

# *Liquidity Risk Management and Capital Adequacy Assessment*

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# Panelists

- Robert Wolf, Moderator
- Panelists
  - Chester Szczepanski (Donegal Insurance Group)
  - Michael Lagomarsino (AM Best)



# Ground Rules



# Ground Rules

- We'll try to provide an open forum
- Panelists provide perspectives from:
  - Chief Actuary/Company Management/ERM
  - Rating Agency
  - Former Regulator
- Your perspectives





# *IL-Liquidity:* Some Pennsylvania Experience

Chet Szczepanski FCAS, MAAA

# Pennsylvania Experience



- ◆ PIC
- ◆ PHICO
- ◆ Legion
- ◆ Reliance
- ◆ L T C
- ◆ SWCF

# Pennsylvania Experience

## PIC:

- Medical malpractice writer
- Discounted reserves
- Reserve deficiencies
- Downgraded
- Doctor's did not care
- Interest rates rise
- Bond Prices Drop
- Speed Up in Court Decisions
- RBC caught them!

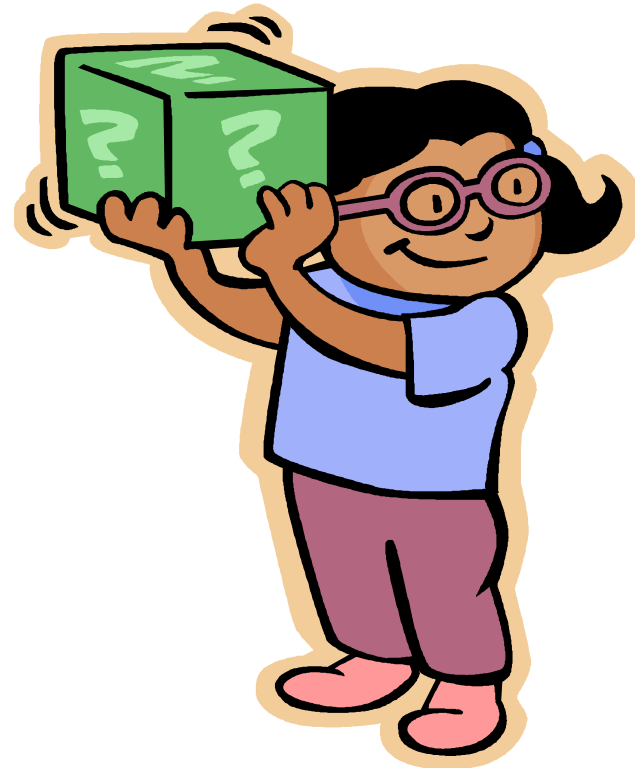




# Pennsylvania Experience

## PHICO:

- Medical malpractice writer
- Rapid expansion into new markets
- Reserve deficiencies
- Downgraded



# Pennsylvania Experience

## PHICO (*continued*):

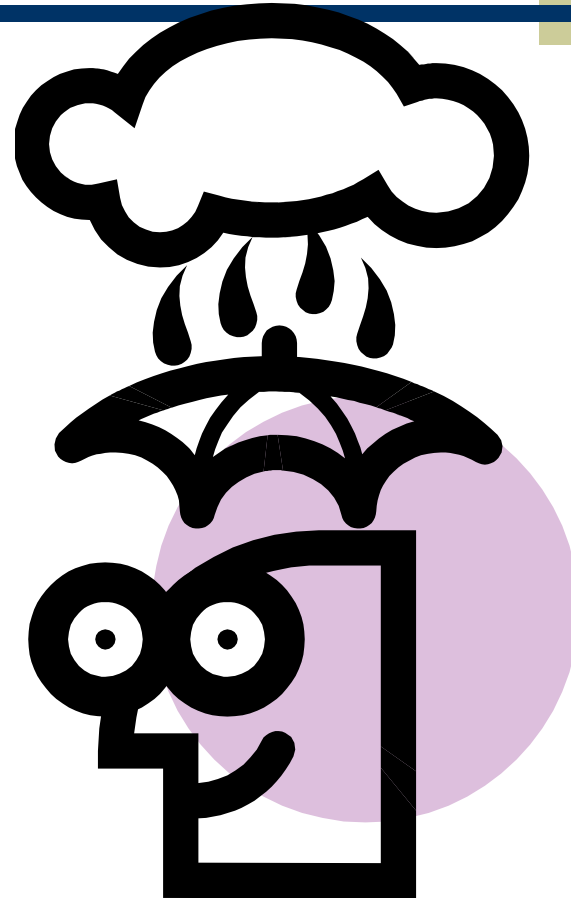
- Significant investment in new, large corporate campus
- Expanded into new markets
- Doctors did not care
- Cash flow issues



# Pennsylvania Experience

## Legion:

- Multi-line writer
- Business was rating sensitive
- Heavily leveraged by reinsurance
- Downgraded



# Pennsylvania Experience

## Legion (continued):

- Claims management decentralized at Managing General Agency level
- Reserves?
- Liquidity, liquidity, liquidity???



