



The Collateral Squeeze

How inflation & a potential recession may impact insurer requirements



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“It’s like déjà vu all over again.”

–Yogi Berra

In less than three years, insurance buyers have grappled with social inflation, COVID-19, economic shutdowns, civil unrest, a hard market and rapidly growing inflation. Many have restructured their programs, taking on more risk and/or absorbing significant rate increases. We can now add the threat of a recession to buyers’ worries — an event that could have significant implications on collateral requirements for large deductible casualty insurance programs.

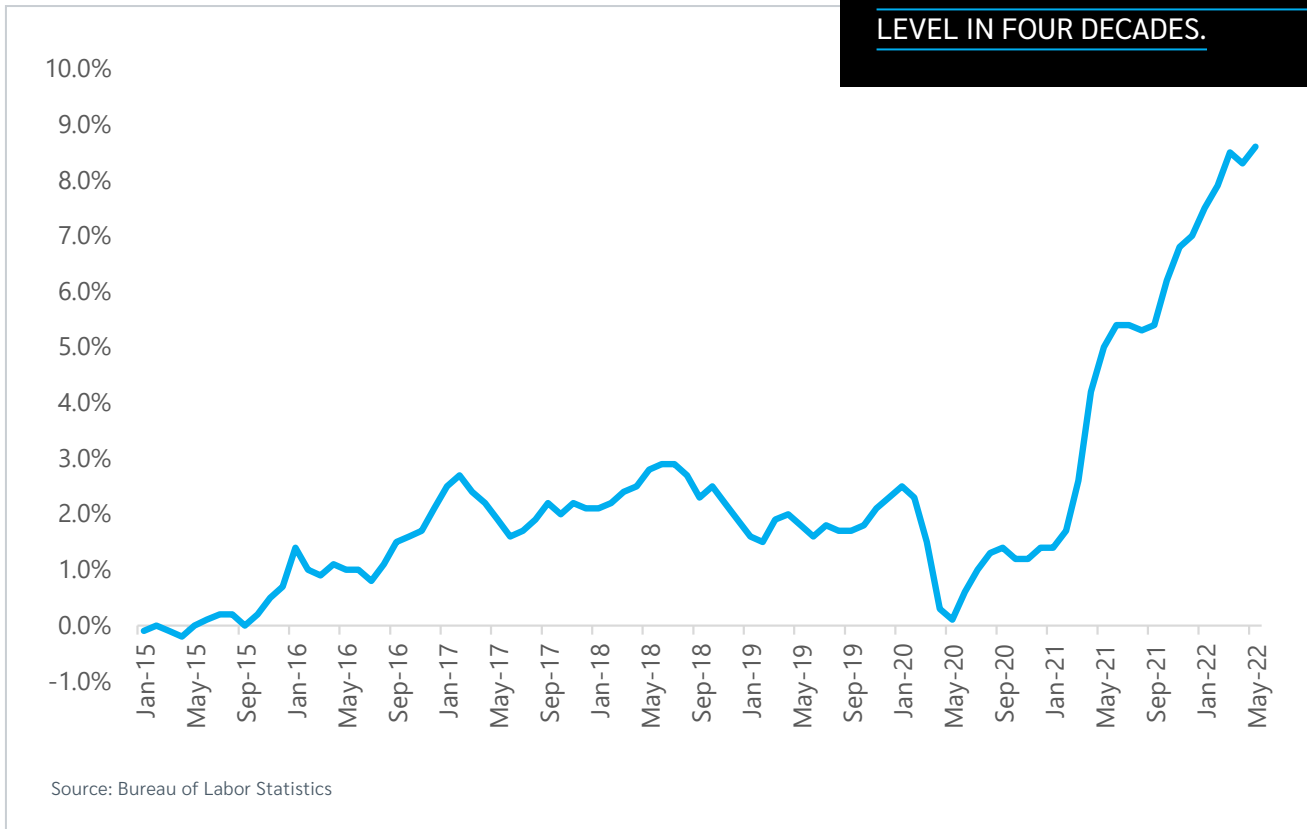
Inflation’s comeback

Disco may be dead, but for those who lived through the 1970s, fears of a repeat are “Stayin’ Alive.”

During that turbulent period, an accommodative monetary policy, energy supply challenges and high unemployment gave way to slow growth, wage-price spirals and rising levels of inflation. The Federal Reserve was criticized for allowing high inflation expectations to set in and ultimately making it more difficult to bring under control. Peak inflation — as measured by the Consumer Price Index (CPI) — hit 13.5% in 1980 and was only subdued following two painful recessions, and the federal funds rate being pushed as high as 19%.

