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Managing liquidity and fraud risk in a time of economic crisis

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Bill Chernelich examines in detail the key liquidity and fraud risks that insurance company directors and management must be aware of in the current economic environment, and describes how proactive and aggressive management of these risks can help them meet the unexpected.

MANAGING LIQUIDITY AND FRAUD RISK IN A TIME OF ECONOMIC CRISIS

The current economic crisis is presenting insurers with a number of challenges, the most prominent of which is managing liquidity risk. While few insurers thus far have faced situations as critical as those affecting many banking institutions, the industry has very real concerns about liquidity – not least because it will be very difficult in the current environment to raise capital. In addition, as so often happens in times of economic distress, the risk of fraud – both internal and external – is much greater now than it has been in many years. Even though most insurers already have comprehensive safeguards against fraud, the current environment will put them to the test.

Liquidity risk

With a handful of highly visible exceptions, most of the insurance sector has been spared the worst of the direct liquidity shortfalls. However, the deepening relationship among sectors means that insurers remain exposed to liquidity risk, both directly through their operations and indirectly through impacts on producers, investment managers, broker-dealers, and business partners. In either case, a sudden loss of liquidity could result in the

need for a significant, and painful, infusion of capital. And, finding that capital right now would be a difficult challenge.

Boards and senior management of insurers need to be aware of these risks and implement robust contingency plans, as well as controls and systems, to carefully identify, monitor, and manage them. In particular, experienced executives know that almost every agreement their company has ever entered into has so-called Armageddon clauses. Lawyers include these clauses to protect their clients, but they are often forgotten or unmonitored, because Armageddon is never supposed to arrive. (However, today's financial market conditions have brought it perilously close.) These clauses can be triggered by a significant rating downgrade, a 'Material Adverse Change,' a change in control, or violation of a debt covenant. In some cases, these clauses will work against a company, and in others they will give a company the right of action against others. Insurers need to ask themselves now when they last did a comprehensive 'Trigger Analysis' to understand their exposures and opportunities under these Armageddon clauses.

Liquidity risk is a challenge that all insurers have to address

It has been brought on by the ever-expanding credit crisis, and is something which has not been widely seen in the insurance industry since collapses in the markets for high-yield bonds and real estate in the late 1980s.

Insurers have multiple liquidity risk exposures. For example, in recent years, several publicly-traded insurers have borrowed heavily to fund stock buyback programs, or to fund acquisitions. This debt often is on the balance sheet of the public holding company, whose only significant source of cash is dividends from its regulated insurance subsidiaries. As the insurance operations experience a perfect storm of declining business, pressure from rating agencies to increase capital, Other than Temporary Impairment (OTTI) charges eroding surplus, and their own liquidity strains, it may not be possible to pay dividends to the holding company.

The ongoing trend of rating downgrades is also having an effect. In some cases Guaranteed Investment Contracts (GICs), general guarantees, support



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letters, credit default swaps, and other agreements have clauses requiring collateral posting in the event of a two- or three-notch drop in an insurer's rating. Reinsurance treaties often allow for rescission if ratings drop too far. For reinsurers, this could mean returning significant amounts of premiums in cash or liquid investments to rescinding cedants.

Some insurers have been seeking new capital, including access to the Troubled Asset Relief Programme (TARP). If too large a portion of the capital is in new hands, change-in-control can be triggered. Many agreements have clauses giving counterparty rights upon a change in control, and tax laws at all levels (including local property transfer taxes) can trigger significant tax costs. In addition, there is an ever present threat of large CAT losses; earthquakes know no season. Replenishing capital lost to CATS will be very difficult under current credit market conditions. Moreover, a very recent and unusual risk for insurance companies is the real possibility that their 'unauthorized' reinsurers (off-shore reinsurers) may not be able to renew lines of credit supporting the letters of credit that insurers must have in order to recognize the reinsurance benefits in their statutory capital. Without the reinsurance benefits, RBC levels could be breached, ratings could take a hit, and dividend-paying capacity could evaporate. The

good news is that the NAIC and key states should provide some relief in this area.

Life insurers are not immune to these problems, either. Although most of them use asset/liability management (ALM) programs to measure their liquidity risk, many of these programs are conducted annually and may not reflect current market conditions. Not only could valuations be out of date, but cash inflows and outflows may need to be recalibrated. For example cash inflows could decline because of reduced prepayment speeds on mortgage-backed securities, failure of bullet mortgage loans to repay, delinquent rents on investment real estate, or a severe decline in the sales of variable products tied to the stock market. On the other hand, cash outflows could accelerate due to surrenders of Bank-owned Life Insurance (BOLI)/Corporate-owned Life Insurance (COLI) policies, surrenders or withdrawals of annuities, an up-tick in policy loan requests, or defaults under securitizations such as AAA deals, European Medium Term Notes, or Trust Preferred deals.

