

**BARINGS**

INSURANCE SOLUTIONS

# The Fluidity of Liquidity

INSIGHTS

To meet policyholder demands and terms of their financing arrangements, life insurers must maintain adequate levels of liquidity. Here are some reasons why today's environment makes liquidity management so critical.



**Ken Griffin**  
Head of Insurance Solutions



**Alex Perez**  
Associate Director,  
Insurance Solutions



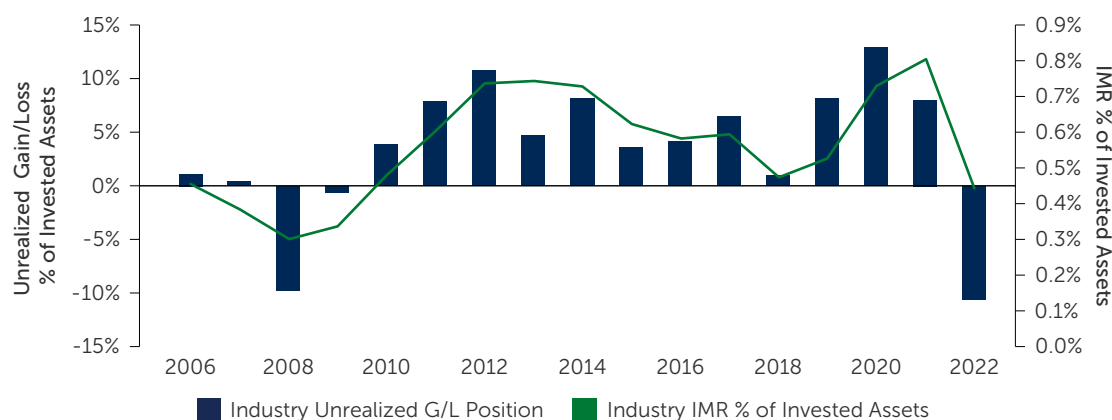
As seen by the recent events in the banking industry, rising interest rates can also pose a challenge for life insurance companies, potentially threatening their financial health. Along with inadequately priced products, poor expense management, investment defaults and fraud, rising rates can be a factor contributing to insurer insolvency by impairing liquidity, or the ability to raise sufficient cash, when needed, to meet payment demands. In the past, insurer liquidity crises largely were the result of poor product management (for example, writing policies that allowed for large-scale, immediate policyholder cash-outs), inadequate liquidity in investment portfolios to fund redemptions, or poor anticipation of disintermediation risk due to changing economic conditions. In hindsight, proper planning and stress testing could have saved most, if not all, insurers facing insolvency in the past. Given today’s environment, attention to liquidity needs is more important than ever.

## Reasons for an Increased Focus on Liquidity

### IMR WOES

The turbulent economic environment of 2022 was characterized by high and unanticipated inflation, a sharp spike in interest rates, and steep declines in the prices of equity and fixed income securities. These extreme events caused a significant decline in asset values for all insurers, leading to grievous unrealized losses in their investment portfolios.

Figure 1: Life Industry Unrealized Gain/Loss and IMR



Source: S&P. As of December 31, 2022.

Thanks to the statutory book-value accounting used by insurance companies, large declines in a portfolio’s market value are rendered harmless until they are realized. But since accounting for realized gains and losses runs through the Interest Maintenance Reserve (IMR), which due to a legacy ruling must be positive to act as a buffer, large amounts of realized losses will eventually begin to degrade surplus positions, regardless of how well assets are managed against liability needs. The unnatural effect of this makes insurers reluctant to trade their portfolio, either for repositioning to improve credit risk management or to accommodate policyholders demanding cash for their policies. These forces create additional liquidity strains for insurers, where a record 26% of life insurers were in a negative IMR position as of year-end 2022.<sup>1</sup>

1. Source: S&P. As of December 31, 2022.

### UNCHARTED LAPSE TERRITORY

Life insurance products have become increasingly innovative and sophisticated over recent years. New index-linked equity products have become popular, often due to features that provide upside appreciation as equity markets rise as well as a downside floor to protect against market corrections. Insurers make assumptions about policyholder lapse rates under diverse economic conditions, but with new products these assumptions are simply educated estimates because there is no historical track record. Even products with long histories, such as deferred annuities, may lack lapse data gathered during a period of sustained higher interest rates. This information is important because policyholders tend to lapse policies when they can achieve higher crediting rates from other insurers as well as higher returns on bank deposits or other investments. This creates a greater degree of uncertainty around the level of liquidity needed by insurers.

