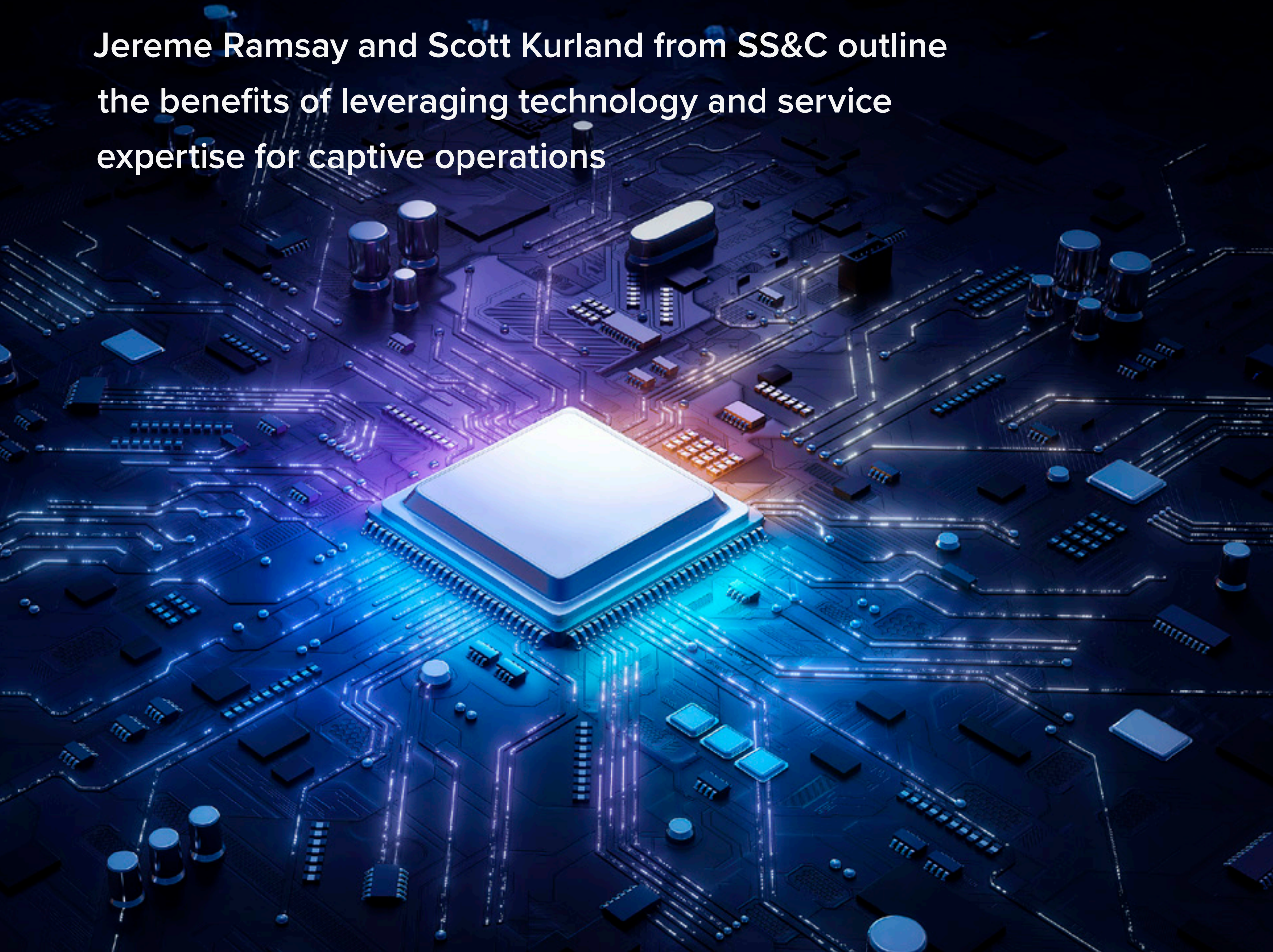
Leveraging technology advancements and service expertise

Jereme Ramsay and Scott Kurland from SS&C outline the benefits of leveraging technology and service expertise for captive operations



Fortune 500 entities and middle markets are increasingly turning to captive insurance structures in response to rising commercial premiums and the need for greater cost control.

There are now more fronting options available for these sophisticated insurers.

New and expanding captives are discovering how selecting the right technology and service vendors can help future-proof their business while improving overall relationships with parent companies, partners, and clients.

Innovation calls for technology

Investing in and embracing innovation is critical for insurers when launching or repurposing their captives.

Technology is the key to remaining cost-efficient, price and competitive and able to meet the growing demands of parent companies, partners and clients.

These platforms offer enhanced operational efficiency and scalability, enabling captives to reduce premiums to remain competitive in the market and have greater flexibility in their underwriting and investment activities.

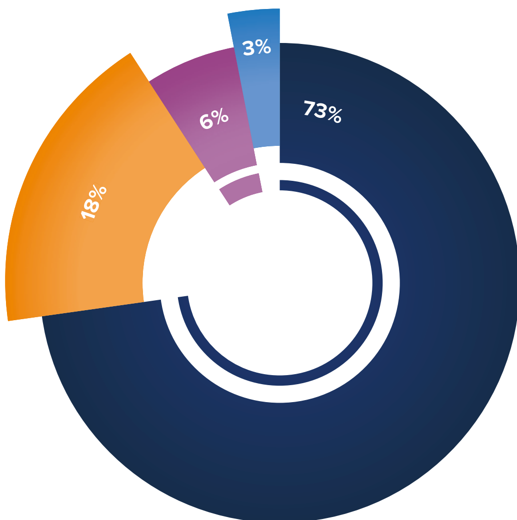
In a secure and robust cloud-native environment, insurers can revolutionise product pricing and improve captive, regulatory, and other stakeholder interactions with these technologies.

