

Fiduciary Best Practices for Captive Insurers

Oklahoma Captive Conference

The Calusa Group

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Fiduciary Perception



This "fiduciary" thing really complicates pillaging a corporation.

Fiduciary Reality

A Historical Perspective

Origin: *Latin* fīdūciārius: of something held in trust

Law #265: "If a herdsman, to whose care cattle or sheep have been entrusted, be guilty of fraud and make false returns of the natural increase, or sell them for money, then shall he be convicted and pay the owner ten times the loss."

Babylon and the Code of Hammurabi (1790 BC)

"In acting on behalf of others, have I always been loyal to their interests?"

Confucius (551-479 BC)

"No man can serve two masters"

Matthew 6:24

Someone who is managing the assets of another person or a company and stands in a position of trust, confidence, or legal responsibility.

Why: **Fiduciary Best Practices?**

- *Enterprise Risk Management*
- *Fulfillment of Responsibilities*
- *Increased Efficiency and Effectiveness*
- *Reputation*

Transition from liability to opportunity

What: **Fiduciary Best Practices?**

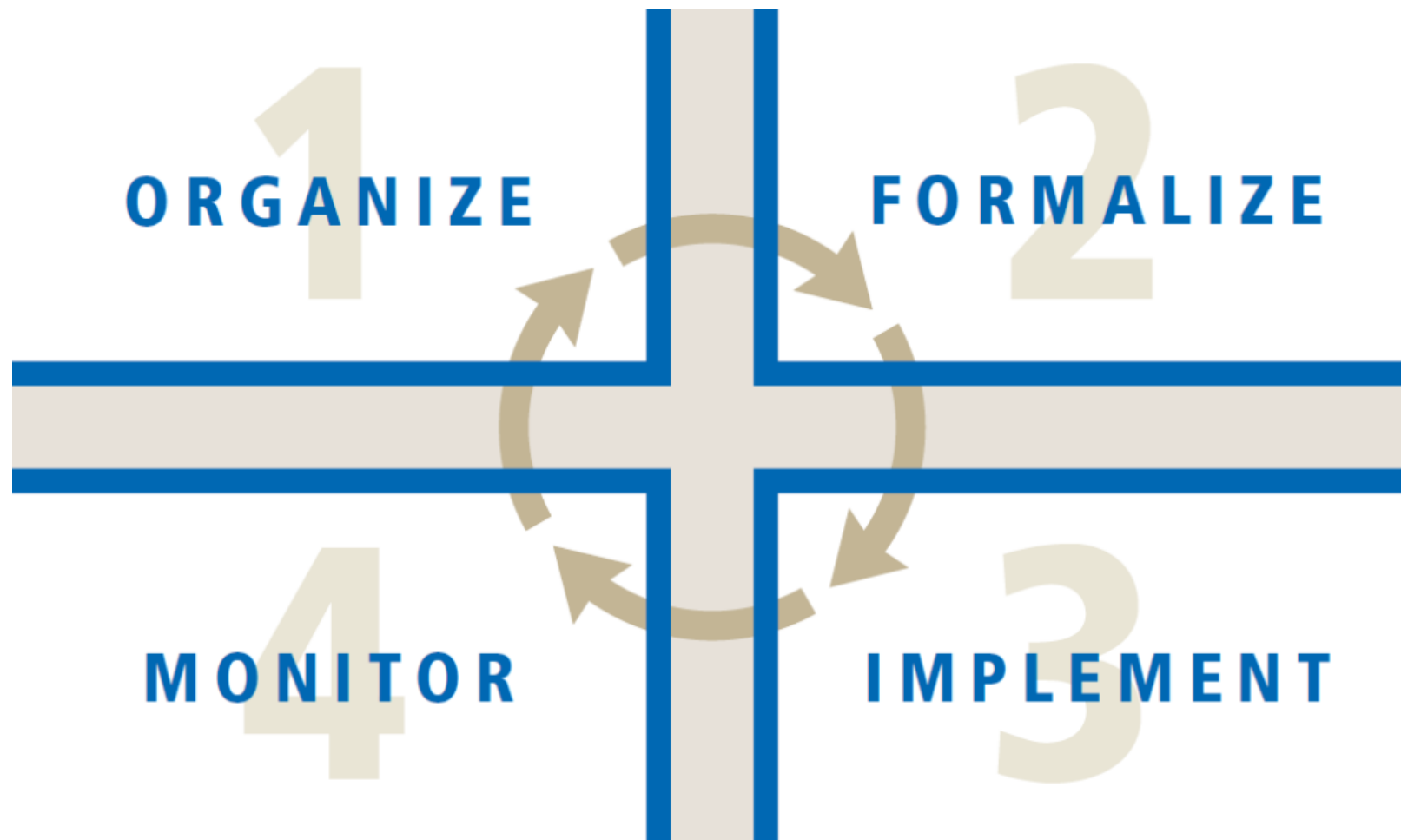
- *Definable*
- *Defendable*
- *Documented*