# Pennsylvania Experience

## Reliance:

- Multi-line writer
- Business very rating sensitive
- Heavily leveraged by reinsurance
- Heavily leveraged by holding company debt



# Pennsylvania Experience

## Reliance (continued):

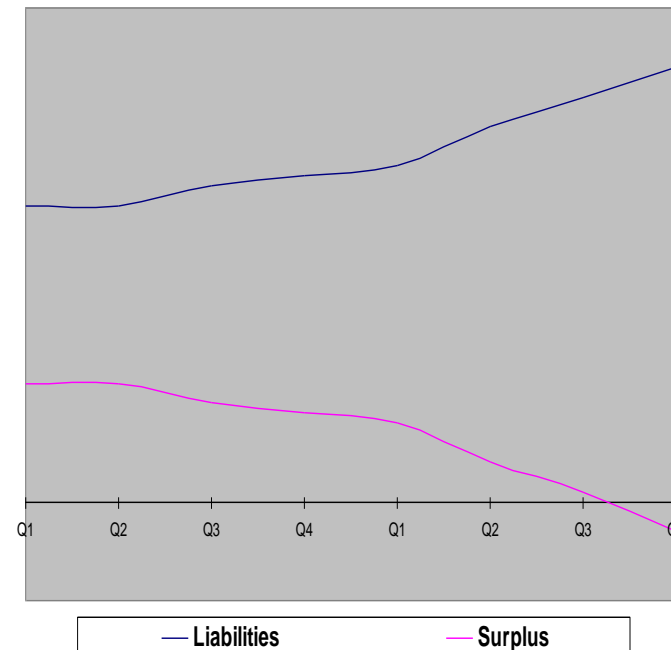
- Uncover
- Reserve deficiencies
- Downgraded!
- Statutory Deposits
- *IL-liquidity, IL-liquidity, IL-liquidity!*



# Pennsylvania Experience

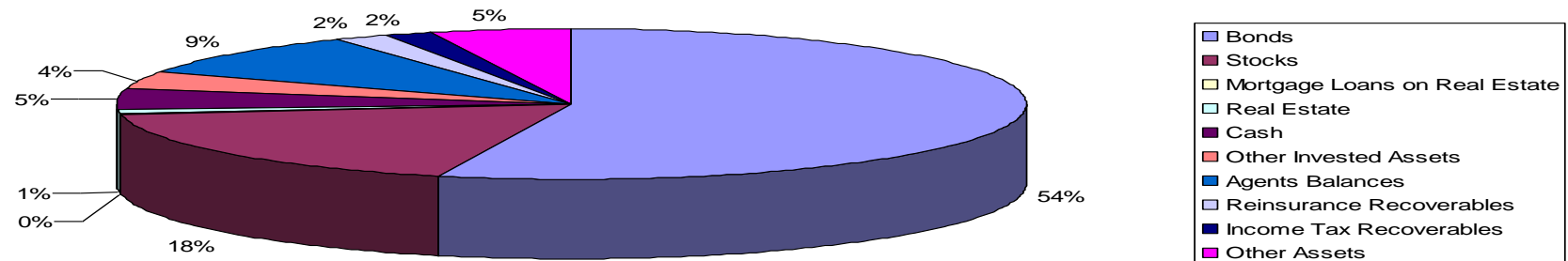
## Frequent Themes:

- Reserve deficiencies
- Ratings downgrades
- Reinsurance Leverage
- Financial Stressors
- Cash flow challenges
- *IL-Liquidity!*