### COLLATERAL STRAIN FROM HEDGES

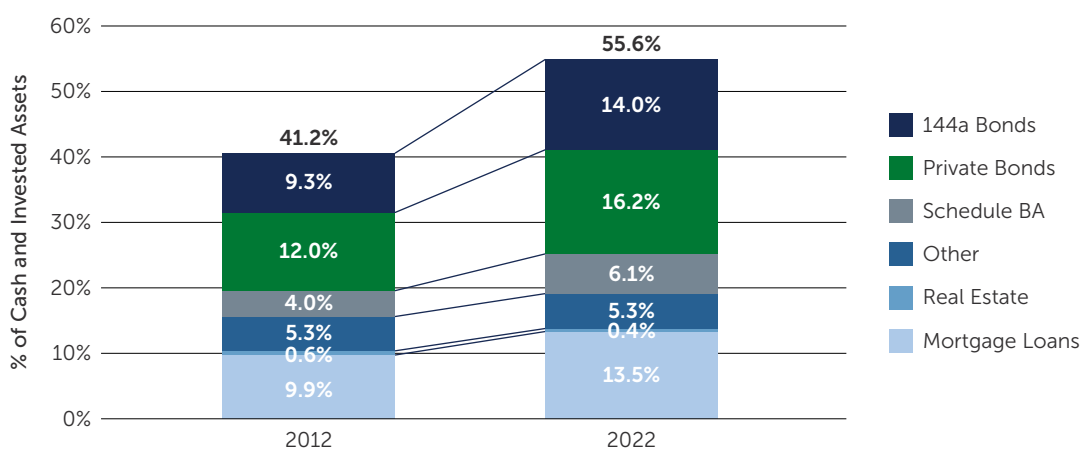
To create their more sophisticated products, many insurers have come to rely to a greater degree on derivative hedges to protect against adverse market moves. Instruments like interest rate futures, bond forwards, or receiver swaps can be used to extend duration in a portfolio when the liability duration risk is greater than the duration that can be achieved in cash markets. When markets move against these positions, as they did during the most recent interest rate spike, insurers are required to post collateral to guarantee the ultimate settling of large derivative losses. The collateral used is often in the form of liquid assets, which then become encumbered

and unavailable for sale to meet other cash demands. Dynamic hedging platforms, which require frequent rebalancing to hedge gamma, or convexity risk can cause additional realized losses, exacerbating the negative IMR restriction and straining capital even though this is a prudent risk management approach.

### STRESS(FUL) TESTING

During the years of historically low interest rates, insurers were often compelled to hold higher returning, but typically much less liquid assets. While the illiquidity premium and returns were certainly attractive, this portfolio structure reduces sources of liquidity and leaves insurers with a smaller margin for error during high cash-call periods. In today’s environment, stress testing—which has always been a critical part of insurance risk management—is more important than ever. Insurers are currently in the throes of simultaneous liquidity stresses on the asset and liability sides of their balance sheet. They also must consider the prospect of even higher interest rates and lower equity returns in 2023 than those experienced in 2022. In other words, while weathering the current storm, they must gird themselves for a potentially worsening storm of more policyholder lapses, greater collateral calls for derivative positions, and further erosion in the value of their investment portfolios. Maintaining enough liquidity to satisfy these additional needs may prove challenging, particularly for those insurers reporting new NAIC regulatory stress tests which require explicit sources of liquidity by time horizon.

Figure 2: Life Industry Allocation to Less Liquid Assets



Source: S&P. As of December 31, 2022.

