SOLVENCY II: RISKS AND OPPORTUNITIES

EUROPEAN CAPTIVE 2016 SERVICES AWARDS WINNER INVESTMENT MANAGER

Franck Launay, head of reinsurance solutions at BNP Paribas, speaks to *Captive Review* about how best to maximise investment opportunities in a changing world

Captive Review (CR): What is the current state of play in the captive investment space?

Franck Launay (FL): It is natural for captives to see their primary source of profit coming from their underwriting business - returns from investment are often considered secondary in the overall management of the captive. This was completely understandable when market yields were delivering 3% to 5% per annum, at which time it was natural to implement more cautious investment policies and expect reasonable returns. Today, with lower yields, we believe captives may be missing an investment opportunity by employing that same investment strategy.

The implementation of Solvency II has also raised some concerns among captives, who need to adapt to this new regulation and risk assessment of their investment policy, for instance in terms of risk concentration.

We believe the Solvency II framework contains potential opportunities for captives. In particular, as the insurance regulator provides a detailed way of measuring risk, which will result in captive owners being more able to assess the risk of an investment in terms of capital. We see this as a positive trend which can be fully accredited to the hard work of the regulator.

At BNP Paribas, we help captives assess the risk/return profiles for their investment portfolios using this framework, then provide investment opportunities which aim to deliver capital protection in line with their requirements. Most proposed investments can be combined with a liquidity feature which allows captives to respond to any unexpected claims.

Franck Launay

As head of reinsurance solutions at BNP Paribas, **Franck Launay**'s team focus on the captive and reinsurance sector, providing solutions on risk management, capital efficiency, and investment strategies. In 2006, Franck joined BNP Paribas as head of structured product sales in Asia, followed by heading the Strategic Solutions Group, assisting clients in their product design and distribution as well as in their portfolio and capital management.

CR: What would be the main concerns of captive owners when investing their own funds?

FL: There are two constraints that hinder the progress of captive owners.

Firstly, many remain traditional in their approach and are reluctant to take capital risk.

Secondly, captives, as a dedicated insurance company for their own group, need to retain as much liquidity as possible to protect against the event of a claim rising from the group. For example, in a scenario where they are investing over the longer term, all of their liquidity may be tied up for years at a time and they might find difficulty in paying a claim, should one arise during that period. This could result in the selling of investments, and, should these be sold at a loss, could lead to a double hit - first on the investment and secondly on the claim.

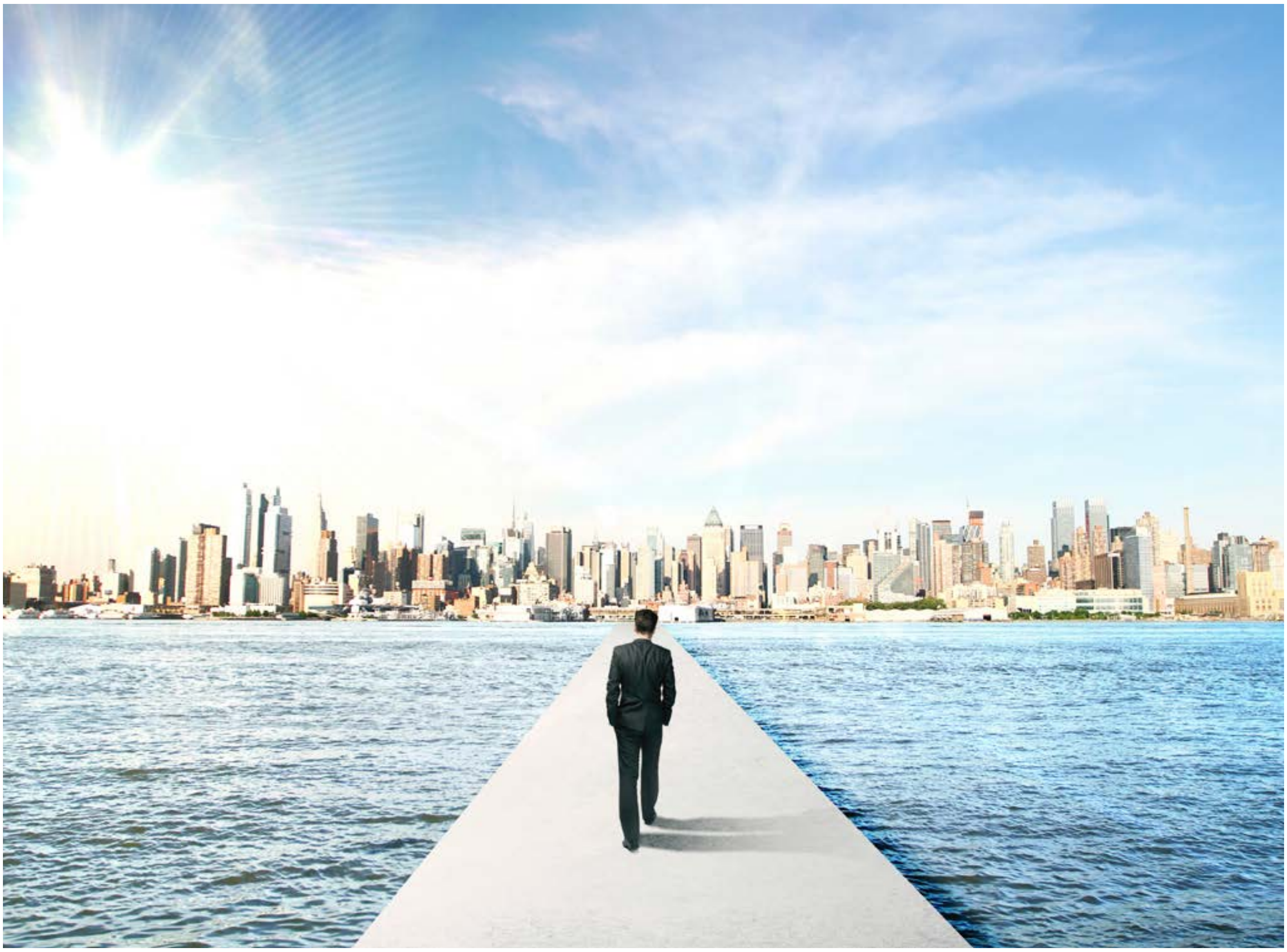
At BNP Paribas, we think that two principles should be at the heart of captive insurance investment policy: capital protection, which aims to avoid investment loss, and liquidity, which allows the captive to respond to unexpected claims.