The Standard Bearers

- *Center for Fiduciary Studies*
 - *Fi360*
 - *Accredited Investment Fiduciary*
- *CEFEX*
 - *Independent global certification*

Fiduciary Best Practices

A Disciplined Approach for Insurers



Fiduciary Best Practices

Step 1: Organize

- **Practice S-1.1** Investments are managed in accordance with applicable laws, trust documents, and written investment policy statements (IPS).
- **Practice S-1.2** The roles and responsibilities of all involved parties (fiduciaries and non-fiduciaries) are defined, documented, and acknowledged.
- **Practice S-1.3** Fiduciaries and parties in interest are not involved in self-dealing.
- **Practice S-1.4** Service agreements and contracts are in writing, and do not contain provisions that conflict with fiduciary standards of care.
- **Practice S-1.5** Assets are within the jurisdiction of appropriate courts, and are protected from theft and embezzlement.

Implementing Step 1: Organize

- **Assess current situation, goals, objectives, and restrictions**
- **Review relevant statutes, laws, and regulations**
- **Determine operational funding (day to day needs, reinsurance premiums etc.)**
- **Determine liability funding (claim payments)**
- **Gather documents, including statements, and agreements**

Fiduciary Best Practices

Step 2: Formalize

- Practice S-2.1 An investment time horizon has been identified.
- Practice S-2.2 A risk level has been identified.
- Practice S-2.3 An expected, modeled return to meet investment objectives has been identified.
- Practice S-2.4 Selected asset classes are consistent with the identified risk, return, and time horizon.
- Practice S-2.5 Selected asset classes are consistent with implementation and monitoring constraints.
- Practice S-2.6 There is an IPS which contains the detail to define, implement, and manage a specific investment strategy.
- Practice S-2.7 The IPS defines appropriately structured, socially responsible investment (SRI) strategies (where applicable).

Implementing Step 2: Formalize

- Target time horizon for cash flow needs
- Document risk tolerance and investment restrictions
- Model asset allocation scenarios
- Select indices and benchmarks
- Construct investment decision process
- Define roles and responsibilities of investment committee, custodian, investment managers, and consultants
- Draft investment policy statement (IPS)

Fiduciary Best Practices

Step 3: Implement

- **Practice S-3.1** The investment strategy is implemented in compliance with the required level of prudence.
- **Practice S-3.2** Applicable safe harbor provisions are followed (when elected).
- **Practice S-3.3** Investment vehicles are appropriate for the portfolio size.
- **Practice S-3.4** A due diligence process is followed in selecting service providers, including the custodian.

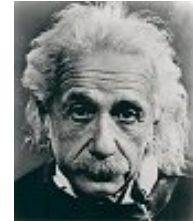
Completing Step 3: Implement

- **Implement investment manager hiring protocol**
- **Screen potential candidates using qualitative criteria**
- **Screen potential candidates using quantitative criteria**
- **Retain best candidates**

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"Not everything that can be counted counts, and not everything that counts can be counted."