## Sources of Liquidity

### FEDERAL HOME LOAN BANK

In search of liquidity, there are several sources available to insurers. The Federal Home Loan Bank (FHLB) system allows for cash advances to member insurers who hold investments that support housing finance and community investment. The terms of such advances are favorable and are collateralized by investments that facilitate the FHLB’s mission of supporting housing finance and community investment, such as loans of residential and commercial mortgages. The extent of borrowing can be sizable for insurers. FHLB advances to insurers have leaped 61% over the four-year period from 2018 to 2022, with a big jump in 2020 at the onset of COVID.<sup>1</sup>

### NEW PRODUCT SALES

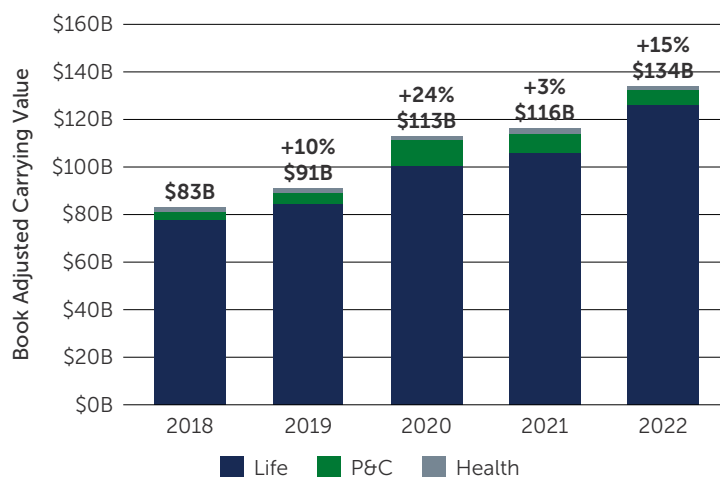
Insurers can also generate new sales to produce cash available for liquidity demands. This approach of underwriting new business to pay for old concerns is fraught with peril as new business is sold with an assumption of new investment at today’s higher interest rates. Not actually investing at these high rates as cash from new premiums is spent elsewhere may only hurt future profitability and extend solvency concerns to a later date. The industry has recently had little trouble generating cash through new premiums as seen by record annuity sales.

### LIQUID ASSETS IN THE INVESTMENT PORTFOLIO

To meet liquidity needs, insurers can also shift their investment allocations from private, less liquid investments to public investments. They also can begin to hoard cash, which may help in cases of an immediate liquidity crunch but lead to lower-than-expected yields and profitability in the intermediate and longer term. Current industry data does not appear to show evidence of either cash hoarding or a switch away from private investments. In fact, allocations to private assets continue to increase as they have over the last several years, and cash balances are declining from their COVID highs.

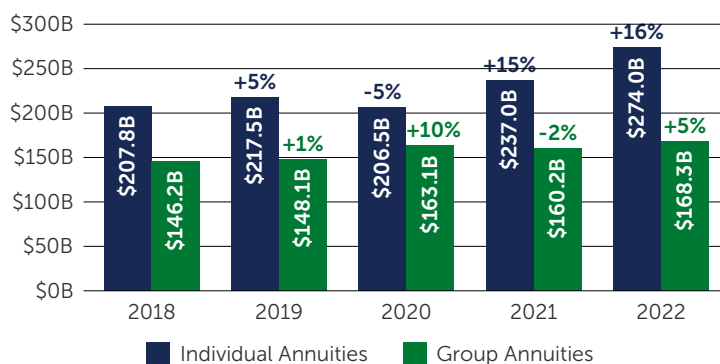
Overall, the life insurance industry’s liquidity challenges should be manageable given proper risk management. But liquidity oversight must be a priority given its pivotal role in an insurer’s financial stability.

Figure 3: U.S. Insurers’ FHLB Advances



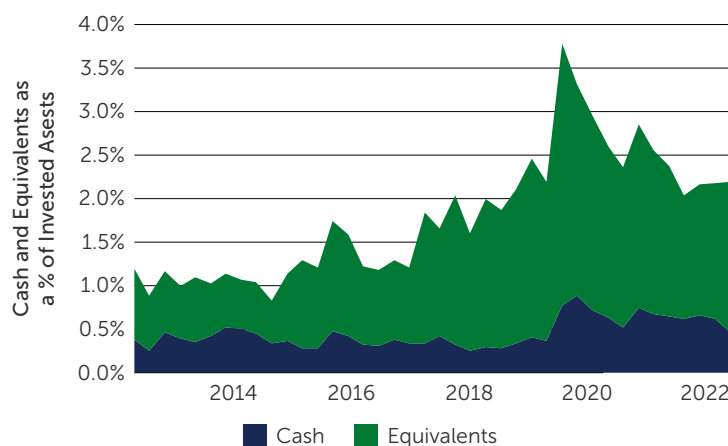
Source: S&P. As of December 31, 2022.