CR: How could a captive achieve both capital protection and liquidity? Are money market funds the only option?

FL: You're right, in the past, captives investing in money market funds were able to generate a decent return, while taking minimum risk. In addition, the money market funds were liquid and could be sold on a daily basis. This way captives were able to achieve both yield and liquidity.

Unfortunately, due to today's low or negative interest rates, this is becoming more challenging to achieve. As a result, today's short-term placements in Euro are becoming increasingly less desirable. If captives place all their investments in Euro money market deposits, they will actually yield negative rates which will prevent them achieving capital protection. This, in effect, denies that first principle of capital protection. In only focusing on the second principle, liquidity, captives may have to accept a loss of around 40 basis points per annum in Euro.

At BNP Paribas, we have developed solutions that tackle liquidity and capital protection issues and enable captives to uphold both principles. In a nutshell, captives can purchase a certificate on which BNP Par-



ibas commits to providing the captive with liquidity. The investment duration is extended to approximately five years, or more, in order to help ensure capital protection.

During the life of the investment, should a claim arise, BNP Paribas lends to the captive against the investment, which can provide access to liquidity. This solution is adapted to the very unique constraints that captives face.

CR: Having overcome the issue of liquidity, how can captive owners maximise the benefits of investing?

FL: Our initial step is to gauge what level of Solvency Capital Requirement (SCR) the captive has. A captive with lots of spare capital, say an SCR over 250%, could consider a more risky investment which will have a better potential return, and reduce its SCR accordingly. On the other hand, a captive with an SCR of 110% might wish to invest in more cautious investments, placing a higher value on capital protection, in order to preserve its SCR.

"Investment returns are a source of potential profits that cannot be ignored in an ever more competitive environment"

At BNP Paribas, we help our captive clients to find the right balance between a target capital requirement and an expected potential investment return. Based on this, we can come up with a tailor-made strategy that will fit the captive's specific situation.

Once the characteristics are chosen, we provide the captive with an in-depth analysis of the potential investment return across a number of historical and future scenarios. In doing this, we believe that one should not simply stick to an expected average return, in fact it's important to understand what the return would be in some of the worst-case scenarios. Our extensive analyses are designed to help captive owners to fully assess their investment risk and return profile.

CR: With these options available to captives, how do you see the future of their investment policy?

FL: We are quite optimistic on the development of captive portfolio management. First, Solvency II has now given a very clear framework for investments. At the same time, low or negative interest rates are necessitating captives to explore new ideas in managing their money.

At BNP Paribas, we believe that investment returns are a potential source of profit that cannot be ignored in an ever more competitive environment. The opportunity exists for captives to manage their investment strategy under the Solvency II risk framework, without compromising on liquidity or capital protection.