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# Liquidity Risk In An Insurance Operation

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**MANY PEOPLE THINK THE POSSIBILITY OF AN INSURANCE COMPANY RUNNING INTO DIFFICULTIES OVER LIQUIDITY ISSUES IS A REMOTE PROSPECT.** After all, there is no leveraging of loans as with the banks, and the reserves are backed by good, solid assets. However, this is not the case, and liquidity risk (sometimes associated with fraud) has been a source of some historic insolvencies.

During the 1970s a number of life insurers fell out of favor because of liquidity issues. Typical examples include:

- A successful insurer that paid a high introductory commission. It was so successful that the new business strain resulted in a lack of funds to meet claims.
- An insurer whose product was linked to a particular investment—indeed, it was perfectly matched. However, on maturity the company granting the loan expected it to be rolled over and defaulted.
- A number of insurers that locked into specific investments, which could not be readily realized in a short time. The investments included property and significant holdings in a particular stock.
- Fraud when the nominal investments were not actually held or were worthless.

In the 1990s there were other types of liquidity problems. A large catastrophe would result in a substantial volume of original losses and these would be compounded by the “inflation” effect of the London market excess of loss (LMX) catastrophe spiral. As a consequence, many insurers were paying out claims with a delay in collecting the reinsurance. This was financed by banks and by brokers in the form of short-term loans against the expected reinsurance recoveries. The crunch came when one of the insurers became insolvent and didn't meet the claim, resulting in a default. Credit then dried up, which led to a cascade of liquidity problems.

But all of this is in the past and won't happen again. Or will it? Conventional wisdom has it that the fixed interest investment backed by an AAA rating could only remotely go wrong—that investment in major financial institutions (banks and insurers) is perfectly reliable. Unfortunately, however, you can readily put names to a number of entities that have got it wrong.

The Bank for International Settlements found in a report in 2006 that whereas banks had integrated liquidity risk into

their risk management system, the same was not true for insurance operations.

Three approaches are used in practice to manage liquidity risk:

- 1) The company maintains a block of unencumbered assets that can be drawn on at any time to meet a liquidity problem.
- 2) The company tries to match the cash flow of assets and liabilities.
- 3) The company uses a combination of these two.

Life insurers generally go for the second approach, but what about general (property & casualty) insurance companies, where cash flow is usually more difficult to predict? A typical personal-lines insurer will have a reasonable estimate of its cash flow, with the only likely exception being a major windstorm or flood, which will give a surge in claims (and associated reinsurance recoveries). However, these are generally manageable as the full amount is often not paid for a period after the event, when repairs are finally completed. It is important to note that in the Basel paper the examples of stress test given relate almost entirely to life insurance, and little to general insurance companies.

The situation of commercial lines insurers and reinsurers is more difficult to assess. With catastrophes, there are clear liquidity issues that may be greater than that of a personal-lines insurer. In addition, there is the prospect of significantly large claims where there is reliance on the reinsurance program.

In respect of Lloyd's syndicates there is a further liquidity issue in that U.S. trust funds are maintained gross of reinsurance, producing a funding strain over the net reserves. It is also not a straightforward process to release such funds when most needed.

A recent consultation paper from the Financial Services Authority (FSA)—CP09/14, “Strengthening liquidity standards 3: Liquidity transitional measures,” released in June 2009—sets out the regulator's proposal for transitional measures to aid implementation of the FSA's new liquidity regime and further underlines how important it is to be prepared. However, it appears to relate only to banks and deposit takers and no reference to insurance operations is made.

Liquidity risk for insurance companies appears not to have been a major issue from the FSA point of view. In the integrated source book, the FSA identifies issues represented in the examples set out above, namely a concentration of assets and the inability to realize the value of the assets at a certain time. However, there has been a significant change in the FSA's attitude.

The reason for this change is the impact that liquidity risk had on the banking system in the recent credit crunch; the surprising fact that in these circumstances it was much more significant than credit risk. Another impact of the credit crunch was to make investments illiquid either because they couldn't be traded or their valuation dropped so much nobody could afford to realize them.

Lord Turner, in a speech given earlier this year, stated:

*“New approaches to the management and regulation of liquidity are equally important. Indeed, we need to ensure that the regulation of liquidity is recognized as being at least as important as capital adequacy, a sense which was to a degree lost over the last several decades, with intense regulatory focus and international debates on capital adequacy, but less focus on liquidity—no Basel 1 or Basel 2 for liquidity to match the equivalents for capital.”*

Again, Lord Turner concentrates on banks. As the regulation should apply to all regulated entities, where does this leave the insurance sector? General insurance companies often view their exposures to liquidity risk as being a consequence of a major catastrophe, and thus see liquidity risk as being contained with insurance risk, investment risk, and/or credit risk. The general reasoning is that, because catastrophic events are rare, concentration is placed on managing vulnerability to such events.

This was precisely the attitude of banks—a catastrophic event such as a run on the bank hadn't been seen for years and the system was designed to stop it. A series of large catastrophes could readily make the insurance sector equally vulnerable.

The other area not considered is monocline operations, where the claims are not a function of random events but are the subject of correlated (often economic) and related events. In the early 1990s mortgage guarantee products were extended so that, by an insurance policy, an insurer would

upgrade the rating of a security based on mortgage loans and other financial transactions. After a period of calm when the market forgot about the problems of these contracts, the same issues have emerged as credit default swaps were created with ratings guaranteed by insurance contracts (this time with AIG being a major player). History repeated itself, and whereas in the 1990s many insurers were on the edge (without falling over it), this time there were also serious liquidity problems with AIG and it needed substantial financial aid from the U.S. government to continue operating. One of the issues raised in these transactions is that banks are on both sides of a trade, and thus can offset one position against another, avoiding much of the liquidity issue. The same is not true for insurance operations, which are on one side of the transactions only, and do not have the offset facility.

One consequence of this will be that insurers will also be in the liquidity framework (it could be that unintentionally it forms part of the banking requirements). One thing is certain: the consideration of liquidity risk is no longer a minor element of the risk management of an insurance operation. ■



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