Areas ripe for automation and improved efficiency include:

- Underwriting.
- Policy administration.
- Claims management.
- Investment operations.
- Accounting.
- Regulatory reporting.
- Real-time risk management.

Furthermore, these platforms' flexible data models and interoperability offer much wider compatibility with upstream and downstream external data sources, formats, and delivery methods. Captives can connect with new counterparties faster; capitalise on new investment opportunities; adapt to changing regulations; or embark on new underwriting activities.

Forrester Consulting conducted a study in January 2024 on the impact of intelligent automation (IA) on financial institutions, which found that the implementation of IA led to a 7.8 per cent increase in revenue and a 5.4 per cent increase in compound annual growth rate (CAGR) over a three-year period. The IA technology also had a 330 per cent return on investment over the three years, paying for itself within six months of implementation. The following were the areas where the biggest impact was observed:



Profit from revenue growth - 73%

Productivity improvement - 18%

Employee retention - 6%

Complience cost avoidance - 3%

Captive owners should work with innovative technology partners to review their options and prepare for a demanding market and rising premiums.

Reviewing the right technology is necessary to bring together the right solution to best prepare for the current and expected market environment.

Capitalising on expertise

While accelerating the licensing and incorporation process is a top priority for captives, it is equally crucial to exercise due diligence when evaluating vendors and service providers.

Mission-critical functions like investment accounting, middle office operations, front office analytics, regulatory reporting, risk management, and performance measurement require a thorough review to ensure the best fit for the captive's business and operational needs.

Investing in a service provider with institutional-calibre people, processes, expertise, and technology can be a game-changer for captive insurers.

Such a partner can act as an extension of the captive's staff, operating as a true strategic partner.

This improves efficiency and scale and saves time and cost over the long term, providing a sense of security and confidence in the business' operating model.

Companies like SS&C have leveraged intelligent automation to reduce average loan processing and handling times for insurers and captives by 57 per cent.

They have also deployed AI technologies such as natural language processing and machine learning to increase the speed of credit agreement processing by almost 95 per cent.

Similarly, for large residential whole loan portfolios — a growing opportunity for longer-term captives

and carriers — SS&C has employed robotic process automation technology to automatically update and roll monthly rates for large volumes of floating rate loans. The automation reduces a days-long completion process to less than a few hours.

Such efficiencies translate into increased scalability and profitability for captives and reinsurers engaging in various public and private credit investment activities, with capital invested from their policies and premiums.

When evaluating service providers and strategic partners, the captive should consider key factors, including:

- Experience and history implementing applications of IA.
- Depth and breadth of expertise of the service teams supporting the underpinning technology and IA applications.
- The service provider's ongoing R&D investment and commitment to enhancing such technologies over time.
- The security, reliability and scalability of the solutions and services.

Embracing innovation is not just about investing in technology, it is also about understanding the captive's current needs and the board's ambitions to expand, flourish, and grow.

Then, the captive needs to carefully select the right strategic partner with the capabilities, expertise, and capacity to implement. Captives who spend time finding partners with these skills are more likely to succeed. In today's complex and quickly evolving market, captive insurers stand to benefit from the power of modern technology and automation, combined with the insights only an experienced expert can provide. ■

Scott Kurland
Managing directors
SS&C

Jereme Ramsay
Director, business development and client relations
SS&C

Ed Goard
Chief investment officer
Yousif Capital Management

Positioning captive portfolios for the next phase

Ed Goard, chief investment officer at Yousif Capital Management, reflects on how the Fed's recent rate cut signals a crucial turning point for captive insurers

The Fed recently began its rate-cutting cycle with a 50 basis point cut in interest rates (moving the target rate from 5.50 to 5.00 per cent), signalling a critical turning point in the investment landscape — one that presents both risks and opportunities for captive insurers.

In recent years, numerous captive portfolios have implemented a laddered Treasury Bill strategy at the lower end of the market, capitalising on an inverted yield curve to generate returns of at least five per cent on their fixed income allocations.

However, now that the Fed has kicked off its rate-cutting cycle, it is time to reassess. Captive insurers should consider rebalancing their portfolios to capitalise on the evolving financial climate and protect themselves against risks associated with falling interest rates.

A dynamic approach to portfolio allocation is becoming crucial for captive insurers, particularly with an expected 200bps rate-cutting cycle. Experts suggest that captive boards should adjust their portfolios and adapt their investment strategies to align with the evolving financial landscape.

Impacts of rate cuts on captive portfolios

The Fed's decision to reduce rates by 50bps marks the beginning of what could be a prolonged period of monetary easing. Historically, such cycles of rate cuts have averaged between 200-300bps, suggesting that further reductions are likely to come. Understanding how these cuts affect the investment landscape is critical for making informed decisions.

For fixed income investments, which play a significant role in captive portfolios, falling rates generally lead to higher bond prices. However, the response varies across different types of bonds. While a laddered Treasury approach at the short-end of the yield curve or floating-rate notes worked well during rising rates, it may now offer diminished returns as rates fall. Longer-duration bonds, which are more sensitive to interest rate changes, tend to benefit the most in a falling rate environment as their prices increase more significantly.