Although we aren’t quite back to the ‘70s yet, warning signs are flashing. In its effort to minimize unemployment following the pandemic, the Fed was slow to recognize and address inflationary pressures. The shortcomings of the Fed’s “Goldilocks” strategy — raising rates slowly and trying to cool the economy without economic disruption — became clear when the CPI rose to 8.6% in May 2022, its highest level in over 40 years.

FIGURE 1: THE CONSUMER PRICE INDEX HAS RISEN TO ITS HIGHEST LEVEL IN FOUR DECADES.



In response, the bank took the unusual step of executing the largest interest rate increase since 1994 — while making clear that more is to come. It also signaled its intent to reduce its \$9 trillion balance sheet of bond holdings, which — in theory — should further reduce the money supply.

The Fed also promised a “full commitment to restore price stability.” Experts now forecast the federal funds benchmark at roughly 3.4% by the end of the year, up from 2% in April.

Since the beginning of the pandemic, U.S. households have added about \$2.5 trillion in excess savings, which has helped drive spending and spurred economic growth. Strong demand and ongoing supply chain issues, however, have driven pricing up, forcing consumers to spend more on basic needs such as rent, gasoline and food. The CPI for food rose more than 10% from May 2021 to May 2022, while energy costs jumped more than 30%. Housing — already expensive — has become even more costly as rents and mortgage interest rates have surged.

Many households, particularly low- and middle-income ones, are now being forced to dip deeply into savings each month simply to get by. By April 2022, the personal savings rate in the U.S. had dropped to a 14-year low of 4.4%.

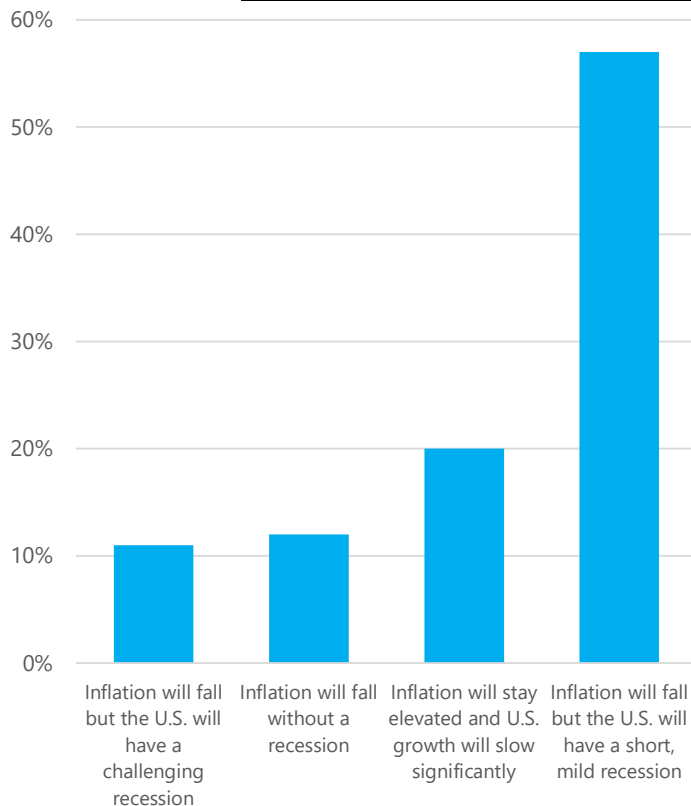
Rapid declines in market valuations, meanwhile, largely reversed the “wealth effect” associated with rising equities. On June 13, the S&P 500 Index closed in bear market territory for the first time since March 2020.

Is a recession inevitable?

JPMorgan Chase CEO Jamie Dimon recently warned of an “economic hurricane” as consumers run through their savings in the next six to nine months, growth slows and the Fed continues to aggressively withdraw liquidity from the market. Economists surveyed by The Wall Street Journal have also dramatically raised the probability of a recession, now putting it at 44% over the next 12 months.

Similarly, CEO confidence has dipped to its lowest level since the beginning of the pandemic. A survey released by the Conference Board in May found that a majority of CEOs believe a recession is likely coming soon.

FIGURE 2: MANY CEOs EXPECT THE FED'S TIGHTENING MONETARY POLICY WILL LEAD TO A RECESSION.



Source: The Conference Board

If a recession seems inevitable, two questions become crucial: How bad could a recession be, and how long might it last?

