SLC Management

A risk management framework for less liquid assets

Markets are challenging. But there are solutions and opportunities that can help insurance companies manage asset risk and advance long-term investment objectives.

Insurance companies of all types continue to face many diverse challenges. Volatile markets, economic uncertainties and continued health concerns are impacting insurance company operations and profitability.

While some of these challenges are familiar, others are not. As a result of COVID-19 and related adjustments to social behaviors, there is unprecedented uncertainty around workplace safety and future economic activity.

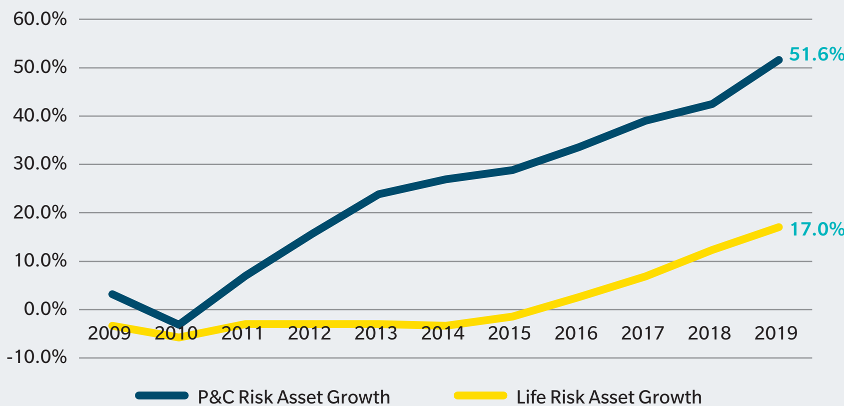
Additionally, persistently low and declining interest rates have put significant pressure on investment portfolios. This has caused many companies to dip lower in credit quality and add new asset classes in an effort to maintain adequate levels of investment income. Since the Financial Crisis of 2008, insurers have increasingly allocated away from traditional public fixed income into more growth oriented assets like equities or less liquid assets such as investment grade private credit, real estate equity, mortgage loans, and private equity. As highlighted in the illustration top left, the cumulative growth in these assets is quite significant, largely driven by increasing allocations to investment grade private credit, which has more than doubled since 2008 on both P&C and Life balance sheets. Allocations have grown as a percent of invested assets from 7.7% to 21.5% and 2.4% to 36% for the P&C and Life industries, respectively.

The migration to lower quality credits within public corporate bond allocations is not without risk. For example, the share of BBB credits in the investment grade corporate credit index has continually increased over the last 20 years, now representing over 50% of the index's market capitalization (from 29% 20 years ago). There is more leverage today among BBB issuers than there was five years ago (the median leverage is currently 2.6x versus 2.2x in 2015) and economic slowdowns can increase the risk of downgrades and defaults in this part of the market.

The recent COVID-19 fallout being felt across the industry has forced insurers to rethink liquidity and fully understand any capital and solvency model implications. The good news is that insurance companies are generally better capitalized with some of the lowest leverage ratios in history, as highlighted by the graph bottom left.

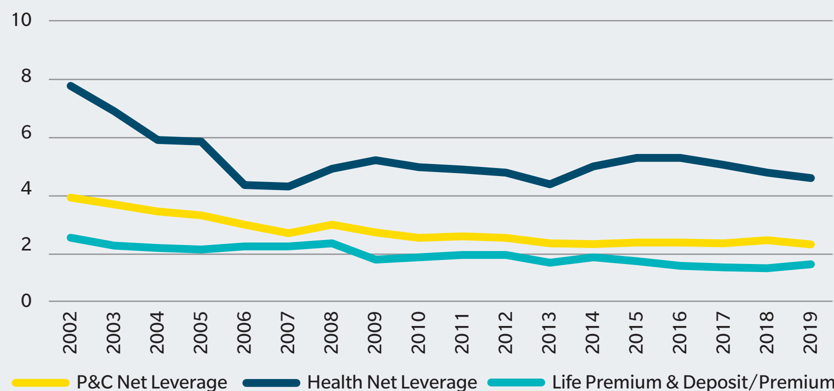
In light of these persistent and more recent market challenges, it's essential that insurance companies

Non-Core Assets



Source: S&P Global Intelligence as of 12/31/2019, NAIC – as of 12/31/2019, AM Best- as of 12/31/2019.