For captives with surplus capital that can invest in equities, the potential for equity returns to be more broadly distributed will likely increase as rates decline, moving beyond the concentration in mega-cap stocks.

"In light of the current concentration risk in the S&P 500, where the top ten mega-cap stocks make up approximately 36 per cent of the index, smart beta strategies offer a compelling alternative for captives with surplus capital to invest"

Lower borrowing costs provide relief not only to large corporations but also to smaller businesses and consumers, especially those whose borrowing is tied to the prime rate. The Fed's policy rate cuts will finally provide some relief to this segment of the economy, burdened by high inflation and elevated interest rates.

In light of the current concentration risk in the S&P 500, where the top ten mega-cap stocks make up approximately 36 per cent of the index, smart beta strategies offer a compelling alternative for captives with surplus capital to invest. One approach is a fundamental weighting methodology, which selects and weights stocks based on factors like sales, cash flow, dividends, and book equity value.

By emphasising these fundamental metrics rather than market capitalisation, this strategy avoids overexposure to inflated stock prices that can occur in traditional cap-weighted indices. In a market where concentration risk is high, a smart beta approach focused on fundamental strength can provide more balanced exposure across sectors and companies, reducing reliance on a few large names.

This method can help captives achieve better diversification, capitalise on companies with solid finances, and potentially avoid the volatility that can arise from market corrections in overvalued sectors.

In this environment, a dynamic portfolio allocation strategy becomes indispensable. Unlike a static approach, which maintains a fixed allocation across asset classes, dynamic rebalancing adjusts the portfolio based on market conditions and economic trends. This responsiveness is key in capturing opportunities and mitigating risks as the interest rate cycle evolves.

Captive insurers can benefit from this strategy due to their unique investment goals and liability structures. As insurance companies, captives must strike a balance between long-term stability, the ability to pay claims, and the need for investment growth.

A rigid, unchanging asset allocation can expose the portfolio to unnecessary risks or missed opportunities, especially in a rapidly changing environment like the one we are entering now.

Rebalancing portfolios for a falling rate cycle

With the Fed signalling more rate cuts ahead, captive boards should consider the following rebalancing strategies:

Shift from short treasury ladders to longer duration notes and bonds

One of the most straightforward adjustments is increasing the allocation to longer-duration notes and bonds (durations and maturities between 5 and 10 years). These have higher interest rate sensitivity, meaning their prices rise more significantly as rates fall. By reallocating capital into these securities, captives can capture price appreciation while locking in yields that may no longer be available as rates continue to drop.

However, captives must carefully assess their liability streams to ensure that this strategy aligns with their long-term obligations. Longer-duration notes and bonds can be advantageous for insurers with predictable liabilities but may expose portfolios to risk if liquidity needs are higher in the short term.

Monitor credit markets for opportunities

Rate cuts also present opportunities in the credit market. As the Fed eases monetary policy, the spread between corporate bonds and Treasury yields may widen, offering higher compensation for taking on credit risk. Following any widening, it could be an opportune time to increase exposure to high-quality corporate bonds, asset-backed securities, or other credit instruments.

However, it is essential to balance the pursuit of yield with credit quality, ensuring that the portfolio remains diversified and resilient to potential economic shocks.

Historically, credit spreads have offered compelling opportunities following rate cuts, but captives must remain vigilant to avoid overextending into riskier credit sectors.

Consider smart beta strategies

In light of the potential concentration risk in traditional cap-weighted indices, captives should consider smart beta strategies as part of their portfolio rebalancing where surplus capital is available. One such strategy is fundamental indexing, where stocks are selected and weighted based on key financial factors such as dividends, cash flow, and book equity value, rather than just market capitalisation.

This approach offers diversification benefits by avoiding overexposure to overvalued mega-cap stocks, which currently make up a significant portion of traditional indices like the S&P 500. By focusing on companies with solid fundamentals, captives can reduce portfolio volatility while capturing upside from underpriced and high-quality companies.

Smart beta strategies can enhance risk-adjusted returns, especially in periods of market correction or when broader equity returns begin to spread across more sectors and market segments.

Managing risk in a rate-cutting environment

While rebalancing for a falling rate environment offers potential for higher returns, it also comes with risks that captives must manage carefully. Investors' reactions to monetary policy changes can increase market volatility, and we cannot rule out the risk of economic downturns or inflation spikes.

To mitigate these risks, captive boards should have their investment managers employ stress testing and scenario analysis to evaluate how different market conditions might affect their portfolios. By anticipating potential outcomes and adjusting asset allocations accordingly, captives can safeguard their portfolios while still pursuing growth opportunities.

A strategic pivot for captives

The Fed's 50 basis point rate cut is likely the beginning of a broader easing cycle, and captive insurers should respond by dynamically rebalancing their portfolios.

By shifting to long-duration bonds, prudently adding credit exposure, and incorporating smart beta strategies, captives can position themselves to capture upside potential while effectively managing risk.

Historical precedent shows that those who adapt quickly to changing interest rate environments stand to benefit, while those who remain static may miss crucial opportunities. In this new phase of the investment cycle, a proactive, dynamic approach to asset allocation will be key to maintaining both financial stability and growth.

