Understanding Enterprise Risk in Holding Company Structures

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Enterprise Risk Management: Considerations of Holding Company Structure, Group Capital, and Liquidity as it relates to Capital Adequacy Assessment

While assessing a P&C insurance company's capital adequacy, have you ever struggled with or confused with understanding affiliate relationships, holding company , and intercompany structures? You're asking questions like

- Who cedes to who?
- Who owns what?
- Who is obligated to who?
- How liquid is the holding company? Are the individual capital and surplus of the individual companies fungible?

This session will provide discussion concerning the interplay and consistency of assessing capital adequacy assessment and liquidity of a company in consideration of the above questions.

Liquidity fundamentally differs from capital adequacy. While both are essential to remaining a going concern, liquidity has a "real time" dimension that capital does not. In addition, insufficient liquidity, non-fungibility of group capital , and the inability raise cash at a cost-effective method can cause "sudden death" in insurers that are otherwise well-capitalized. As a result, the insurer's capital management framework may be inappropriate. This session is intended to discuss this gap plus include considerations of the fungibility of Group Capital, Holding Company Financial Considerations, and Liquidity as it relates to the capital adequacy of a P&C insurance Group.

Let's get started - definitions

- **Holding company (holdco):**
  - An insurance holding company is a business entity whose main activity is to acquire and hold controlling interest in other companies, in particular the holding of subsidiary insurance companies
    - Together these are known as an insurance group of companies with the holding company referred to as the parent company
    - The holding company can also hold other non-insurance businesses
  - An insurance holding company can be organized as publicly traded company, privately held company, or mutual holding company
- **Insurance Operating Company (opco):**
  - A company that undertakes the business of insurance and is subject to NAIC regulation, i.e., a "statutory" insurance company
    - Not all insurance companies are part of a holding company or group
- **NAIC Holding Company Act:**
  - Regulates the ownership of insurance operating companies and the transfer of capital and dividends amongst a holding company group
  - Holding company and affiliate structured detailed in Schedule Y

Holding Company Ownership and Capitalization

- Holding company can be owned by public shareholders, private owners or equity, or mutual policy holders
  - Differentiating factors:
    - Access to capital
    - Stakeholder goals
    - Financial strategy
    - Risk appetite
    - Disclosure
- Holding company can provide access to capital and financial flexibility
  - New ownership shares
  - Issuance of stock
  - Issuance of debt
  - Profit retention and hard capital allocation

Holding Company Ownership and Capitalization (continued)

- Holding company structures can have multiple levels or tiers
  - Intermediate holding companies
  - Operating companies which directly own other affiliates rather than being side-by-side affiliates
    - Can results in stacking of capital and earnings
    - Rating agencies evaluate the “rating group”, could be multiple
- Holding company capital can be down-streamed to operating companies
  - Contributed capital
  - Debt or finance LOC’s
  - Surplus Notes (receive equity credit at operating company level)
- Operating company proceeds can up up-streamed to parent holdco
  - Support stockholder dividends or share repurchases
  - Service debt repayment and interest payments
  - Re-allocated capital to other affiliated opcos within group

Strategic Role of Subsidiary to Parent

- A company's strategic position within a larger group can range on a continuum from strategically core to a transactional investment
  - Is the subsidiary publicly linked to holding company?
    - Similar name, marketing strategy, reputation
    - Would divesture lead to change in business strategy
  - Integrated into the group's operations and management
    - Common management, systems, and processes
  - Significant contributor to group earnings
    - Volatility of earnings
  - Parental ability and willingness to provide support
    - Track record of providing support
    - Significant intra-group reinsurance
    - Net worth maintenance agreement
  - Dependence of the subsidiary and its ability or requirement to "stand alone" – how supported or insulated is opco from holdco

Capital strength

Ability of Surplus to withstand risk from various sources while continuing to meet policyholder obligations

Pricing Risk

Reserve Risk

Investment Risk

Credit Risk

CAT Risk

Policyholder Surplus

Need to further evaluate if losses or reduction in dividend paying capacity impairs holding company capital or debt financing potentially impairing "going concern" status