Many experts believe that any downturn will be mild and short-lived, but are also quick to note any number of unknowns. Inflation expectations could also become self-perpetuating, forcing the Fed to take even more drastic action. The war in Ukraine, rising crude and commodity prices, shutdowns in China, and additional COVID-19 variants could also amplify the economic pain.

As Lockton noted in a recent report, inflation will complicate exposures, valuations, loss estimates and accruals. Buyers of large deductible casualty programs could also see a significant impact on collateral, precisely when they can least afford it.

Record levels of corporate debt, rising interest rates and intensified risk aversion could increase refinancing and funding costs. Borrowers with fixed-rate debt could feel the impact as existing debt approaches maturity and is refinanced at higher rates. Variable-rate debt costs could also rise once benchmark rates exceed their floors. In the face of this and a potential economic slowdown, collateral discussions are likely to intensify.

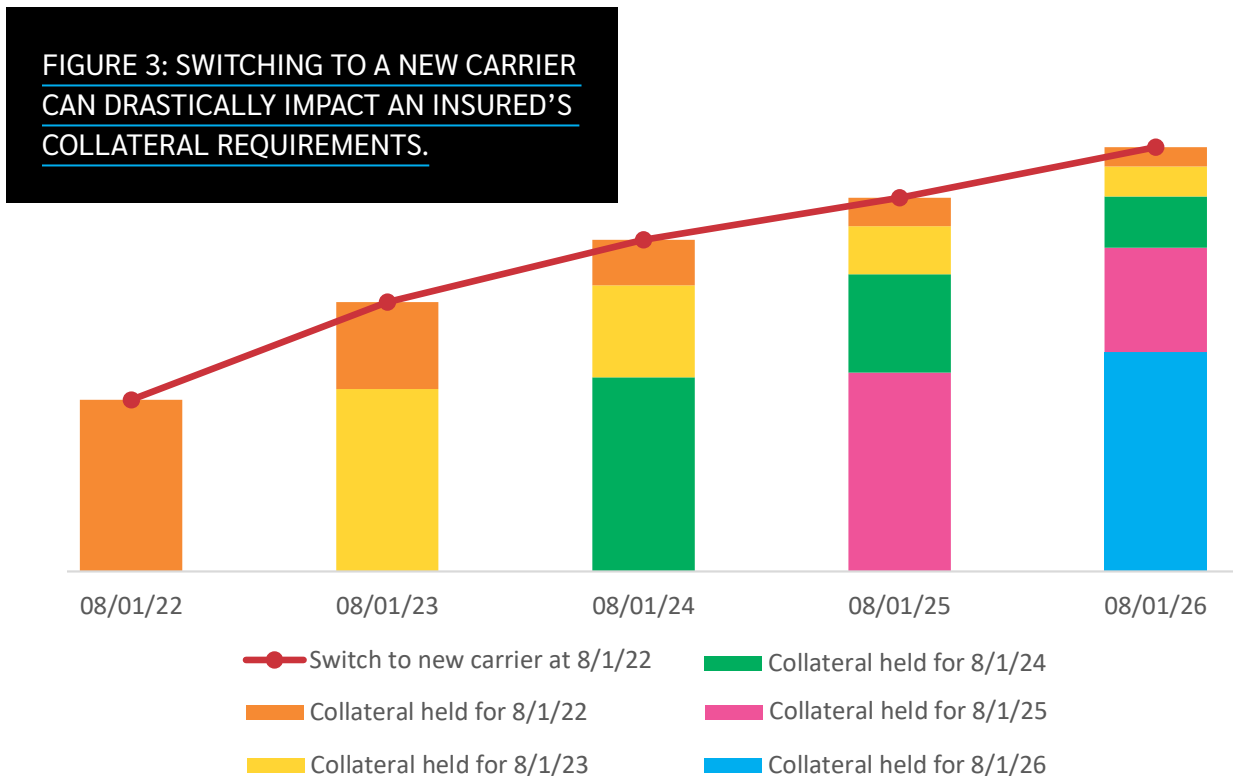
Why collateral is needed

Under a large deductible insurance program, buyers agree to accept a share of claim costs in exchange for lower premiums. The insurer agrees to pay claims as they occur and invoice the policyholder for all sums that fall under the deductible.

Since these claims may take years to pay out and be reimbursed, insurers typically require a policyholder to post collateral, usually in the form of a letter of credit. This collateral minimizes the credit risk associated with policyholder default or bankruptcy and helps insurers meet the surplus requirements of financial rating agencies.