For captive boards, the call to action is clear: "Engage with your investment managers, assess your current allocation strategy, and prepare to pivot as the rate-cutting cycle unfolds." ■

Reshaping asset strategies under Solvency II

Diana Bui sits down with industry experts to assess how Solvency II modifications and other regulatory changes affect asset management strategies for captive insurers in Europe

Winston Churchill once remarked: “To improve is to change; to be perfect is to change often.”

This philosophy rings true for Europe’s captive insurance sector, as it stands on the brink of significant regulatory changes. While these reforms stop short of revolutionising the industry, they offer a lighter regulatory touch that could unlock new avenues for captives to optimise their investment strategies.

As the industry prepares for these regulatory updates, set to roll out in 2026, EU-domiciled captive entities can expect “a more streamlined, proportionate, and risk-based prudential process,” according to AM Best in its market segment report on European captives. Under the new regulatory landscape, captive insurers will have the opportunity to reassess and potentially diversify their asset portfolios.

Marine Charbonnier, head of captives and facultative underwriting, APAC and Europe, AXA XL, observes: “Recent modifications to Solvency II, aimed at enhancing the proportionality for captives, could potentially improve their efficiency.

“These changes may lead to reduced reporting requirements and capital charges. However, the long-term impact might require captives to adopt more sophisticated risk management and investment strategies to fully leverage these regulatory relaxations.”

Solvency II modifications

On 22 September 2021, the European Commission proposed a directive to amend the Solvency II framework, the EU’s comprehensive regulatory regime for insurance companies. The proposed changes, which reached a provisional agreement in April 2024, are set to significantly impact captive insurance companies operating within the European market. Although the exact implementation date remains uncertain, it is anticipated that these amendments will come into effect by early 2026.

The revisions, developed in collaboration with the European Insurance and Occupational Pensions Authority (EIOPA), aim to refine the regulatory environment. The focus is on enhancing stability across the market while introducing greater flexibility for insurers, particularly those with specialised risk profiles, such as captives. The changes seek to address challenges that have emerged since Solvency II was first implemented, ensuring the framework can adapt to new risks and evolving market conditions.

In light of these recent modifications to Solvency II, Simon Grima and Pierpaolo Marano, professors from the University of Malta, highlight several fundamental changes and their specific implications for captive insurers.

Among these is the proposed reduction in the cost-of-capital rate used in risk margin calculations, which is expected to ease the capital reserve requirements for captive insurers with long-term liabilities. By lowering this rate from the current 6 per cent to around 4.75 per cent, the amendments aim to free up significant resources, potentially improving solvency ratios for these specialised insurers.

Additionally, the scope of the matching adjustment is set to expand, allowing captive insurers to invest in a broader range of assets, including infrastructure bonds and high-quality corporate debt.

According to Grima and Marano, this expansion is designed to align investments more closely with long-term liabilities while promoting sustainable, green projects.

They add that another key aspect of the reforms is the simplification of regulations for smaller insurers. The new measures are expected to reduce the reporting and capital calculation burdens for captives classified as ‘small and non-complex’, allowing them to focus more on their core business operations.

The volatility adjustment mechanism is also being overhauled to make it more responsive to real-time

image by aapsky/stock.adobe.com

"Captives may shift their portfolios towards these newly favoured assets, reducing their exposure to higher-charge investments to maintain strong solvency ratios and capital efficiency"

Vittorio Pozzo
Director of Europe and
Great Britain captive advisory team
WTW

market conditions. This change will help captive insurers maintain their solvency during periods of market stress without the need for drastic actions, such as selling off assets at unfavourable prices.

Furthermore, the recalibration of capital requirements based on updated risk assessments may lead captives to adjust their investment portfolios, favouring more stable, lower-cost assets over equities.

Finally, Grima and Marano say that the addition of environmental, social, and governance (ESG) factors to the Solvency II framework will make captive insurers more likely to invest in long-lasting assets.

These investments may benefit from lower capital requirements, aligning with broader sustainability goals, and enhancing the reputational standing of captives within larger corporate groups.

Reassessing investment portfolios

Captive insurance companies in Europe often prioritise underwriting over investment strategies, according to Vittorio Pozzo, director of Europe and Great Britain captive advisory team at WTW. “Captives tend to place little emphasis on investment policy and asset allocation relative to the emphasis placed on underwriting,” Pozzo says. He notes that their asset management strategies are usually basic, focusing mainly on cash pooling or short-term investments, driven by the need for flexibility and liquidity. Pozzo explains that structured asset management is often secondary for captives, as their primary role is to challenge the commercial insurance market, retain underwriting profits, and create additional capacity for future claims. “Captives are driven by the liability side of the balance sheet,” he adds.

Under Solvency II, Pozzo highlights the importance of diversifying investments across counterparties and focusing on high-rating assets. “With regards to the cash pooling investment, the arbitrage is typically between capital requirements vis-a-vis liquidity,” he says.

The recent changes to the regulation, especially concerning the 'prudent person' principle, have strengthened the importance of a careful and risk-aligned approach to asset management for captive insurance companies in the European market. According to AXA XL's Charbonnier, this principle requires captive insurers to invest in assets in a way that ensures the portfolio's security, quality, and liquidity, which directly influences their asset management strategies.

"Captives, smaller and more specialised than traditional insurers, may find it challenging to adhere to these strict requirements while maintaining flexibility in their investment strategies. They need to prioritise low-risk, highly liquid assets, limiting their ability to pursue higher-yield investments," she remarks.

Meanwhile, William Gibbons, principal in insurance investment at Mercer, explains that the prudent person principle dictates that insurers should invest in a manner that a prudent person would — meaning investments should be sensible, measured, and aligned with the ability to identify, monitor, manage, and control associated risks.

