

## **Part IV**

### ***Policy papers***

IV.1 Policy paper Corporate Governance for Captive Insurance Companies

IV.2 Investment Policy for Captive Insurance Companies

## **IV.1 Policy Paper Corporate Governance for Captive Insurance Companies**

### **1. Introduction**

This guidance applies to all licensed captive insurance companies operating in or from Aruba.

Corporate Governance is concerned with promoting corporate fairness, accountability and transparency. It is embodied through systems of direction and control that are implemented through rules and procedures so that decisions on corporate affairs can be made.

Captive insurance companies are not immune from mismanagement, nor the associated reputational and financial risks. Indeed it could be argued that the risk of corporate governance failure is higher in a captive, due to the fact that the only investor may be the parent and accounts are frequently not scrutinised by independent rating agencies.

Ultimately however, it should be the decision of the Supervisory Board (Board) to determine which corporate governance provisions should apply. Consideration should be given to the size, nature and complexity of business written by the captive, and the potential for that business to generate a reputational risk for the offshore jurisdiction.

Whilst corporate governance failures for captives cannot be totally eliminated, effective procedures can minimize specific risks.

Additionally, a captive insurer with good corporate governance may benefit when being reviewed by ratings agency.

Corporate governance is the subject of one of the International Association of Insurance Supervisors (IAIS) Core Principles.

### **2. The Supervisory Board**

Effective corporate governance flows from the Board to the captive insurance company.

#### **2.1 Function**

The function of the Board should be clearly prescribed. The Board's objectives should be stated and private transactions, self dealing, preferential treatment of favoured entities, covering of trading losses and other inordinate practices of a non-arms length basis, not entered into, without prior approval of the Board.

Management should be aware that they take instructions from the Board, and not from individual Board-members (unless the Board has ratified that instruction).

## **2.2 Composition**

The Board should ensure it has sufficient expertise to understand the issues involved in operating and controlling the captive. Furthermore, it should ensure those responsible for the daily running of the captive have the necessary skills, qualifications and competence.

The Board should include at least one person who is independent of both the captive's parent and the insurance manager.

The composition of the Board should be considered at least every three years, and the Statutes should clearly set out procedures for the appointment, removal and retirement of directors.

## **2.3 Duties of the Board**

### **2.3.1 Risk identification**

The Board should be responsible for the identification of all operational risks. Such risks would include (but not be limited to) underwriting, credit, market, liquidity, legal, business, regulatory, crime, systems and operations, information and communications technology, disaster and reputational risks. Procedures should be in place to monitor, control and report on these risks.

Any new risks should be promptly brought to the Board's attention as and when they are identified, and procedures developed to accommodate them.

### **2.3.2 Internal controls**

The Board should establish internal procedures for

- Controlling operational risks.
- Monitoring capital/solvency requirements.
- Monitoring compliance issues. In the case of a captive administered by an insurance manager, the Compliance Officer's role could be fulfilled by the corporate appointment of the insurance manager.
- Dealing with the public, if appropriate.
- Dividing responsibility between the captive's management and third party service providers.
- Custody arrangements, including bank mandates.
- Internal audit procedures and the formation of an audit committee.

Such controls should be documented in a procedures manual, which should be checked for accuracy and breadth by insurance supervisors.

The Board should also maintain documents relating to cases where the captive's corporate governance principles have failed.

### **2.3.3 Investment strategy**

The Board should develop, implement and minute an investment strategy. Such a strategy should be carefully monitored and controlled.

The investment strategy should have due regard to the issues of mismatch between assets and liabilities. Consideration should be given to the size, nature and complexity of the insurer's business. Scenario/resilience testing should be considered, to model a variety of market scenarios and changing investment and operating conditions on the captives performance.

### **2.3.4 Supervisory functions**

The Board should ensure that the duties, responsibilities, authorities and remuneration of the licensed insurance manager (if employed) are clearly defined in the management agreement, which should be reviewed at least every three years. In addition, the Board should satisfy itself that any remuneration paid to the insurance manager reflects the work required to operate the captive insurance company.

For managed captives, the corporate governance procedures of the manager are clearly important, and the regulator should review these as part of its onsite visits.

### **2.3.5 Annual review**

The Board should review its corporate governance procedures on an annual basis.

Consideration should be given to the formation of an audit committee, reporting to the independent directors of the Board.