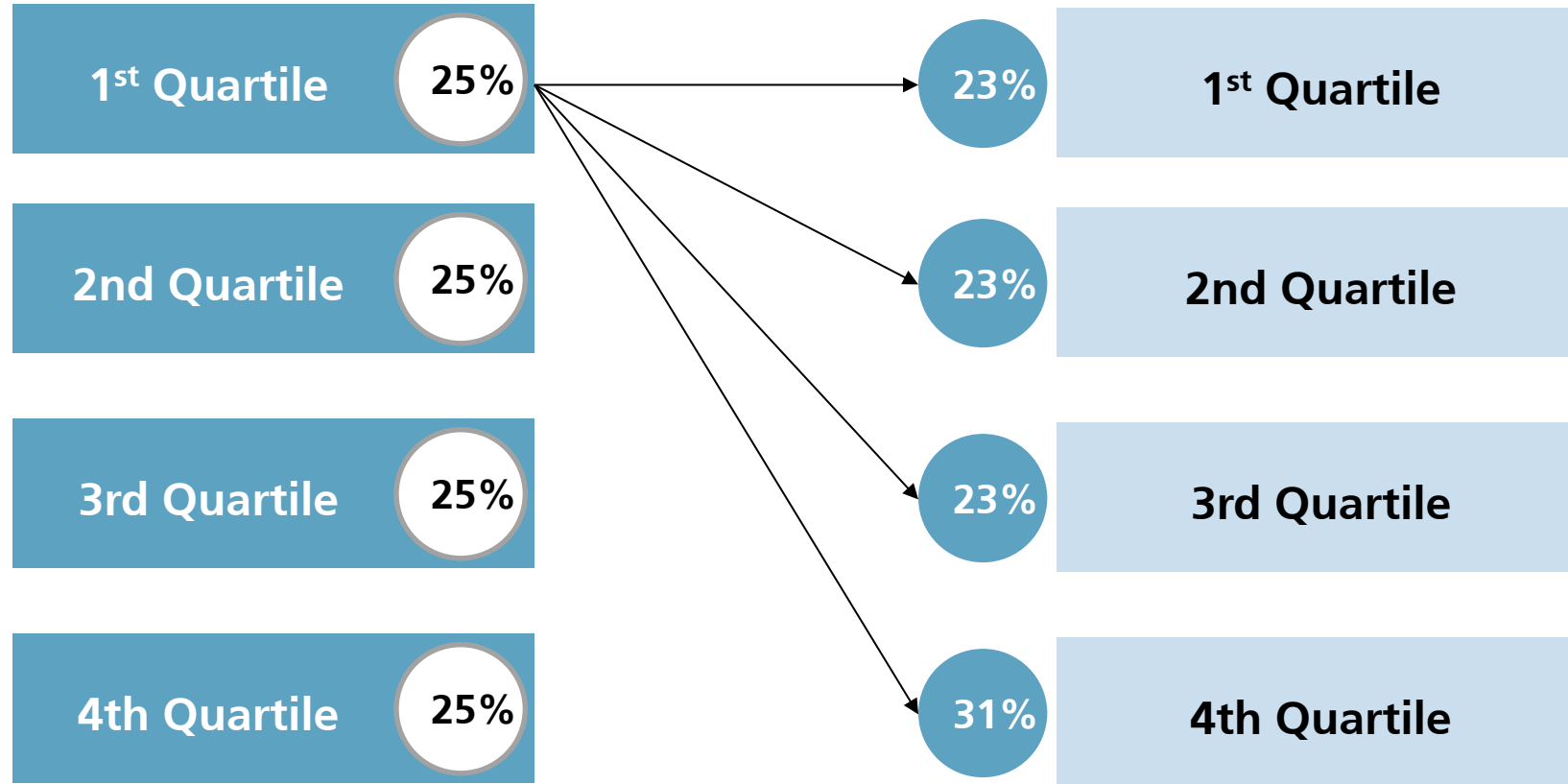
-- Albert Einstein



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Past Performance is a Poor Predictor of Future Success

If Past Performance Were Your Only Determinant



Source: PSN Enterprise, 2009

The chart illustrates findings from a study of the Large Cap Value Universe of domestic managers with a performance record of at least 10 years. The left column shows five-year quartile return rankings ending March 2004. The right shows how the top-performing managers ranked against their peer group over the following five years (ending March 2009).