Insurance Leverage



Source: S&P Global Intelligence as of 12/31/2019, NAIC – as of 12/31/2019, AM Best- as of 12/31/2019.
Net leverage is defined as the sum of an insurance company's net premiums written ratio and its net liability ratio.

evaluate the current state of their operational profile and investment portfolio relative to future business and investment goals.

Evaluating the portfolio's current state

Now more than ever it's important to assess operational and investment risk profiles of the insurance enterprise. The insurance solutions group at SLC Management has developed, and refined over decades, a robust and holistic framework for evaluating an insurance company's investment risk within the context of operational and capital management considerations.

Our analytical framework includes:

1. **Industry and peer review** – Profiling different segments of the insurance industry for establishing benchmarks of investment risk behavior.
2. **Capital and surplus position** – Understanding the assets needed to support reserves provides important insight on optimal non-core and less liquid asset allocation, which is typically measured against capital.
3. **Cash flow modeling** – Sources and uses of cash flows coupled with stochastic cash flow modeling highlights a company's ability to remain solvent during periods of stress.
4. **Tiers of liquidity** – Understanding alternative sources of liquidity can have important implications for allocating into less liquid asset classes. Some of these alternative sources of liquidity include, Federal Home Loan Bank (FHLB) funding, reinsurance structure and lines of credit.
5. **Expanding the opportunity set** – Utilizing efficient frontier modeling that seeks to maximize the risk to reward ratio.

We also monitor regulatory and capital requirements to avoid adverse impacts on portfolio results. Our regulatory, accounting and capital management expertise includes:

1. Managing assets within regulatory frameworks of various domiciles, including investment restrictions, tax considerations and reporting/ audit requirements.
2. Accounting principles focused on multiple accounting basis including SAP, GAAP, Tax, etc.
3. Capital modeling that reflects various rating agency models and corresponding asset allocation.

By conducting an analysis that's supplemented by regular monitoring of markets and capital management expertise, companies are better able to navigate market cycles, weather downturns and take advantage of market dislocations.

Creating the guideposts for risk appropriate investing

Establishing a baseline for risk appropriate behavior begins with a detailed and highly customized peer analysis. This will help to define an appropriate statement of investment policy that supports long-term investment objectives. Below we illustrate a sample analysis that focuses on investment risk leverage. Reserve and surplus portfolios can have very different risk profiles. Management of reserve portfolios typically are fixed income oriented with duration and maturity profiles that match ongoing liabilities. Surplus portfolios, on the other hand, can create capacity for non-core and less liquid asset classes that can allow companies the potential to increase return and yield profile. Key takeaways include:

- Peer analysis
- Capital capacity for less liquid and illiquid investments
- Percent of capital allocated to risk assets

In conjunction with the balance sheet analysis, further analysis on liquidity can help define appropriate maturity structure and alternative asset allocation. The illustration of Projected and Stochastic Cash Flow overleaf provides a general output of projected balance sheet and cash flows from operations. By using a hypothetical P&C insurance enterprise, we can highlight our stochastic cash flow modeling, to help identify potential operational cash shortfalls. In this example, in a VaR 99% (1 in 100 year event), operational cash shortfalls are easily met by the reserve portfolio's maturities and prepayments (blue bar). This highlights the portfolio's ability to invest surplus assets (yellow bar) to increase return and yield by increasing duration or investing in non-core, less liquid and other alternative and risk assets. To summarize, this risk modeling impacts two important operational considerations:

- **Asset Liability Management** – Assessing the amount of assets needed to support potential liability cash flow demands and those assets assigned to capital and surplus for achieving higher risk adjusted returns.
- **Stochastic Cash Flow Analysis** – This exercise tests whether maturities from the reserve portfolio are sufficient to support potential operational cash needs or if assets assigned to surplus are required.

Additional considerations for less liquid assets

When allocating into less liquid assets, there are three key considerations that SLC Management takes into account on behalf of our clients.