Insurers also could be affected by the financial condition of their business partners, such as Managing General Agents (MGAs), investment managers, and insurance brokers. These partners could go into bankruptcy or receivership while owing debts to an insurer. They also could take advantage of the insurer by delaying cash transfers to meet their own immediate operating cash needs. In addition, there

is a risk that a business partner could engage in fraud. (See the PricewaterhouseCoopers' Point of View, 'Insurance Company Fraud Risk') They also need to understand their exposure to receivables from reinsurers and other business partners.

Insurers also are exposed to risk related to their invested capital. The liquidity, performance and safety of many investments are in question. Although most insurers have by now reviewed their portfolios to identify problematic direct holdings, they may not fully understand their exposure through assets included in partnerships such as hedge funds. In addition, the valuation of many holdings, particularly less-liquid derivative products, is far from clear. The uncertainties over mark-to-market accounting, including controversies over Financial Accounting Standards Board fair value accounting guidance under FAS 157 and FAS 159, have only added ambiguity to these calculations.

Insurers need to take aggressive and proactive steps to identify, monitor, and mitigate liquidity risks

They should begin by identifying potential problem spots. For example, they should carefully review all of their significant agreements, determine what occurrences could trigger a default or cash call, and take steps to prevent such events wherever possible. They also should re-evaluate their ability to renew expiring credit facilities, and

closely test the performance of sidecars and other standby capital vehicles intended to protect liquidity. Similarly, they should update their ALM programs to reflect current conditions and valuations. These reviews may lead to a decision to increase the amount of liquid investments on hand – and, as importantly, decide what a liquid investment is in today's environment.

During periods of tightened liquidity, it is crucial that management prepare contingency plans for unforeseen developments. For example, they may want to delay share repurchases, have solid lines of credit available, or be able to address an event of default or cash call before it triggers a domino effect elsewhere. Directors also should review projected holding company and insurance subsidiary cash flows and contingencies for shortfalls. Often, cash outflows are fixed whereas cash inflows require action, approval, or agreement, all of which take time.

While many insurers may have identified the investment risks in their own portfolios, they also need to carefully monitor the risks extant in indirect investments made through partnerships and joint ventures. They also need to be current with accounting guidance for valuation, in order to be able to assess potential OTTI charges on their holdings.

Liquidity risk is an ongoing challenge, and insurers understand better than anyone the importance of managing it.

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While the unexpected always can occur, liquidity risks associated with ordinary operations can frequently be mitigated through proactive, ongoing, and collaborative initiatives and robust management. Directors and managers need to identify potential risks early on through rigorous due diligence, implement corrective measures, and establish contingency plans. This will not be easy or inexpensive. And, of course, once these risks are understood and plans are in place, the SEC will expect full disclosure to help investors understand the risks and what management is doing about them.

Fraud risk

In the current economic downturn, insurance companies face many of the same risks as other financial services companies. However, one of those risks – fraud risk – has aspects which are unique to insurance. Most insurers already have in place robust controls and systems to identify, monitor, and manage fraud risk, and protect themselves, their policyholders, and their shareholders from risks. However, the current environment will put those measures to the test.

Economic downturns historically feature increased risk of fraud-related losses. Insurers need to focus on the leading sources of fraud, both internal and external, including policyholders, business partners, and employees.

Perhaps the most common fraud risk comes from false claims made by policyholders; for example,

homeowners who have over-leveraged the equity in their houses. With falling housing values, about one in six US homeowners – 12 million households – currently possess property that is worth less than what they owe on the mortgage. Unscrupulous owners may try to cover losses through insurance claims, and second homes and investment properties are especially at risk of arson or other criminal actions. The risk is not only from homeowners: small business owners, unable to obtain credit, may resort to arson or false claims to raise money.

Business partners provide another source of fraud risk

In recent years, insurers have outsourced many basic functions. They hire third-party administrators (TPAs) to process claims, rather than handle them in-house. However, insurers often grant TPAs effective control over a company's checkbook as a means of expediting claims payment. In such circumstances, TPAs could use the insurer's funds to cover their own operating costs or debt payments.

