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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.

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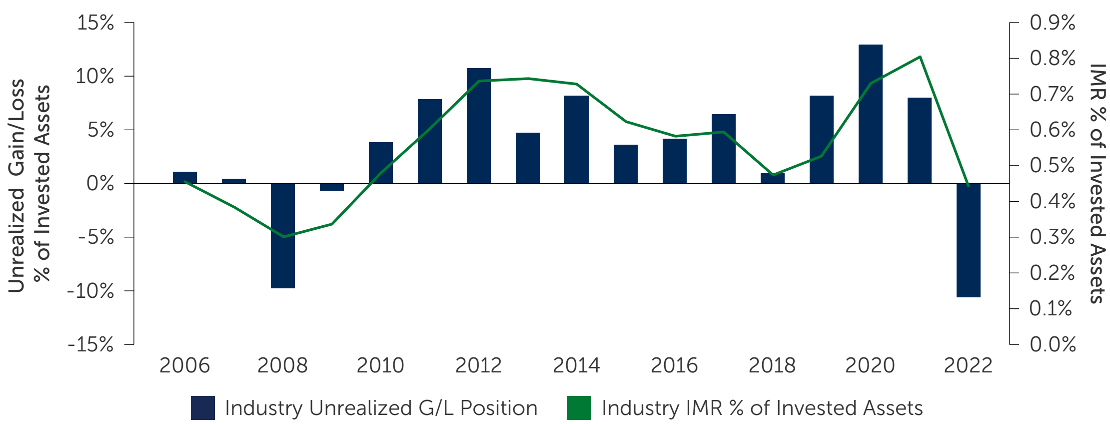
As seen by the recent events in the banking industry, rising interest rates can also pose a challenge for life insurance companies, potentially threatening their financial health. Along with inadequately priced products, poor expense management, investment defaults and fraud, rising rates can be a factor 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.[1]

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

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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.

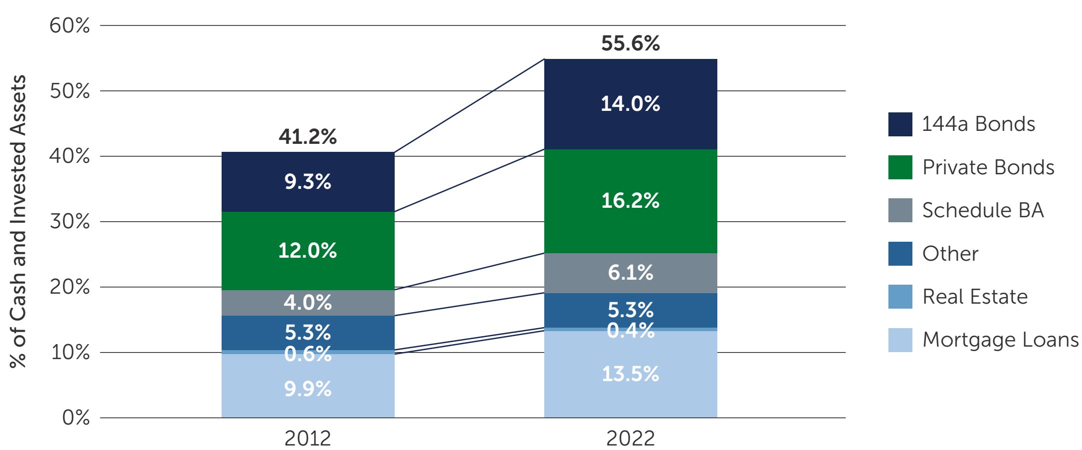
COLLATERAL STRAIN FROM HEDGES

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.[1]

NEW PRODUCT SALES

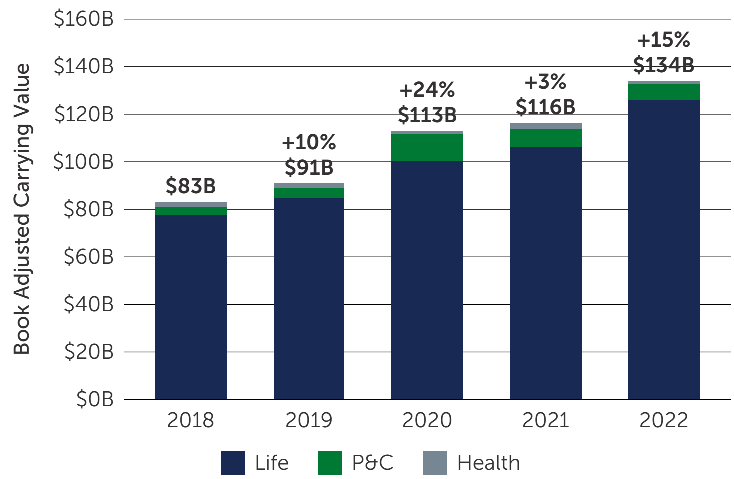
Insurers can also generate new sales to produce cash available for liquidity demands. This approach of underwriting new business to pay for old concerns is fraught with peril as new business is sold with an assumption of new investment at today's higher interest rates. Not actually investing at these 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.

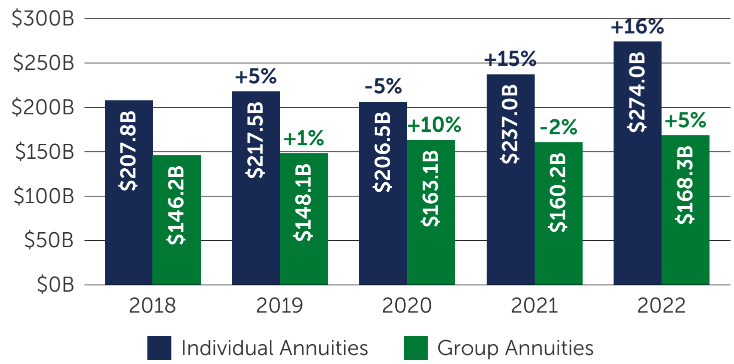
Overall, the life insurance industry's liquidity challenges should be manageable given proper risk management. But liquidity oversight must be a priority given its pivotal role in an insurer's financial stability.

Figure 3: U.S. Insurers' FHLB Advances



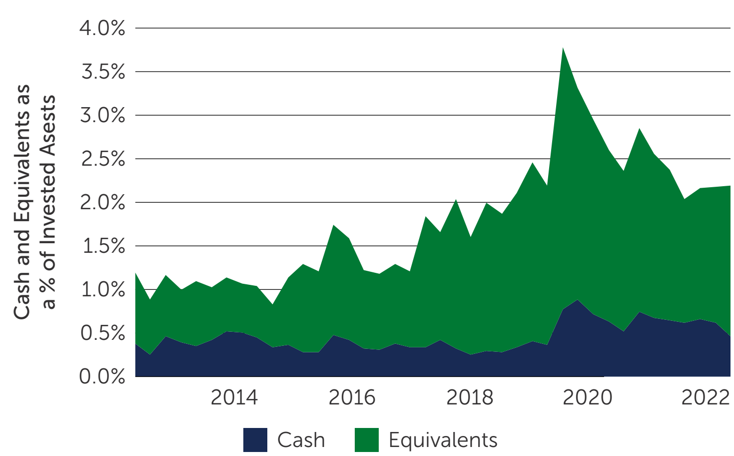
Source: S&P. As of December 31, 2022.

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.

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