# P&C Industry Asset Distribution for 2001

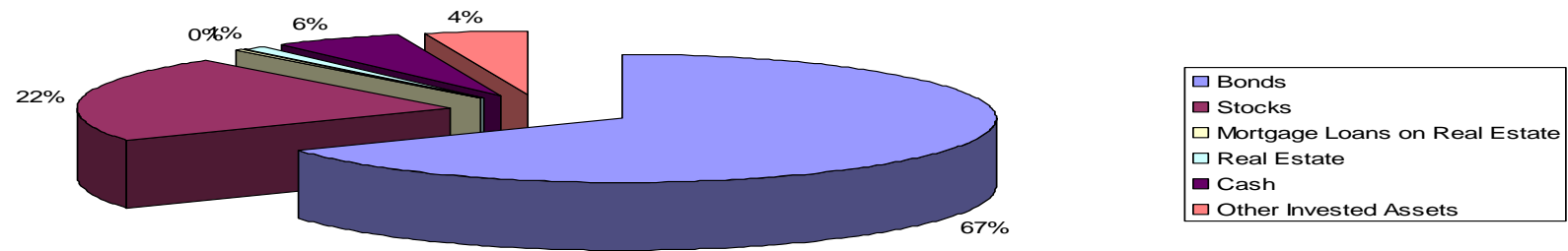
P & C Industry Asset Distribution for 2001





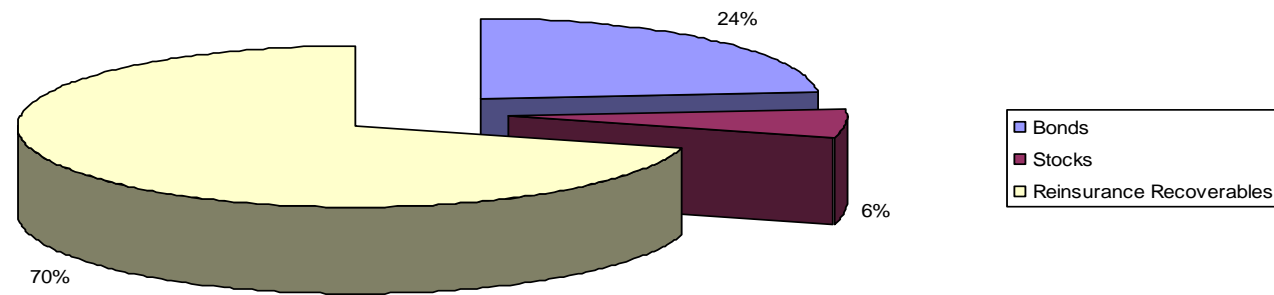
# P&C Industry Invested Asset Distribution for 2001

P & C Industry Invested Asset Distribution for 2001



# Reinsurance Leverage

Reliance Asset Distribution



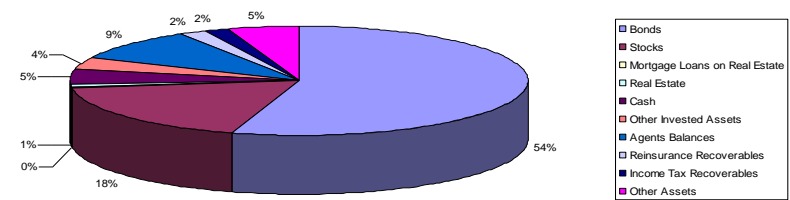
# Reinsurance Leverage

- ◆ Add rating sensitive business
- ◆ Mix in a downgrade
- ◆ \$1,000,000,000 or more in Statutory Deposits
- ◆ \$500,000,000 in one Stock
- ◆ *IL-Liquidity?*

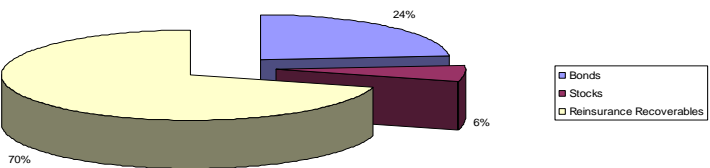


# Reinsurance Leverage

P & C Industry Asset Distribution for 2001



Reliance Asset Distribution



# Pennsylvania Experience

## Long Term Care Provider:

- Contract Price to be honored for life of contract
- Initial offering substantially underpriced to gain market share
- Sought regulatory approval to collect subsidy in new policies for prior inadequacy