"Insurers must be comfortable with the risks involved in their investment strategies and manage them appropriately. Regulators and supervisors often use this principle as a benchmark. If there's any concern about an insurer's investment strategy, they may reference the prudent person principle to ensure that the strategy aligns with best practices."

EIOPA has provided specific guidance for captive insurers, covering areas such as cash pooling, security, asset quality, availability, and asset-liability management. Gibbons notes that the purpose of these guidelines is to assist insurers in adhering to the prudent person principle by carefully weighing these aspects in their investment decisions.

Looking at the recent modifications in Solvency II from an investment standpoint, Shadrack Kwasa, executive director at London and Capital, remarks that the

"The group CFO and treasury manager must align the captive asset management strategy with Solvency II by focussing on capital efficiency, ensuring the portfolio is balanced to meet liquidity needs without compromising solvency"

Marine Charbonnier
Head of captives and facultative underwriting
APAC and Europe, AXA XL

> "These trends collectively point towards a more innovative, resilient, and strategically focused European captive insurance market better positioned to thrive under the evolving Solvency II framework"
>
> **Pierpaolo Marano**
> Professor
> University of Malta

most significant benefit for captives is this newfound flexibility." With reduced regulatory burdens, captives can now allocate more time and resources towards refining their investment strategies. This shift allows them to maximise market opportunities, making their capital work more efficiently."

Kwasa explains: "For captives dealing with long-tail businesses, such as life insurance or pension-related products, these changes bring material benefits to asset management. The reforms make assets like infrastructure equity, private equity, and private debt more attractive to captives, who are now better positioned to explore these markets. Additionally, changes in the treatment of assets that match liabilities, especially in terms of volatility, enable captives to manage these assets with reduced risk, thereby reducing their susceptibility to interest rate fluctuations."

To help captive insurers balance the liquidity, security, and profitability in their investment portfolios under Solvency II, Charbonnier recommends a multifaceted strategy. She advises captives to invest in high-quality liquid assets (HQLA) to cover short-term obligations, while strategically allocating a reasonable portion of their portfolios to higher-yield investments that maintain a reasonable level of safety. "Additionally, to improve the solvency ratio, captives might explore reinsurance arrangements that provide capital allocation optimisation."

Managing asset allocation

Kwasa says that the capital charges under Solvency II have significantly impacted the asset allocation strategies of captive insurers. These regulations have compelled captives to reevaluate their investment portfolio management strategies, aiming to optimise them not only for economic returns but also from a regulatory standpoint.

"The challenge lies in balancing investment-efficient and Solvency II-efficient portfolios, which

means captives need to hold the least capital while maximising returns.”

Historically, captives have often opted for simpler asset classes like cash or loans, focussing more on supporting their parent companies’ insurance programmes rather than chasing high investment returns. With the recent changes, there is now a greater opportunity for captives to rethink their investment strategies.

“They can now consider factors such as risk appetite, market conditions, and available capital more carefully when structuring portfolios to make the most of the opportunities available, ultimately achieving greater efficiency in their investment approach,” Kwasa notes.

Grima and Marano reiterate Kwasa’s remarks on capital charges, stating that Solvency II assigns capital charges to asset classes according to their risk profiles. Higher-risk assets like equities and real estate attract higher charges, while lower-risk assets like government bonds and high-quality corporate debt are subject to lower charges. These capital charges have a direct impact on how captives allocate their assets, as they seek to optimise capital efficiency while managing risk.

The professors from the University of Malta explain that the recent recalibration of capital charges includes more favourable treatment for certain asset classes, such as infrastructure bonds, as well as a renewed focus on sustainable investments. This provides captives with new opportunities to enhance returns without significantly increasing their capital requirements. As a result, captives may shift their portfolios towards these newly favoured assets, reducing their exposure to higher-charge investments to maintain strong solvency ratios and capital efficiency.”

In order to minimise capital charges while ensuring profitability, Charbonnier recommends captives to “optimise the allocation towards low-risk investments by exploring less capital-intensive alternative investments.

"Captives may shift their portfolios towards these newly favoured assets, reducing their exposure to higher-charge investments to maintain strong solvency ratios and capital efficiency"

Simon Grima
Professor
University of Malta

"With reduced regulatory burdens, captives can now allocate more time and resources towards refining their investment strategies"

Shadrack Kwasa
Executive director
London and Capital

“The group CFO and/or treasury manager must align the captive asset management strategy with Solvency II by focussing on capital efficiency, ensuring the portfolio is balanced to meet liquidity needs without compromising solvency.”

As the market and the regulatory landscape evolve, so do captives. Pozzo observes a trend among some sizable and well-established captives to try and structure a more sophisticated asset management strategy with their available cash in excess of what they have to commit for insurance and regulatory purposes. “Captives may choose to accept a higher level of investment risk in exchange for higher returns,” he says. However, Pozzo advises carefully evaluating the combined impact of all risk factors when assuming greater-than-normal underwriting risk to prevent stressing the captive’s financial stability.

When it comes to fund administration, Gibbons notes that when selecting investments, it is crucial for captive insurers to consider the adequacy of reporting — particularly through the Tripartite Template (TPT), which ensures compliance with regulatory reporting requirements. He also emphasises the importance of targeting a specific Solvency Capital Requirement (SCR) level, which directly correlates with the risk profile of the investments.