Insurers also have retained managing general agents (MGAs), especially for specialized lines or 'program business' in which they lack in-house expertise. However, MGAs could apply underwriting guidelines more loosely to under-price new business in order to make sales. In two or three years' time (when claims begin to flow), the MGA and the company's commissions may be gone. Moreover, in the past, MGAs also

'Liquidity is an illusion. It's always there when you don't need it, and rarely there when you do.'

Michael Milken, 1989

have delayed reporting claims and slowed premium transfers to take advantage of the float.

Because retail agents operating on commission make most insurance sales, they face the temptation to skirt guidelines to increase sales. In the current market, there have been cases in which agents have created false statement balances for their customers, with the agent pocketing the money. Agents also have colluded in false valuations. It has been more than ten years since the Insurance Marketplace Standards Association (IMSA) was established to provide assurance over ethical sales practices in the life insurance industry. It is likely that some companies have not remained fully compliant with IMSA sales practices, or have even had an IMSA review. With the huge drop in the equity markets, there will surely be plaintiffs' lawyers claiming that their clients did not understand the risks in the variable policies they were sold.

Other business partners, such as investment managers, also could engage in fraud for their own ends. People whose incomes are tied to performance will not want to see their income drop too far. Alternative investments will be especially exposed to deferred recognition of declining value.

An insurer's own employees present another source of fraud risk

They may be in financial distress because of investment losses, excessive debt, or reduced income. The risk is not limited to lower-paid employees: even senior executives may be at risk. The recent evaporation of trillions of dollars of personal wealth is unprecedented. Many executives may have lost most of their life's savings, and there have been well-publicized examples of senior executives needing to sell company stock to meet margin calls. In addition, some executives have purchased second or third homes as investments. As interest rates reset, or bullet mortgages become due, they may suffer financial reversals and resort to fraudulent behavior, including the acceptance of bribes or embezzlement, 'borrowing' from the till, if only until their circumstances change. Directors should remember that, no matter how strong their company's controls are, senior executives often have the ability to circumvent those controls. These are extraordinary times, so extraordinary temporary controls are sensible.

Significantly, a recent, proprietary PricewaterhouseCoopers survey of insurance company directors

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and executives found that the boards of directors at 93% of the respondents have not determined whether any of the top five or ten executives in their company are currently in significant personal financial distress. In three years' time, will directors be accused of being aware of this risk but be unable to demonstrate that they responded to it?

Insurers need to take aggressive, proactive steps to identify, monitor, and mitigate fraud risk from all common sources.

- In light of the high risk of policyholder fraud, insurers need to carefully monitor property claims for evidence of arson or other malfeasance. This is especially true for residences with overextended owners or businesses that are

failing. Some of this is common sense: a fire at a failing business that has recently increased its coverage limits should automatically raise red flags and spur closer investigation;

- As a result of problems with sales compliance in the early 1990s, many insurers strengthened their insurance sales compliance efforts, including compliance monitoring. Insurers need to make certain that they have maintained rigor in executing compliance, and monitor sales efforts by agents;
- Insurers need to prevent business partner fraud by strengthening their insurance sales compliance efforts, monitoring TPA claims processing and expenditures, and carefully examining MGA

activities to make certain that guidelines are being followed. Insurers should not take it for granted that adequate controls are in place; and

- Employees, including senior executives, should not be exempt from scrutiny, both before and after hiring. Insurance company boards should make certain that their financial and operating controls are robust and cannot be circumvented by any one individual. Even in today's post-Sarbanes-Oxley environment, a single highly placed executive can override systems or approve contracts or claims.

Since internal theft is usually covered by directors' and officers' insurance, the real loss in cases of employee fraud is in reputation and a loss of the company's credibility. That cannot be insured against, so strong steps are needed.

Better screening during hiring, identification of at-risk employees through credit and background checks, and multiple redundant approval systems can help reduce or eliminate internal fraud. Such systems are fairly routine in

investment management firms and in broker-dealers, but less so in the insurance industry.

Strong conflict of interest policies can reduce the opportunity for fraud. In addition, employee assistance programs – including something as basic as a helpline for individuals who may be experiencing financial distress – can help provide overextended employees with the help they need to avoid the temptation to defraud the company.

In many cases, the losses caused by fraud will come when they are least expected

Since these threats are both internally and externally generated, the solutions must be directed at identifying and neutralizing potential threats from both sides of the fence – something that insurers, reluctant to alienate customers, employees, or business partners, have been historically reluctant to do. But the enormity of the threat in the current credit crisis, market turmoil, and possibly an extended economic downturn means that insurers must take proactive steps – now – to protect against fraud. □

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