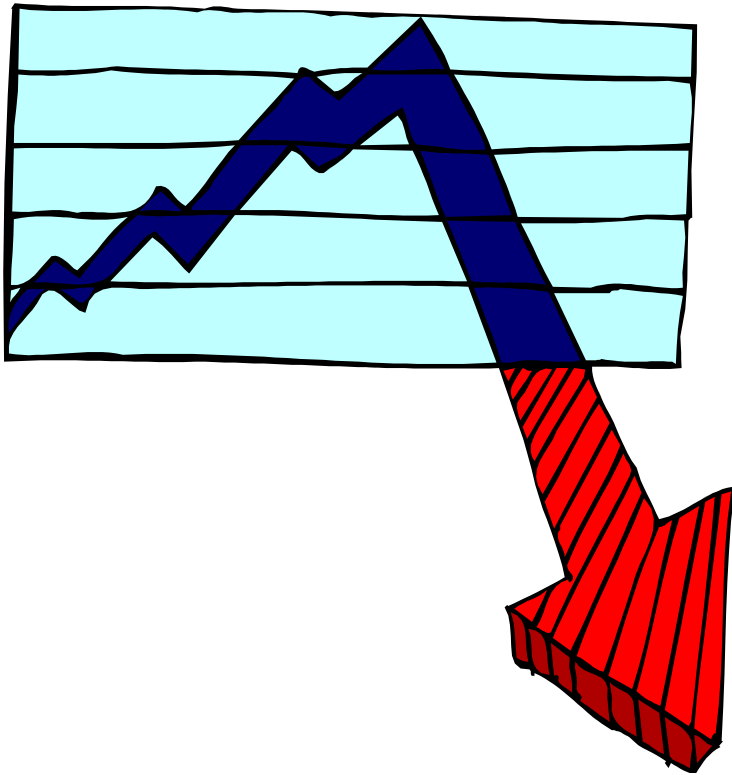
# Pennsylvania Experience

## State Workers Compensation Facility:

- Insurer of last resort
- Significant Surplus ‘borrowed’ by Government to pay off Unemployment debt to federal government
- Remained Liquid!



# *Conclusions?*



- ◆ Risk elements to liquidity always exists
- ◆ Some are naturally occurring
- ◆ Some are artificially created
- ◆ Interactions can lead to disastrous results

# *Insight?*

Risk elements  
must be identified  
and managed!





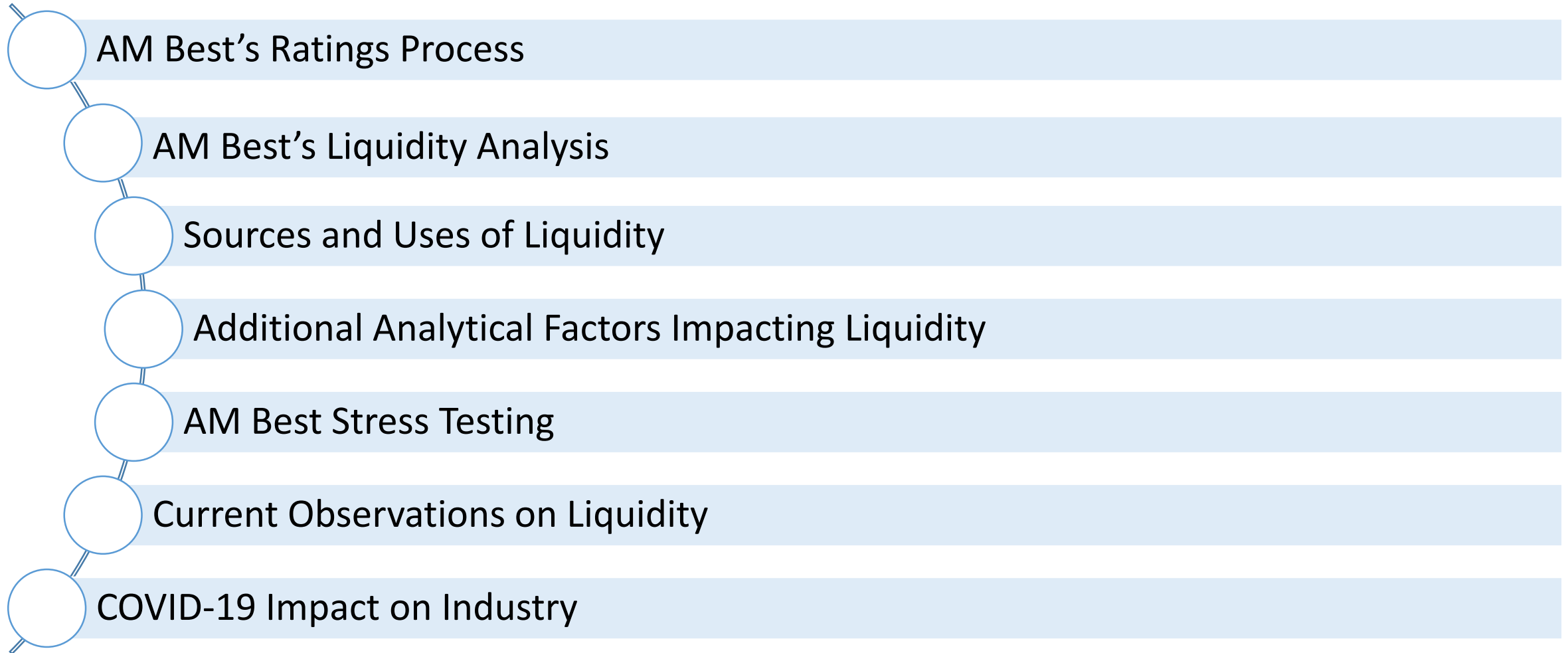
# Liquidity Risk Management and Capital Adequacy Assessment