## **3. Complaints procedures**

Where a captive is issuing policies to third parties, a complaints procedure must be in operation. Such a procedure, at the very least must advise of the complaints hierarchy existing in the captives' jurisdiction. Complaints should in the first instance be addressed by the insurance manager (or management if the captive is self managed) and ultimately progressed to the regulator and/or ombudsman. The customer should be advised of their options at all times, and provided with the relevant contact information to progress their complaint.

The captive should maintain a record of all complaints.

## **4. The role of the supervisor**

The Bank must approve the individual members and composition of the Board of a captive insurance company. This approval is dependent on the provision of sufficient information, as to allow the Bank to confirm the fitness and propriety of the proposed directors of the Board.

Any changes to the Board composition should require the Banks' prior approval.

Should information become available to the Bank which alters the Bank perception of the board, then the Bank should have the ability to alter the composition of the Board, and exercise this when necessary.

The Bank will review the corporate governance procedures of captives licensed in Aruba and ensure they are satisfied with the corporate governance procedures in place. The Bank should be comfortable with this arrangement, and that the corporate governance standards of the parent are of an equivalent or higher standard than that of the local jurisdiction.

## **IV.2 Investment Policy for Captive Insurance Companies**

### **1. Introduction**

This guidance note serves to promote sound and prudent investment management practices for a Captive Insurance Company (Captive) and assist the captive in developing investment strategies suitable to the size and complexity of their operations that will demonstrate that it is managing its investment portfolio in an appropriate manner.

A key element of any insurance business is its investment portfolio. An investment portfolio carries with it a range of investment-related risks that might affect the financial strength of a captive and, consequently, require sound management. In order that captive's can demonstrate that they manage their investment business in a sound and prudent manner they should ensure that they have a written investment strategy and procedures in place that enable them to identify, measure, report and control the main investment-related risks that they face.

Investment management processes and procedures must take into consideration the nature of the captive's liabilities, the size and the complexity of the captive's asset portfolio, ability of the captive to absorb potential losses and the overall strategic business objectives of the company. At a minimum captives should conduct a detailed analysis of the management of their assets and liabilities and ensure that safe custodial arrangements exist, that assets appropriately match liabilities and that their asset portfolios are adequately diversified and liquid to enable them to meet their and other obligations as they fall due.

### **2. Board of Directors**

The Supervisory Board ("Board") is responsible for formulating the investment policy of the captive and ensuring that it is implemented. They should, along with key management staff, possess sufficient expertise to understand the important issues related to investment management.

In formulating the investment policy the Board should analyze:

the asset/liability relationship. That is verifying that the captive will have sufficient liquid assets to meet liabilities as they fall due;

the captive's overall risk tolerant and its long-term risk and return requirement; and

the captive's solvency position.

The Board must also ensure that adequate reporting and internal control systems for the captive are in place to provide evidence that assets are being managed in accordance with the investment policy and legal and regulatory requirements.

The Board should review the adequacy of the overall investment policy at least annually to ensure that it meets the needs of the company's activities, risk tolerance, expected long-term return and solvency position.

### **3. Management and/or Insurance Manager**

The formulation of the operational policies and procedures for implementing and reviewing the investment policy is the responsibility of management. This activity might be undertaken by its Aruba resident insurance manager. In any event the insurance Manager of the captive should be well versed in and understand the captive's investment strategy and how its investments are managed. This should include ensuring that the original business plan of the captive when it applies for an insurance license includes appropriate reference to the company's proposed investment policy and that the policy is in compliance with regulatory requirements.

Management/insurance manager should ensure that all individuals conducting, monitoring and controlling investment activities are suitably qualified and have appropriate levels of knowledge and experience.

At least annually, management/insurance manager should review the adequacy of its written operational procedures and allocated resources in the light of the captive's activities and market conditions.

### **4. Investment Policy**

All captives should have a written investment policy in place which has been approved by the Board. The complexity of such a policy will depend upon the nature of the business undertaken. The policy should be flexible and adjustable to changes in internal and external market conditions and other risk factors. It should contain contingency plans to mitigate the effects of deteriorating conditions.

This guidance note highlights the areas that an investment policy should address, at a minimum:

-Risk Profile – The risk profile of the captive should set out the risks faced by the captive as well as the extent to which the captive is willing to assume various types of risk. Typically risks would fall under the headings insurance underwriting, investment, liquidity and credit risks. Scenario analysis can be used to test the investment portfolio's ability to withstand varying risk levels. The risk profile of the captive should also indicate how these risks will be mitigated. For example risks are reduced through the diversification of the investment portfolio and investing in different asset categories, markets, sectors and geographical areas.