The amount of collateral required is typically tied to unpaid loss estimates. During the first several years with a new carrier, this amount will build or “stack” as reserves build at a faster pace than losses are paid out. Over time, loss payments from historical policy years should accelerate to the point where they largely offset new reserves — causing the total collateral requirement to plateau. How quickly this happens will depend on changes in deductibles, exposures and operations.

When a program is moved, the collateral held by the prior insurer should decline each year until all losses are closed. Any new insurer will, however, need to collect its own collateral, starting the stacking process all over again. This can often create leverage for an incumbent market and become an impediment to moving a program.





Potential effects on collateral

Even under the best of circumstances, collateral negotiations can be a time-consuming and burdensome process for policyholders. Credit guidelines, transparency of calculations, preferred instruments, flexibility and consistency can vary widely from one insurer to another.

Collateral requirements are also heavily dependent upon loss and payment estimates. Standard actuarial methods rely on past patterns to predict future outcomes. A significant rise in inflation, however, invalidates that assumption and increases uncertainty around ultimate costs.

Insurers are keenly aware of the relationship between inflation and future development. An inflationary outlook is likely to lead to conservatism in the form of elevated loss picks, pressure to accept higher retentions and/or higher collateral requirements.

A recession may further complicate matters by impairing insureds' financials through reduced demand, rising costs and declining margins. **This could result in reduced discretionary credits, higher borrowing costs and/or diminished borrowing capacity.**

In short, the natural tension that already exists in the collateral process is likely to increase significantly.

Effectively managing all of this requires careful planning and a fundamental understanding of the interplay among four main quantitative and qualitative factors that drive insurers' collateral estimates.

01 *Loss analysis*

A thorough analysis of historical and projected losses is one of the main determinants of an individual insured's collateral requirements. This review should be done early in the renewal process and include all available information.

Underwriters, however, are often pressed for time and can sometimes overlook important information about an individual company's loss history. Similarly, there can be a tendency to paint certain industry sectors with a broad brush, while failing to account for an insured's unique operations or characteristics.

Economic uncertainty may also raise concerns in an underwriter's mind about potential changes in employee behavior. Underwriters may be concerned that the threat of a recession could lead to a spike in workers' compensation claims frequency as employees seek a "hedge" against potential job losses.

It is critical to partner with a broker's actuary, who understands the process and has a strong working relationship with carrier counterparts. While it may seem that loss analysis should be a relatively proscriptive process, in reality it is a blend of art, science and practical experience.

A good actuary will take the time to understand an insured's business, including growth projections, claim payment patterns, TPA reserving practices and changes in operations or state mix. This insight, combined with a solid foundation of actuarial knowledge, is crucial for effective advocacy and optimal collateral outcomes.

Insurance buyers should keep several factors in mind as they look to differentiate their risks in collateral negotiations.

Effective collateral negotiations start with the basics. Before starting any modeling, loss data should be carefully reviewed to ensure that deductible or occurrence caps have been appropriately applied. Similarly, historical claims associated with divested or discontinued operations should not be included in any estimate of future losses.

Exposures represent another opportunity for insurance buyers, who should adjust for audits, layoffs and/or changes in business operations. They should also be careful to differentiate between real and nominal exposure increases. Are payrolls going up because of higher wages, or has the company added new workers? Are sales rising because of new business or higher costs?



What should be included in a collateral review?

- Outstanding liabilities, by policy year
- Projected losses for the upcoming policy year
- Frequency/loss trends
- Claim closure patterns
- Loss trends
- Exposure analysis
- Policy terms

When possible, insureds should provide exposure metrics that are not sensitive to inflation, such as headcount and units sold, alongside typical payroll and revenue figures. This can help to delineate between real and nominal changes in risk.

Insureds and their brokers should take the time to highlight favorable trends, including frequency/loss rates, claim turnover or closure rates. The use of relevant benchmarking tools — including Lockton Insight, which can help companies uncover the true drivers of losses — can help validate strong, historical claim performance relative to peers. When presented with quantitative evidence of consistent favorable experience, insurers are often willing to take more insured-specific nuances into account, leading to more favorable collateral outlooks.

Although historical data can create convincing arguments, insurance buyers should not overlook qualitative factors that differentiate their go-forward risk. For example, with unemployment at historical lows, many employers have been forced to hire new, untrained workers. A May 2022 Travelers study found that more than a third of workplace injuries occur during employees' first year on the job.