**Michael Lagomarsino, CFA, FRM, Senior Director, 11/10/2020**

CAS Annual Conference

# Outline

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# AM Best's Definition of Liquidity

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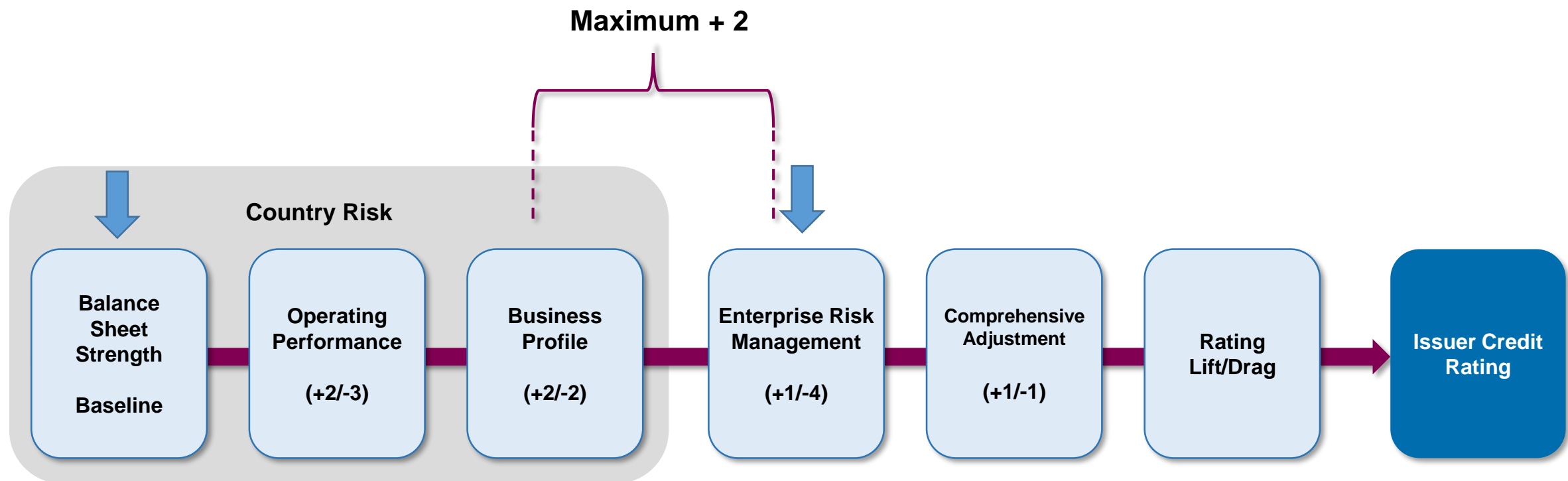
Liquidity measures an insurer's ability to meet anticipated short- and long-term obligations to policyholders and other creditors when due

Liquidity depends on the degree to which financial obligations can be satisfied by holding cash, sound, diversified and liquid investments and operating cash flows

A high degree of liquidity helps an insurer meet unexpected cash needs without the untimely sale of investments or fixed assets ("buy and hold")

Liquidity is the first line of defense against adverse pressures (internal or external)

# BCRM Building Block Approach



**Liquidity impacts a number of building blocks; Namely Balance Sheet Strength and ERM**

# AM Best's Liquidity Analysis

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Holistic approach that examines liquidity at a rating unit and hold co.