“The insurer must hold more capital due to the higher capital charge associated with riskier investments. By controlling capital requirements, asset managers help provide stability for captives, allowing them to know precisely how much additional capital they need to hold against investment risks. This approach supports better business management and future planning.”

For captives governed by Solvency II, Gibbons warns against investment strategies that incur excessive capital charges. “Simply pursuing high-yield or securitised investments without considering their capital implications can be counterproductive,” he says, highlighting that such strategies can lead to increased capital requirements and ultimately lower profitability.

Instead, he advocates for a balanced approach that aligns investment returns with prudent capital use, ensuring compliance with regulations while maintaining financial stability.

Racing to attract captives in Europe

European jurisdictions are increasingly vying for a share of the captive insurance market and are starting to reap the benefits, according to Best's Review published in August. While Europe hosts a fraction of the world's 6,000 captives, inconsistent reporting across jurisdictions makes tracking growth challenging. However, more captives were licensed in Europe in 2022 than were dissolved.

Guernsey reclaimed the top spot among European captive domiciles, followed by Luxembourg and the Isle of Man, driven by a vigorous market push. Larger European countries like France, Italy, and the UK, which historically overlooked this business, are now seeking ways to attract captives. London, in particular, is exploring a captive insurance framework as part of efforts to enhance the UK's risk transfer environment. Gibbons highlights the competitive landscape among domiciles, noting that some jurisdictions provide distinct regulatory frameworks tailored to the specific needs of captive insurers. "Whether a group is looking to establish a reinsurance captive, a direct writing captive, or an offshore captive, the choice of domicile can be influenced by these unique regulatory offerings," he explains.

To stay competitive in the industry, Gibbons advises: "European captive insurance companies may wish to adjust their strategies in response to recent changes in financial markets, particularly the rise in interest rates. For many years, interest rates remained exceptionally low, from the period following the global financial crisis up until the COVID-19 pandemic. However, with rates now elevated, there are greater opportunities to generate returns from investment strategies. Captive insurers are now re-evaluating their investment strategies, focussing on balancing

"European captive insurance companies may wish to adjust their strategies in response to recent changes in financial markets, particularly the rise in interest rates"

William Gibbons

Principal in insurance investment

Mercer

risk while maximising returns. For instance, rather than keeping funds in low-yield cash accounts, insurers might consider investing in bonds or funds offering higher yields. Failing to adapt could mean missing out on significant income opportunities."

He predicts that the European captive insurance market is poised for growth, driven by regulatory changes that could increase the amount of capital held within captives. "As more assets flow into these structures, there will be a stronger emphasis on investment strategies. Captives will need to refine their approaches to remain competitive, with a focus on generating higher investment returns.

"Strategies may include loaning cash back to the parent company or exploring bond-based investments to maximise income. I think the trend suggests a growing importance of investment strategy within captives as they seek to optimise returns on their increased capital reserves."

Gibbons points out that while Solvency II imposes stringent requirements on captives domiciled within the EU, these captives benefit from the ability to conduct business directly across the EU. "Captives within the EU can write business on a direct basis without the need for fronting relationships or the guarantees typically required by fronting insurers," he says.

Meanwhile, Grima and Marano forecast that the European captive insurance industry would move towards capital efficiency in response to Solvency II and recent regulatory changes. They say that captives would invest more in low-capital charge assets like infrastructure projects and ESG-compliant investments. "This shift will be driven by the adjusted capital requirements and broader eligibility for matching adjustments introduced by the Solvency II modifications."

The professors also highlight a growing emphasis on sustainability as captives integrate ESG factors into their investment and risk management strategies.

Digital transformation is expected to accelerate, with captives adopting advanced technologies for risk management and compliance to enhance efficiency and quickly adapt to regulatory changes. Smaller captives may also seek collaborations to scale up and navigate the complex regulatory environment.

"These trends collectively point towards a more innovative, resilient, and strategically focused European captive insurance market," Grima and Marano add, noting the sector's enhanced position to thrive under the evolving Solvency II framework.

On the other hand, Kwasa believes that European captives can turn the regulatory and reporting burdens imposed by Solvency II into a competitive advantage. "Solvency II mandates that European captives be well capitalised, well managed, and rigorously overseen," Kwasa notes. "This robust framework positions them to better withstand market shocks and underwrite riskier lines, such as cyber risks or climate-related risks. European captives, with their deeper awareness of ESG factors, are well-suited to address these emerging challenges."

He observes a shift in European captives' approach, in which risk and investment strategies are increasingly considered in the early stages of formation.

"The goal is to make the captive as efficient and self-sufficient as possible, supported by a robust investment portfolio. This proactive approach allows European captives to shine relative to their peers, particularly in handling uncertainty and risk," he adds.

As the landscape for European captives evolves, the challenging market is pushing more companies to consider captives as a viable option. For European captives, the key lies in leveraging their strengths, capitalising on their inherent advantages, and solidifying their position in the market. "The captive is returning home, and there's clear momentum in the right direction," Kwasa says. The outlook is promising, but the industry will be watching closely to see how this development unfolds. ■

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Impact of APRA's prudential standards on captive insurers' asset management strategies in Australia

Toby Blyth, partner at Dentons Australia, looks at the regulatory landscape and its potential impact on asset management in the country

The Australian insurance market is heavily regulated, with the Australian Prudential Regulation Authority (APRA) playing a crucial role in overseeing the activities of insurers, including captive insurers.