Tenure, training, safety practices and injury rates can all impact workers' compensation loss projections. Employers should be prepared to review these with actuaries and underwriters.

It is also important for companies and their insurers to compare loss projections and reconcile any differences. **Even when the same loss and exposure inputs are used, seemingly subtle differences around loss development factors, frequency/severity trends, actuarial methodology or the application of discretionary credits may produce highly disparate outcomes.** Understanding the net impact of these differences is critical, as is working with an advocate that can make a strong case to an insurer to adjust conflicting assumptions and reduce collateral requests.

Because the loss analysis is usually conducted early in the renewal process, there can often be three to four months between the time collateral is calculated and the inception of a new program. Buyers should be careful to ensure that an insurer's initial collateral figure includes credit for payments that will be made through policy expiration. These estimated payments should then be reconciled at policy expiration.



02 *Credit rating*

Collateral is primarily intended to minimize an insurer's exposure to the credit risk of its policyholders. Although each insurer has its own unique criteria, all will review audited financials and business plans to assess claim payment capacity and develop an overall credit rating. Insurers will more closely scrutinize insureds with weaker financials and be less flexible when setting both the amount of collateral and instrument required.

In a recessionary environment, transparency and communication are key. Risk managers should involve treasurers and CFO in collateral discussions and consider whether a meeting with a carrier's credit officer would be useful. Such meetings are best viewed as investor presentations, with a full discussion of financial trends, credit capacity, cash flow, profitability and debt maturity/covenants. Buyers should also review anticipated changes to the business and address any concerns about their companies and industries.

A carrier's credit rating also directly impacts the paid loss credits applied to any collateral calculation. If an insured's financials are considered sound, insurers will typically discount collateral by an amount equal to the loss payments estimated to be made over the next 12-18 months. Insureds should validate how many months are being applied **and** the supporting calculation for estimated monthly losses, as there can often be significant discrepancies between buyer and insurer estimates.



03 *Program structure*

Collateral is heavily influenced by the structure of an insurance program. If business slows and the cost of capital rises, insureds must carefully evaluate their priorities. For example, faced with rising premium rates, buyers often seek to reduce premium expense through higher deductibles. Ultimately, this can expose the insured to additional retained losses and higher collateral, potentially impairing available credit. Conversely, a lower retention may drive up premium expense but allow an insured to reduce collateral.

Insureds may also be able to minimize collateral obligations through the use of guaranteed cost or retrospectively rated insurance programs, group captives, risk retention groups, self-insured retentions or nonsubscription. It should be understood, however, that such changes will generally only impact collateral associated with the current and future years.

Once a structure has been selected, it is important to carefully negotiate the program agreement to define how collateral will be calculated, adjusted or closed out in future years. No two agreements are alike, and insurers sometimes inflate collateral requirements by including loss conversion factors or claim handling charges.

To reduce any potential for surprise, both parties should consider codifying the timetable for annual adjustments, credit rating methodology and how collateral requirements will be calculated. In some instances, predetermined loss development factors or closeout features may be appropriate. Insurer flexibility will vary widely, but any agreed terms should apply for the life of the program.

Finally, it is important to recognize that collateral can also be impacted by an insured's overall relationship with its insurer. Although the term "partnership" is sometimes used too liberally, policyholders that forge long-term, multiline relationships with insurers typically see more willingness to compromise. When a credit officer and underwriter understand the risk and have a personal relationship with a buyer, the assumptions and outlook informing their collateral calculations can become more optimistic.

04 Instrument

Once an amount has been agreed upon, the final step is to determine the form in which it is provided. Although insurers will ultimately have to agree on what is acceptable, an insured should seek to negotiate the instrument best aligned with its overall objectives, financial priorities and credit position.

The most prevalent form of collateral for loss sensitive programs continues to be a letter of credit (LOC). Insurers believe that an LOC represents the strongest form of protection since it is a contract between a carrier and an unrelated third party (the insured's issuing bank). It is also a demand instrument and provides the insurer with an unconditional right to draw funds, if needed.

When issuing a LOC, a bank charges a fee against the amount pledged. These fees can vary widely based on overall credit conditions or an insured's financial position. LOCs also represent a use of a company's overall credit facility, and therefore reduce available borrowing capacity.

Depending on the creditworthiness of an insured and/or the competitive nature of a transaction, an insurer may be willing to accept alternate instruments for some or all of the collateral. Some of the more traditional options are shown below.