Insurance Leverage and Capitalization Ratios

- **Premium Leverage**
  - Net Written Premium (NWP) to Policy-holder Surplus (PHS)
  - Sensitivity of Surplus to pricing errors
- **Net Leverage**
  - NWP and Liabilities (mainly reserves) to Surplus
  - Sensitivity of pricing and reserving errors
- **Investment Leverage**
  - Assets to PHS
  - Stocks to PHS
  - Sensitivity of PHS to investment losses
- **Reinsurance Leverage**
  - Reinsurance Recoverables to PHS
  - Reinsurance dependence
  - Degree of credit risk
- **Risk based capital**
  - Single measure incorporating all risks
  - Specific factors for lines of business, asset class, etc
  - Various versions
    - NAIC RBC
    - AM Best BCAR
  - Minimum thresholds
    - Regulatory action
    - Rating levels

- **Leverage measures (lower better)**
- **Solvency Ratios (higher better)**

Metrics are typically calculated on statutory company or group of company basis. Holding company leverage and flexibility evaluated separately

Holding Company – Financial Leverage

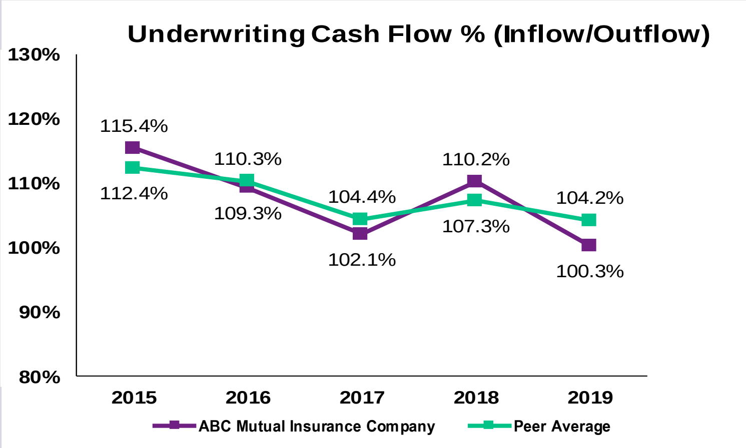
- It is possible for an insurance operating company to raise debt
  - Can get Statutory “equity credit” (i.e., counted as Surplus Note) if meets regulatory standards of tenor, dividend deferral, etc.
- If have a holding company can have more flexibility in issuing debt
  - Can be supported by other sources of income
  - Access to capital markets, equity and private and public debt
  - At holding company GAAP reporting level, debt is typically not equity
- However, holding company debt capital can be down-streamed to subsidiaries
  - Either in form of contributed capital
  - Or qualifying Surplus Note receiving equity credit at subsidiary level

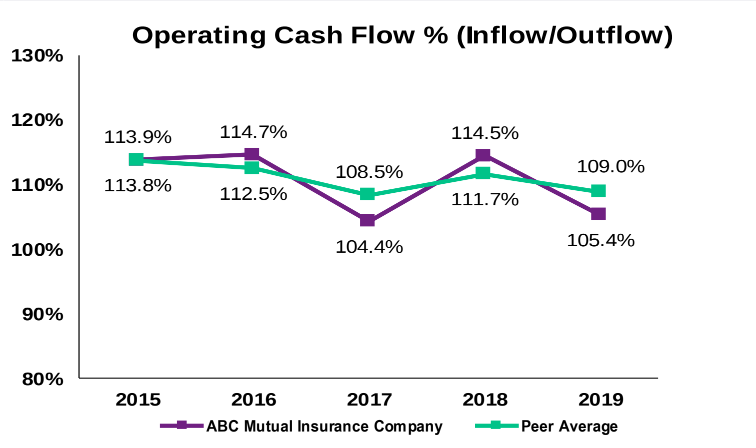
Holding Company – Financial Leverage (continued)