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Qualitative Investment Criteria

Factors Considered

- Structure/Ownership
- Age
- AUM/Growth
- Account Minimums
- Regulatory Issues
- Registration

Staff

- Number of Professionals
- Tenure/Turnover
- Credentials/Experience
- Compensation Structure
- Support Staff

Philosophy & Strategy

- Asset Classes/ Products
- Stated Strategy/Styles
- Resources
- Changes
- Intangibles

Process

- Research
- Implementation
- Responsibilities
- Consistency
- Risk management

Administration

- Trading
- Service
- Back-office

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Quantitative Investment Criteria

Performance

- Rolling Time Periods: 1, 3, 5, & 10 years
- Absolute and Relative
- Vs. Primary Style Index, Market Index
- Vs. Russell Universe/Peers
- Risk-adjusted/After-Tax Results
- Actual vs. Stated Results

Portfolio Statistics

- Portfolio Construction
- Number of Holdings, Turnover
- Security, Sector Weightings
- P/E's, Yields, P/B, Capitalization, Maturity, Issuer, Quality

Risk Measurement

- Account Return Dispersion
- Standard Deviation
- Sharpe, Information and Capture Ratios
- R², Alpha, Beta
- Tracking Error

Return-Based Attribution

- "Backwards Looking" Method of Estimating a Manager's Style Using the Manager's Performance History
- Style Verification, Style Change Monitoring
- Return Regression Analysis for Best-Fit Asset Class and Style Indices

Security Level Attribution

- Systematic Method of Confirming Style and Process Success
- Examination of Actual Portfolio Holdings
- Style Verification, Implementation Ability
- Security selection, sector selection, portfolio construction

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Step 4: Monitor

- **Practice S-4.1** Periodic reports compare investment performance against appropriate index, peer group, and IPS objectives.
- **Practice S-4.2** Periodic reviews are made of qualitative and/or organizational changes of investment decision-makers.
- **Practice S-4.3** Control procedures are in place to periodically review policies for best execution, “soft dollars,” and proxy voting.
- **Practice S-4.4** Fees for investment management are consistent with agreements and with all applicable laws.
- **Practice S-4.5** “Finder’s fees” or other forms of compensation that may have been paid for asset placement are appropriately applied, utilized, and documented.
- **Practice S-4.6** There is a process to periodically review the organization’s effectiveness in meeting its fiduciary responsibilities.

Implementing Step 4: Monitor

- Quarterly reports to the investment committee
- Compare portfolio against IPS constraints, goals, and benchmarks
- Monitor risk levels and asset allocation against IPS
- Ongoing due diligence of investment managers
- Utilize Manager Watchlist
- Terminate and replace underperforming/compromised managers
- Conduct full program reviews every three to five years

Call to Action

- ✓ *Review current process*
- ✓ *Identify weakness*
- ✓ *Develop a strategy to address those weakness*
- ✓ *Revitalize your investment plan*

Fiduciary **Not-so-Best Practices**

Lack of Process and Oversight

- ❑ 8,593 trades in 18 month period
- ❑ 23 per trading day
- ❑ 5,700 annualized
- ❑ 50% in gold/mining stocks
- ❑ 1200% portfolio turnover
- ❑ \$2,300,000 in commissions
- ❑ Subpar investment performance

Unintended Consequences

- ❑ Fined \$1,260,000
- ❑ CEO resigned
- ❑ Stock price dropped 10%
- ❑ Lost \$23,500,000 in market cap.

The screenshot shows the Insurance Journal website. The main article is titled "Florida Fines Universal P&C Co. \$1.26M" dated October 9, 2013. The article text reads: "Florida's second largest property insurer is paying a fine of \$1.26 million. Florida Insurance Commissioner Kevin McCarty announced Monday that Universal Property & Casualty Insurance Co. has agreed to pay the fine and change its business practices. Universal has roughly 542,000 policyholders statewide and collects more than \$765 million a year in premiums. Only Citizens Property Insurance Corp. has more customers. State regulators earlier this year determined that Universal had unnecessary delays in paying claims. The company was also unable to prove that it mailed out cancellation notices or notices of non-renewal in a timely manner. Universal initially challenged the proposed fine, but company officials signed a consent order with regulators last Friday. That order requires the company to review nearly 300 claims it had previously denied."

The sidebar advertisement for ACE at RIMS includes the text: "JOIN ACE AT RIMS. EXPERT SPEAKER SESSIONS, PRODUCT DEMOS, THOUGHT LEADERSHIP AND MORE. Learn More ▶ @ACE_GroupNA during #RIMS2014". It also features the RIMS 14 logo (Denver | April 27-30) and the ACE insured logo.

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