Cash flows are reviewed since they can meet some liquidity needs

Liquidity resources at holding company

Monitor access to the capital markets and other sources of liquidity

Evaluate the quality, market value and diversification of assets

Discussions with management on how the company would react in a stress scenario and immediate and cash demands as part of analysis

- A company's liquidity policy should not only address known uses but incorporate a strategy for handling stress scenarios

# Sources & Uses of Liquidity

## Sources

- Operating cash flow
- Cash and short term investments
- Diversified high quality of investment portfolio
- Bank lines of credit
- Access to Federal Home Loan Bank
- Contingency capital facilities

## Uses

- Claims including under stress events
- Short-term debt and current portion of long-term debt
- Servicing cost of borrowings
- Contingent liabilities
- Off balance sheet financing obligations
- Common stock dividends or buy-backs

# Additional Analytical Factors Impacting Liquidity

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## Quality and Appropriateness of Reinsurance Programs

- Pay particular attention to dependency and concentration of reinsurers
- Cash call provisions

## Adequacy of Loss Reserves

## Financial and Operating Leverage

## Quality of Capital

## Fungibility of Capital

# AM Best Stress Testing

Analysts run stress tests scenarios to ensure adequate level of capitalization and liquidity

- Natural catastrophe stress test
- Terrorism risk stress test
- Surety stress test

AMB runs stress tests on rated companies for systemic events

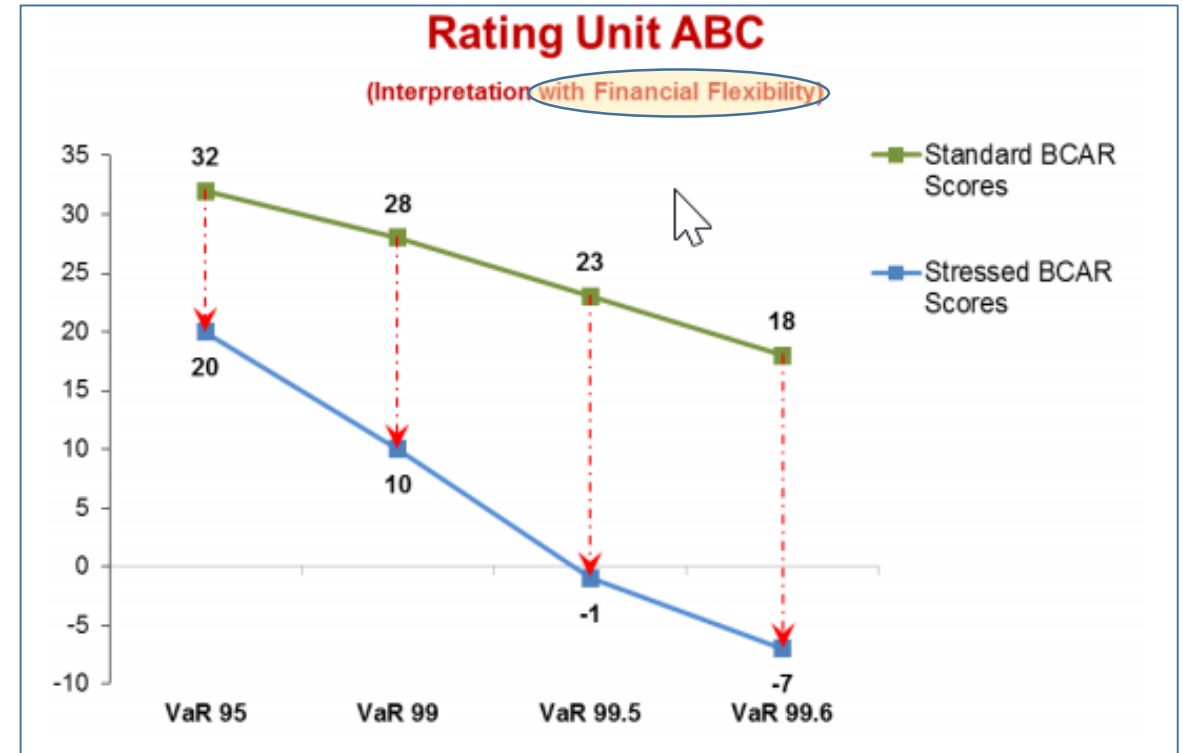
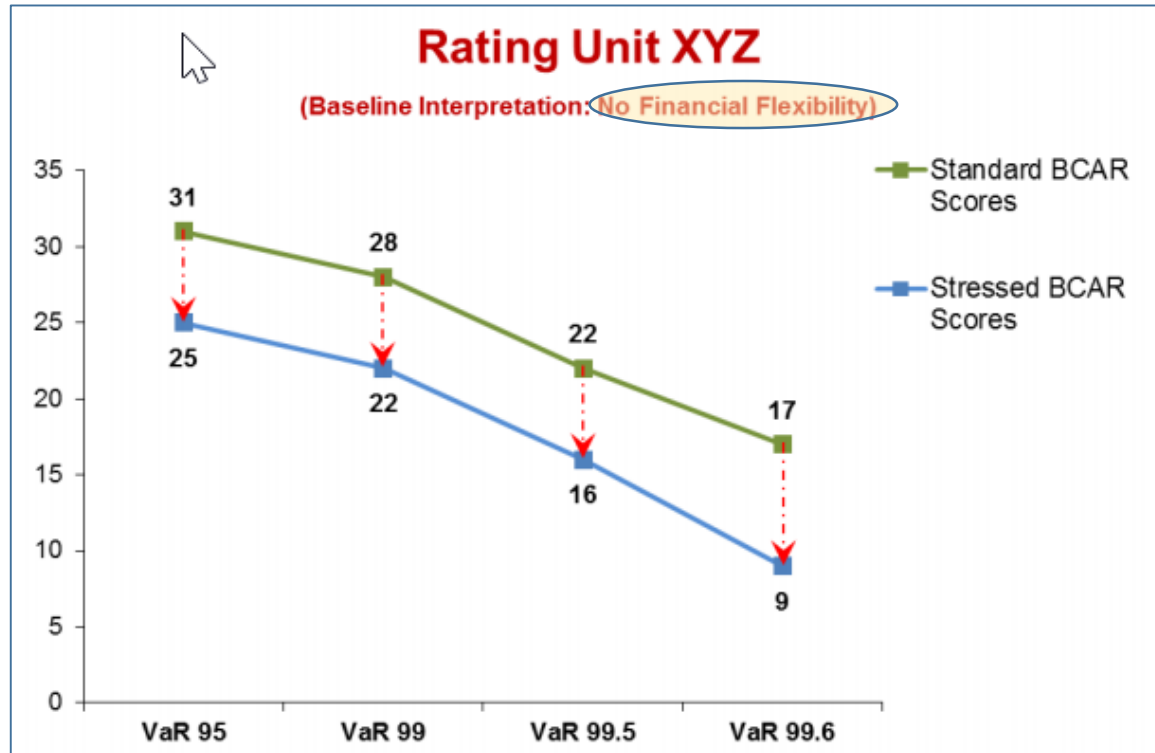
- COVID-19