- Financial leverage measured as debt leverage = debt / capital which measures insurers pressure to dividend upstreaming and liquidity
- Down-streaming capital can result in “double leverage” where financial debt leverage at operating companies is not clear unless perform holding company analysis
- Need to assess holding company requirements for debt services
- Also, debt leverage and servicing needs at an affiliate company can indirectly cause a draw upon a company’s earning through a common holding company

Insurance Cash Flow

- Strong and stable UW and operating cash flows are favorable
  - A growing profitable company produces positive cash flow
    - Unprofitable growth also has positive cash flow (*not for long*)
  - Typically, companies do not sell assets to pay claims
    - Usually, incoming premiums pay past claims
  - Reinsurance helps manage event risk driven cash calls
- Cash flows influenced by unexpected losses, changes to key lines of business, and movements in written premiums





Liquidity Metrics

- Liquidity measures firm's ability to meet anticipated obligations to policyholders and other creditors whether by:
  - operating cash flow
  - cash or other investments that are liquid (converted quickly to cash at booked value)
- Need to evaluate cash flows at the holding company and its reliance on the insurance subsidiary to service debt or fulfill other obligations
- As well as the level, quality, volatility and diversification of earnings at the consolidated holding company level,

Key Liquidity Measures

Current Liquidity = (invested assets) / (total liabilities)

Quick Liquidity = (cash equivalents) / (total liabilities)

Positive UW cash flow

Positive operating cash flow

Liquidity Risk Management

There is one main liquidity indicator used to assess insurance companies but analysts also monitor the liquidity risk management policies of the insurer.

LIQUIDITY RISK INDICATOR	LIQUIDITY RISK MANAGEMENT		
Liquid assets / liabilities	Cashflow generation	Refinance risk	Contingency liquidity
• An insurer balance sheet is dominated by (usually) liquid investments. • Liquid assets consist of cash, investment grade bonds and other liquid assets such as equities. • Liabilities should include both insurance and financial liabilities. • General insurers typically have liquidity ratios of close to 100%. • Life insurers can support lower liquidity ratios but are often 60%-80%.	• Insurers usually have positive cashflow as premiums are collected (well) in advance of claims. • Positive operating cashflows are invested on behalf of policyholders. • Surplus cashflow after policyholder investments can be used to make acquisitions or pay dividends / share buyback. • Deficits after investing are usually financed by debt.	• Insurers who borrow face the risk that they cannot repay or refinance the debt at maturity. • Debt (particularly subordinated debt used as capital) tends to be very long dated. • Key mitigants are to ensure that debt maturities are spread over a range of maturities and that the insurer can access diverse sources of refinance e.g. money and capital markets, banks.	• Insurers frequently arrange lines of credit from banks which enable them to borrow if they face temporary liquidity needs. • The line of credit is off balance sheet unless drawn. • The bank will charge a fee for this facility.

Sources and Uses Analysis

Sources	Uses
Cash on hand Operating cash flow Subsidiary dividend capacity Short term debt Lines of credit	Claim payments (event risk) Operating expenses Capital spending Debt servicing obligations Stock dividends and buybacks

- Evaluate for ability to meet operating and financing obligations
  - Correlations and dependence between various sources and uses
  - Overall leverage and ability meet obligations
    – Interest and cash coverage
  - Asset liability matching or mismatch
  - Contingency plans if funding sources become unavailable

Possible Drivers of Holding Company and Liquidity Risk

- Reduced funding from business operations – limited upstream dividend capacity
  - Lower than expected inflow of premium income
  - Lower profits
  - Catastrophe or event risk resulting in cash call
- Write down of intangible assets, goodwill, deferred tax assets
- Reduction in assets market value or FX movements
  - Limiting funds for collateral posting
- Limited access to external funding,
  - Short term and long-term debt refinancing
- Limited access to internal funding – lack of “fungibility” of capital
  - Restrictions in transfer of liquid assets between legal entities due to holding company financing requirements or legal regulations
- Inability of holding company to meet obligations to capital providers
  - Debt or equity

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