Figure 4: Life Industry Direct Premiums, Individual Annuities and Group Annuities



Source: S&P. As of December 31, 2022.

Figure 5: Life Insurance Industry Cash Balance



Source: S&P. As of December 31, 2022.

*Barings is a \$347+ billion\* global investment manager sourcing differentiated opportunities and building long-term portfolios across public and private fixed income, real estate and specialist equity markets. With investment professionals based in North America, Europe and Asia Pacific, the firm, a subsidiary of MassMutual, aims to serve its clients, communities and employees, and is committed to sustainable practices and responsible investment.*

#### IMPORTANT INFORMATION

Any forecasts in this document are based upon Barings opinion of the market at the date of preparation and are subject to change without notice, dependent upon many factors. Any prediction, projection or forecast is not necessarily indicative of the future or likely performance. Investment involves risk. The value of any investments and any income generated may go down as well as up and is not guaranteed by Barings or any other person.

**PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.** Any investment results, portfolio compositions and or examples set forth in this document are provided for illustrative purposes only and are not indicative of any future investment results, future portfolio composition or investments. The composition, size of, and risks associated with an investment may differ substantially from any examples set forth in this document. No representation is made that an investment will be profitable or will not incur losses. Where appropriate, changes in the currency exchange rates may affect the value of investments. Prospective investors should read the offering documents, if applicable, for the details and specific risk factors of any Fund/Strategy discussed in this document.

Barings is the brand name for the worldwide asset management and associated businesses of Barings LLC and its global affiliates. Barings Securities LLC, Barings (U.K.) Limited, Barings Global Advisers Limited, Barings Australia Pty Ltd, Barings Japan Limited, Baring Asset Management Limited, Baring International Investment Limited, Baring Fund Managers Limited, Baring International Fund Managers (Ireland) Limited, Baring Asset Management (Asia) Limited, Baring SICE (Taiwan) Limited, Baring Asset Management Switzerland Sarl, Baring Asset Management Korea Limited, and Barings Singapore Pte. Ltd. each are affiliated financial service companies owned by Barings LLC (each, individually, an "Affiliate"). Some Affiliates may act as an introducer or distributor of the products and services of some others and may be paid a fee for doing so.

**NO OFFER:** The document is for informational purposes only and is not an offer or solicitation for the purchase or sale of any financial instrument or service in any jurisdiction. The material herein was prepared without any consideration of the investment objectives, financial situation or particular needs of anyone who may receive it. This document is not, and must not be treated as, investment advice, an investment recommendation, investment research, or a recommendation about the suitability or appropriateness of any security, commodity, investment, or particular investment strategy, and must not be construed as a projection or prediction.

Unless otherwise mentioned, the views contained in this document are those of Barings. These views are made in good faith in relation to the facts known at the time of preparation and are subject to change without notice. Individual portfolio management teams may hold different views than the views expressed herein and may make different investment decisions for different clients. Parts of this document may be based on information received from sources we believe to be reliable. Although every effort is taken to ensure that the information contained in this document is accurate, Barings makes no representation or warranty, express or implied, regarding the accuracy, completeness or adequacy of the information.

Any service, security, investment or product outlined in this document may not be suitable for a prospective investor or available in their jurisdiction.

Copyright and Trademark

Copyright © 2023 Barings. Information in this document may be used for your own personal use, but may not be altered, reproduced or distributed without Barings' consent.

The BARINGS name and logo design are trademarks of Barings and are registered in U.S. Patent and Trademark Office and in other countries around the world. All rights are reserved.

**LEARN MORE AT [BARINGS.COM](https://www.baring.com)**

*\*As of December 31, 2022*

*23-2780912*