The level of acceptable drop in BCAR scores between the standard BCAR and stress tested BCAR is driven by:

- Financial flexibility and liquidity throughout the enterprise
- Group's ability to generate consistent earnings to replenish capital



# Stressed BCAR Interpretation



# Current Observations on Liquidity

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Despite lower interest rates and pressures on top line cash flows remain solid

Investment portfolios maintain solid liquidity and high credit quality

Industry is well capitalized and has strengthened capital management practices

- Many companies have halted share buy-backs
- Raised capital via senior debt (pre-fund debt maturing over 24 months) and equity
- Access to bank lines of credit and growing participation in FHLB

Industry strengthened risk management practices learning from past events

- Continue to run stress testing alongside liquidity impacts
- ORSA

# COVID-19 Impact on the Insurance Industry

# COVID-19 Questionnaire – March 2020

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**COVID-19 impact on company operations**

**Stress test scenarios modelled for pandemic risk**

**Planned adjustments to 2020 financial projections**

**Changes to product assumptions**

# COVID-19 Questionnaire – Responses

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**Business continuity plans in effect**

**Updates to projections or assumptions**

**Strong levels of capital and liquidity**

**Concern about legislative activism**

**Uncertainty the common theme**

# COVID-19 Stress Testing – Adjustments

## Assets

- Bonds
- Mortgage loans
- Common stocks
- Real estate
- Alternative assets

## Underwriting

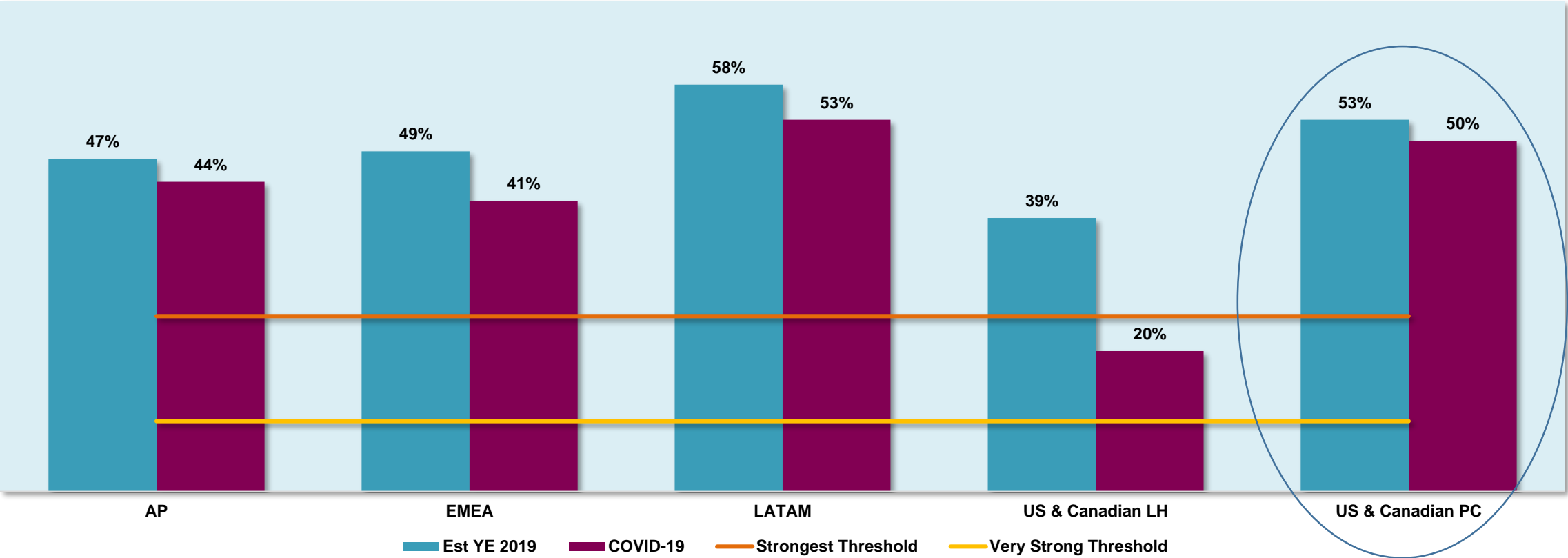
- Property / Casualty
- Mortality
- Annuities
- Health

## Available Capital

- Soft capital
- Hybrid debt

# COVID-19 Stress Testing – Global View

Median BCAR Score



US insurance industry is well capitalized

# Liquidity Assessment

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- Review of liquidity involves dialogue with insurers
  - Review cash needs the next 12-18 months at holding company
  - Understand drawdown of credit facilities, LOCs – update to leverage calcs
  - Examine company's own liquidity stress
- Companies reevaluating dividends and share repurchase
- Significant liquidity injected into the market by Fed and others



# COVID-19 Stress Testing – Property / Casualty Results

Results	Key Exposures	BCAR/Liquidity	Status
<ul style="list-style-type: none"><li>• BCARs generally declined &lt;10%</li><li>• No credit for risk mitigation</li></ul>	<ul style="list-style-type: none"><li>• Outsized equity or alternative asset exposure</li><li>• Concentrations in certain lines of business</li></ul>	<ul style="list-style-type: none"><li>• ‘Strongest’ Capitalisation</li><li>• Sound Liquidity</li><li>• Good access to financial markets</li><li>• Risk mitigation in place</li></ul>	<ul style="list-style-type: none"><li>• Some lines will see spike in claims</li><li>• Other lines will see reduced frequency</li><li>• Capital management</li><li>• Close monitoring of interpretation of contract language</li></ul>

# COVID-19 Stress Testing – Follow Up Steps

Follow up Steps	Key Themes to Monitor
<ul style="list-style-type: none"><li>• Additional information to refine BCAR</li></ul>	<ul style="list-style-type: none"><li>• Possible resurgence of pandemic</li></ul>
<ul style="list-style-type: none"><li>• Evaluate mitigating factors</li></ul>	<ul style="list-style-type: none"><li>• Spikes in claims activity</li></ul>
<ul style="list-style-type: none"><li>• Assess impact on other building blocks</li></ul>	<ul style="list-style-type: none"><li>• Deterioration of financial markets</li></ul>
<ul style="list-style-type: none"><li>• On-going surveillance</li></ul>	<ul style="list-style-type: none"><li>• Business continuity issues</li></ul>
<ul style="list-style-type: none"><li>• Monitor macro-economic conditions</li></ul>	<ul style="list-style-type: none"><li>• Potential liquidity strain</li></ul>
<ul style="list-style-type: none"><li>• Rating Committee</li></ul>	<ul style="list-style-type: none"><li>• Interpretation of contract language</li></ul>

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# Some Core Principles



# Q & A

Discussion