For captive insurers looking to operate in Australia, understanding the impact of APRA's prudential standards on their asset management strategies is of utmost importance.

This article explores the key regulatory considerations and their influence on the appeal of Australia as a captive domicile.

Captive insurance plays an important role in the risk management strategies of many Australian corporate groups.

However, the regulatory environment in Australia, driven by APRA's comprehensive prudential standards, can present significant challenges for captive insurers looking to establish operations within the country.

By understanding the nuances of the regulatory landscape, captive owners and asset managers can make informed decisions about their risk management approaches and the viability of Australia as a captive domicile.

Regulatory landscape for captive insurers in Australia

The Insurance Act 1973 (IA) establishes the legal framework for general insurance business in Australia. Under the IA, carrying on insurance business in Australia without authorisation from APRA is generally prohibited, with some exceptions.

Whether a foreign insurer, including a captive insurer, is considered to be 'carrying on' business in Australia involves a fact-specific analysis, considering factors such as the insurer's level of activity, physical presence, and the nature of the insurance contracts.

Key factors in determining if a foreign insurer is carrying on business in Australia include:

- *Whether the insurer is incorporated in Australia.*
- *Presence of a representative office in Australia.*
- *Registration for tax purposes in Australia.*
- *Meeting the AKAI criteria (place of residence/business, contracting, performance, and nature/subject matter of the contract).*
- *Repetition of acts and activities with a permanent nature.*

Exemptions from APRA regulation

In certain circumstances, the IA provides exemptions that allow unauthorised foreign insurers (UFIs) to conduct business in Australia without being subject to APRA's full prudential regulatory regime.

These exemptions include:

- *Insurance for high-value insureds with average operating revenue or gross Australian assets of at least AU$200 million (US$131.4 million), or an average of 500 employees.*
- *Insurance for atypical risks.*
- *Insurance certified by an Australian broker as unable to be reasonably placed with an Australian insurer.*
- *Insurance required by foreign laws to be issued by specified insurers.*

Captive insurers and the Australian regulatory environment

Unlike some other jurisdictions, Australia does not have a separate or light-touch set of rules specifically regulating captive insurers and the regulatory environment is not well matched to the less rigorous prudential rules that apply to captives in other locations.

Australian companies operating a captive to insure Australian risks will fall within the Australian jurisdiction, as they are carrying on insurance business in Australia, unless an exemption applies.

To avoid the full APRA regulatory regime, Australian captives often domicile offshore and minimise their contacts with Australia, even if the foreign-issued policy covers Australian risks. They may also rely on the exemptions provided in the Insurance Regulations 2024 to avoid being considered as 'carrying on' insurance business in Australia.

Key APRA investment governance requirements

If a captive insurer is conducting insurance business in Australia and is not exempt from APRA regulation, it must comply with the full range of APRA's prudential standards.

The key standards that specifically affect a captive insurer's asset management strategies are:

- ***GPS 110 Capital Adequacy:*** *This sets minimum capital management requirements for entities, including captive insurers.*
- ***GPS 230 Reinsurance Management:*** *This requires insurers to maintain a specific reinsurance management framework to manage the risks arising from their reinsurance arrangements.*

Discretionary mutual funds as an alternative

Some large Australian corporate groups have chosen to establish discretionary mutual funds (DMFs) instead of captive insurers as a means of managing their risks. DMFs are regulated by the Australian Securities and Investments Commission (ASIC) rather than APRA, and their regulatory burden is significantly lower than that of a captive insurer (if they are not retail facing).

DMFs offer a more flexible and less-regulated alternative to captive insurers, as they allow for shared control among members, the ability to insure difficult or 'unpalatable' risks, and the discretion to pay claims. This makes DMFs an attractive option for Australian companies seeking a risk management solution that is better suited to the local regulatory environment.

Conclusion

The Australian regulatory environment, driven by APRA's comprehensive prudential standards, has a significant impact on the appeal of Australia as a captive domicile. Captive insurers looking to provide insurance in Australia must comply with the full range of APRA's requirements, which can be challenging and may lead them to domicile their captives elsewhere.

However, Australian corporate groups have found alternative risk management solutions, such as discretionary mutual funds, that offer a more favourable regulatory environment.

Understanding the nuances of the Australian insurance landscape is crucial for captive owners and asset managers to navigate the complexities and make informed decisions about their risk management strategies. By exploring the regulatory exemptions, alternative structures, and the practical implications of APRA's prudential standards, captive insurers can determine the most appropriate approach for their needs and effectively manage their assets within the Australian market. ■

"The regulatory environment in Australia can present significant challenges for captive insurers looking to establish operations within the country"

Toby Blyth
Partner
Dentons Australia Limited

SERVICE PROVIDERS

A.M. Best Company, Inc.

Company Address

A.M. Best Rating Services, Inc.
1 Ambest Road / P.O. Box 700
Oldwick, New Jersey 08858-0700
United States

Phone: +1 (908) 439 2200

Company Description

Founded in 1899, AM Best is the world's largest credit rating agency specializing in the insurance industry. Headquartered in the United States, the company does business in over 100 countries with regional offices in London, Amsterdam, Dubai, Hong Kong, Singapore and Mexico City.

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Barbados International Business Association

Company Address

#19 Pine Road, Belleville,
St. Michael, Barbados, West Indies.