Letter of credit	Cash	Trusts — static	Trusts — working	Surety
<p>PRO</p> <ul style="list-style-type: none"> • Cash flow efficient. • Easiest administration. • Carrier's preferred form and credit deviations more likely. • Considered bankruptcy remote. <p>CON</p> <ul style="list-style-type: none"> • Nonworking and stacks over time. • Ties up credit revolver capacity that could be used for other capital expenditures with higher rates of return. • Rising interest rates may make this more expensive • Only adjusted once a year. 	<p>PRO</p> <ul style="list-style-type: none"> • Investment income potential. • Doesn't tie up capacity under revolver. • No trust oversight fees. • Easier to administer than trusts. <p>CON</p> <ul style="list-style-type: none"> • Requires significant upfront cash flow. • Nonworking and stacks over time. • Investment rate of return typically lower than insured's cost of capital. • Carriers do not have as optimistic view of cash as bankruptcy remote and therefore may be more conservative on paid loss credits. 	<p>PRO</p> <ul style="list-style-type: none"> • Investment income potential. • Greater control over investments, as funds held by third party vs. the carrier. • Doesn't tie up capacity under revolver. • Typically viewed as more bankruptcy remote than cash held at carrier. <p>CON</p> <ul style="list-style-type: none"> • Requires significant upfront cash flow. • Investment rate of return typically lower than insured's cost of capital. • Nonworking and stacks over time. • Carriers will charge an oversight fee to ensure asset value of trust covers collateral need. 	<p>PRO</p> <ul style="list-style-type: none"> • Efficient use of funds as claims are being paid out of collateral. • Mitigates the stacking effect of collateral. • Potential for investment income but lower than static as trust balance decreases over the year, and funds must be highly liquid. <p>CON</p> <ul style="list-style-type: none"> • Requires significant upfront cash flow. • No paid loss credits — 100% collateralized. • Carriers may charge a surcharge to account for working. • Carriers will charge an oversight fee to ensure that asset value of trust covers collateral need. 	<p>PRO</p> <ul style="list-style-type: none"> • Does not restrict the borrowing or letter of credit capacity. • May be cheaper than letter of credit fees or opportunity cost of cash collateral. <p>CON</p> <ul style="list-style-type: none"> • Carriers usually accept only 15% to 25% in surety. • Limited number of acceptable sureties. • Acceptable bond language will need to be modified to meet carrier requirements.

Other less traditional options may include

COLLATERAL BUYDOWNS: In response to increased economic uncertainty, some insurers have offered more creative credit alternatives. One such option is a collateral buydown agreement, in which an insurer levies a credit charge in exchange for a reduction in collateral. The size of the credit charge can vary considerably based on an insured's financials and cost of capital. When an insured has a material restriction on its credit position, however, a credit buydown can be effective.

OFF-BALANCE SHEET TRANSACTIONS: Insurance buyers seeking to reduce or minimize the impact of collateral on available credit can pay an annual financing fee, typically comparable to an insured's subordinate debt rate, to a third party. That entity then arranges with an NAIC-approved bank to issue a new/replacement LOC on the insured's behalf. In theory, this would be an off-balance sheet transaction, with the financing fee considered an insurance expense. Although Lockton recommends that insureds exploring this sort of option consult with their financial advisors, they are slowly becoming more mainstream and are likely to expand in use.

LOSS PORTFOLIO TRANSFER: In the face of rising inflation, open claims will only become more expensive. As a result, buyers may wish to consider the efficacy of a loss portfolio transfer (LPT) for historical policy years. Under such a structure, an insured pays a lump sum to eliminate ongoing liability for the claims being transferred and reduce the need for collateral. The cost/benefit of such a transfer can be evaluated based on actuarial projections, cost of capital, tax benefits and the savings associated with eliminating collateral. Given rising interest rates, insurers may be inclined to more aggressively price LPTs now than in past years.

Conclusion

As the Federal Reserve continues to scramble to get ahead of inflation, its focus will clearly be on reducing the money supply, which will make borrowing more expensive. Regardless of whether the U.S. economy actually enters a recession, economic growth and consumer spending are likely to slow over the next six to 12 months. When this is combined with rising inflation, companies across all industries will likely struggle to maintain profitability and liquidity.

Property and casualty insurance buyers should prepare for this environment by scrutinizing their programs and establishing clear priorities. Risk professionals should also seek to work closely with their organizations' finance teams and risk management advisors to anticipate and mitigate any impact to collateral. The best outcomes will flow from careful planning and the integration of actuarial, brokerage and risk finance expertise.







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