-Allocation of Assets (asset mix) – The captive should identify how it intends to allocate its resources over broad investment categories such as equities, bonds, cash and property. The captive should also indicate what individual assets will make up each assets category and the percentages.

-Selection Criteria – The captive should indicate what criteria are to be used in the selection of broad investment categories and the individual securities or assets that form the investment portfolio. The investment policy should indicate the minimum acceptable credit or investment rating for securities investments or captives of securities and provide for the use of financial derivatives. The captives should also maintain a list of investment activities or investment practitioners that are authorized or not permitted to engage in or which indicates assets that are allowable for the purposes of the captive meeting its minimum margin of solvency.

-Concentration Limits – The captive should have clearly defined and documented securities portfolio concentration limits. This will ensure that the nature and level of an captive's exposure to various risks such as credit risk, interest rate risk, currency risk and price risk are monitored when making investment and credit decisions. All limits need to be established in the context of the captive's aggregate investment and credit exposure and not in isolation.

-Portfolio Performance Criteria – Risk and return are generally directly related. Consequently, the captive should have an idea of the level of return acceptable based on the risk level of the investment portfolio. The captive should also have an indication of the time frame over which the acceptable rate of return is expected to be received, along with the expected volatility of that rate.

-Selection of Investment Personnel – The investment policy should identify the criteria used for the selection of internal and external investment managers. This should include security dealers and other related counterparties. These key personnel must have the appropriate level of skills, experience and integrity to perform their duties adequately.

-Asset/Liability Management Strategy – The investment policy of captive should anticipate the captive's short-term and long-term cash needs and address how these needs will be provided. The captive's investment portfolio should be constituted in such a way as to reflect the cash needs of the captive and any anticipated changes in them. Investment activities should take into consideration the asset/liability position of the captive since it is important to ensure that liabilities can be settled as they fall due.

-Liquidity of Investment – The investment policy should make provisions so that assets are not liquidated unexpectedly and potentially at unfavourable prices and that the portfolio does not contain amounts of cash or low yielding liquid assets.

-Related Party Transactions – The investment policy should set out the criteria for assessing the extent and significance of related or connected party transactions.



-Accountability Requirements – The investment policy should contain a framework of accountability for all asset transactions. Each captive needs to implement accounting policies and information systems to monitor the transactions that take place in its investment portfolio.

-Valuation Policies – The investment policy should indicate the methodologies used in the valuation of assets and calculation of liabilities.

Solvency Requirements – In developing the investment policy the Board must take into consideration the solvency margin (the amount by which the total value of a captive's allowable must exceed the total amount of liabilities) requirements of the captive. Captives are required to meet a minimum level of solvency whether they are conducting general or long-term business.

#### **4. Internal Control and Internal Audit Procedures**

The investment activities of the captive must be governed by sound internal control and internal audit procedures. An internal control system in this context should ensure that investment activities are conducted in accordance with the approved policies and procedures of the captive and the applicable legislation and regulation. Internal audit procedures should be objective, transparent and clearly defined and the internal audit process should be conducted independently of those managing the assets.

Internal control systems should at a minimum include:

- procedures to ensure that investment transactions are properly documented and authorized and that the formal documentation is completed promptly and accurately;
- systems to measure, record and monitor security positions and market conditions;
- procedures to ensure that guidelines outline in the investment policy are adhered to such as;
- ensuring that restrictions on certain assets are observed;
- ensuring that the captive's diversification policy is observed;
- ensuring that any asset transaction limits are not exceeded;
- procedures to ensure that any breaches or inaccuracies in investment activity are reported on a timely basis and remedial action is taken;
- procedures to ensure that there are timely reports on investment activity; and
- procedures to ensure reconciliation of security positions and that these positions are promptly settled and reported.

Internal audits are important because they provide an objective assessment of investment performance and the integrity of the management of the investment activity. The internal audit process is also vital in the detection of problems or potential problems. The internal audit should test to determine whether certain policies are in place to ensure that:

-the captive's asset portfolio and written investment management policies and procedures are in compliance with the regulatory obligations, including Aruban laws and regulations;

## **POLICY PAPERS**

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- investment transaction are duly authorized and accurately and completely recorded;
- recorded securities exist and are valued based on the relevant laws and regulations; and
- internal control weaknesses and operating and accounting system deficiencies are identified and reported.