Tel: (246) 537-2422
Fax: (246) 537-2423

Company Description

In 2020, we rebranded as “BIBA, the Association for Global Business” to signal that we embrace all companies in Barbados who service global markets, both domestic and international, and to align with Prime Minister Mottley’s expressed goal to cement Barbados as a global business hub.BIBA has a current membership of over 140 companies drawn from Canada, the US, the UK, Latin America, and Europe, primarily in banking and wealth management, insurance, fintech, manufacturing, logistics, legal, accounting, tax, and corporate service providers, and many more.

Ms. Carmel Haynes
Executive Director
BIBA

Email: biba@biba.bb
Tel: (246) 537-2422
Fax: (246) 537-2423

CIBC MELLON

CIBC Mellon

Company Description

CIBC Mellon is a Canadian company exclusively focused on the investment servicing needs of Canadian institutional investors and international institutional investors into Canada.

Founded in 1996, CIBC Mellon is 50-50 jointly owned by The Bank of New York Mellon Corporation (BNY) and Canadian Imperial Bank of Commerce (CIBC).

CIBC Mellon's investment servicing solutions for institutions and corporations are provided in close collaboration with our parent companies, and include custody, multicurrency accounting, fund administration, recordkeeping, pension services, exchange-traded fund services, securities lending services, foreign exchange processing and settlement, and treasury services.

As at September 30, 2024, CIBC Mellon had more than C$2.9 trillion of assets under administration on behalf of banks, pension funds, investment funds, corporations, governments, insurance companies, foreign insurance trusts, foundations and global financial institutions whose clients invest in Canada.

CIBC Mellon is part of the BNY network, which as at September 30, 2024 had US$52.1 trillion in assets under custody and/or administration. CIBC Mellon is a licensed user of the CIBC trade-mark and certain BNY trade-marks, and is the corporate brand of CIBC Mellon Trust Company.

www.cibcmellon.com

Shane Kuros
+1 905 755 7121
shane.kuros@cibcmellon.com

Richard Anton
+1 416-643-5240
richard.anton@cibcmellon.com

Cook Islands Financial Services Development Authority

Company Address

P.O. Box 3255,
Clarkes Building,
Parekura,
Rarotonga, Cook Islands
Cook Islands
(682) 21-175

enquiry@fsda.gov.ck

Company Description

The Cook Islands is a recognized jurisdiction for the establishment of international trusts. The emphasis in the past has been on protecting trust assets from frivolous and sometimes vexatious claims by third parties against settlors.

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In 2013 the Cook Islands passed the Captive Insurance Act 2013 (the "Act") and placed itself at the forefront in the Asia Pacific region of an industry that is continually growing and seeking strong well respected jurisdictions from which to establish and administer captive insurance structures.

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Well known for its trust legislation, the Cook Islands also offers corporate entity formation through International Companies, Limited Liability Companies, Foundations, and International Partnerships. Legislation also allows for various insurance services including Captive Insurance, and the jurisdiction maintains access to premium banking services through relationships with international banks. Trust companies also provide a wide array of administrative services to allow centralized and efficient operation of client structures. The jurisdiction also has a strong Maritime Registry with representatives in countries all over the world, including China. As the client composition of the jurisdiction continues to diversify, the integration of multinational wealth and corporate services in an international best practices framework strengthens the quality of industry work.

Located in the heart of the Pacific, the Cook Islands provides a full range of corporate, trust, and financial planning services in a globally advantageous business environment. Whether you represent large corporations, closely held businesses, family offices, or individuals, you will find everything you need in the Cook Islands.

www.cookislandsfinance.com

Jersey Finance

Company Address

Jersey Finance Limited
4th Floor, Sir Walter Raleigh House,
48-50 Esplanade, St Helier,
Jersey JE2 3QB, UK

Tel: (246) 537-2422
Fax: (246) 537-2423

Company Description

Jersey has been a leading international finance centre for more than 60 years. In particular, Jersey has developed a well-respected and forward-thinking funds sector that offers regimes from retail options through to the more sophisticated and institutional end of the market.

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PNC Institutional Asset Management

Company Address

4720 Piedmont Row Dr., 3rd floor
Charlotte, NC 28210
www.pnc.com

Office: 704-571-0708
Cell: 443-827-2109

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Wade Meadows
Head of Insurance and Specialized Industries Group
Managing Director, PNC Institutional Asset Management
wade.meadows@pnc.com

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Note: All figures as of September2024

Gregory H. Cobb
Director of Insurance Solutions
gcobb@sageadvisory.com
www.sageadvisory.com

SS&C Singularity

Company Description

SS&C is a global provider of industry-leading software and services for insurance, reinsurance and captive firms. Founded in 1986, SS&C is headquartered in Windsor, Connecticut, and has offices around the world. SS&C delivers innovative technology-driven solutions that enable organizations to streamline operations, manage risk, and drive efficiency. With a presence in over 40 countries and serving more than 20,000 clients worldwide, SS&C has become a trusted partner for insurers seeking advanced financial and business process outsourcing services.

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Jereme Ramsay
jereme.ramsay@sscinc.com

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Yousif Capital Management

Company Address

39533 Woodward Ave,
Suite 100,
Bloomfield Hills,
MI 48304
United States

Phone: +1 248-940-5505

Company Description

Yousif Capital Management, a leading institutional investment advisor, specializes in providing customized investment solutions for captive insurance programs.

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Dale McCann
dmccann@yousifcapital.com,
248-940-5505 office,
269-352-7631 mobile

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as at June 2024

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as at June 2024

700

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as at June 2024

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