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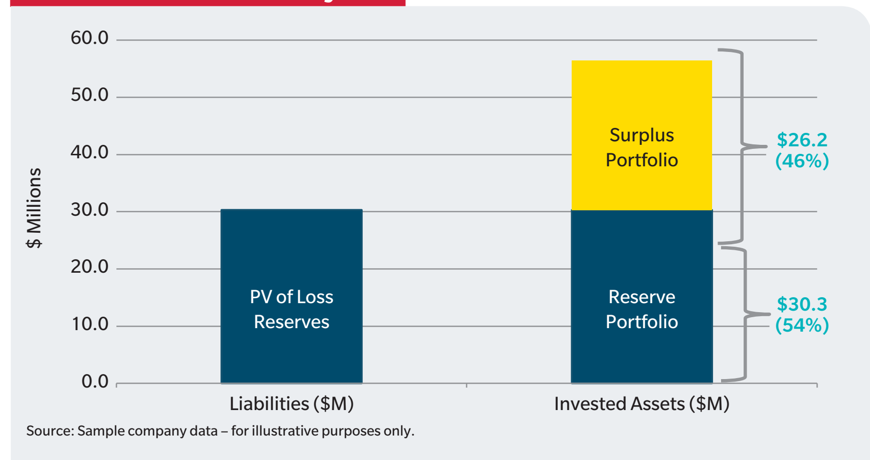
Balance Sheet Analysis



Source: Sample company data – for illustrative purposes only.

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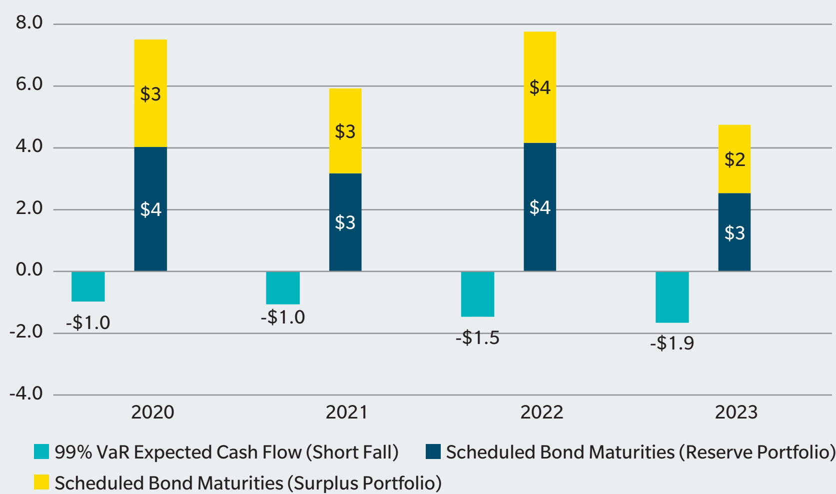
Projected Stochastic Cash Flow



Source: Sample company data – for illustrative purposes only.

1. **Balancing risk while capturing yield:** We leverage an SAA framework to understand how to increase yield in a risk aware manner while also increasing portfolio diversification. Blindly hunting for yield could introduce risks to surplus and operations that are often unknown until a triggering event like COVID-19 occurs.
2. **Understanding liquidity requirements and the illiquidity premium:** Liquidity analysis is critical for companies to ensure they not only have the necessary cash to pay claims and support the business, but are also effectively using illiquidity within the investment portfolio. Illiquidity is a lever that can help maximize yield without adding credit risk, which we believe may be a prudent approach for some insurers in current market conditions.
3. **Preparing for success across market cycles:** Effectively managing operations and investment portfolios allows insurance companies to understand current positioning and the implications of stressed scenarios. This helps organizations be less reactive during market downturns and business interruptions, and well-positioned to take advantage of market dislocations. Examining different approaches through the lens of COVID-19 could be a helpful exercise.

The importance of the asset manager partnership

Insurance companies must plan for and react to a number of unknown variables. And with current market volatility likely to persist, insurers could benefit from an investment manager that has the experience, processes and tools to create customized strategies based on their unique needs and operating profile. There is no single asset allocation approach or set of guidelines that will work across the board; every company has a unique set of risk, yield and liquidity requirements.

SLC Management understands the regulatory, capital and market challenges facing P&C, Life and Health companies of all sizes. We manage the full spectrum of insurance mandates, including fully outsourced and standalone investment-only mandates across public, private, liquid and illiquid strategies. We combine this insurance-focused mentality with proprietary tools to create strategies that build and optimize surplus and add value to our clients' core business. And we deliver exceptional client service through our team of credentialed actuaries and insurance experts.

Our team is focused on the importance of implementing a risk management framework for less liquid assets. Coming soon is three part series aimed at providing actionable insights to help support long-term investment objectives.

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