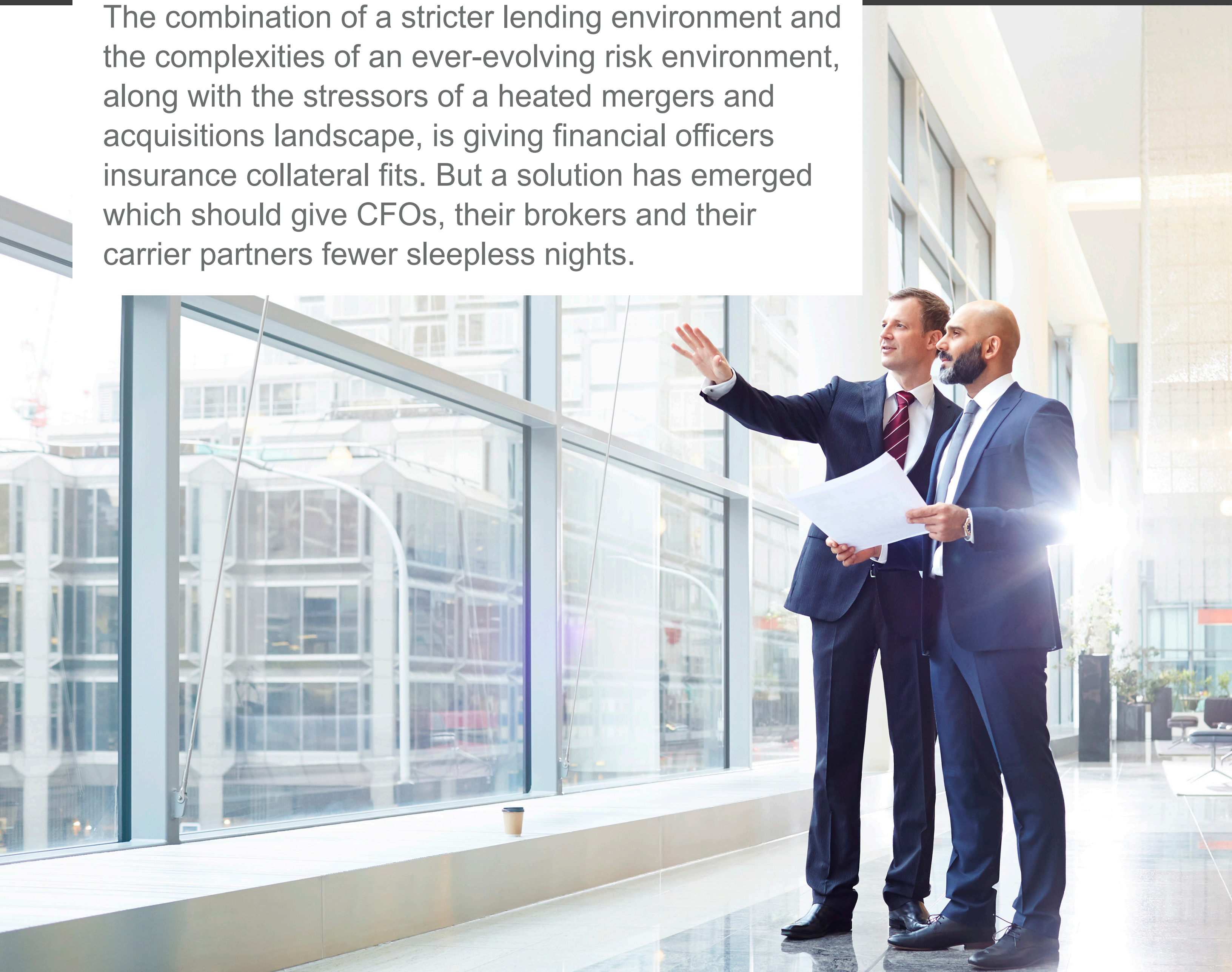
Fixing the Insurance Collateral Crunch

The combination of a stricter lending environment and the complexities of an ever-evolving risk environment, along with the stressors of a heated mergers and acquisitions landscape, is giving financial officers insurance collateral fits. But a solution has emerged which should give CFOs, their brokers and their carrier partners fewer sleepless nights.



1970 GROUP

The use of insurance collateral to bolster financial liquidity is not a novel concept.

Well-run companies that would rather devote resources to buying new equipment, acquiring another company, or hiring top-notch talent, would frequently turn to letters of credit or sureties to cover collateral requirements for insurance obligations and loss exposures.

But what worked well enough, say, 15 years ago, is not effective anymore. One important factor is that in the wake of the financial crisis of 2007-2008, banks are much tighter with their lending requirements. This has put increasing pressure on financial officers, and their insurance brokers, to find efficient solutions that can keep the vital taps of liquidity open and flowing.

In just one example among many in the past five years, Risk & Insurance editors reviewing applications in the workers' compensation category of its Power Broker® contest have increasingly run into narratives from industry-leading brokers that mention collateral challenges as a problem their clients urgently need their help in addressing.

Stephen Roseman, the CEO of the 1970 Group, which went live in 2020 with a substitute insurance collateral product, said credit-crisis-imposed regulatory changes exert a heavy influence on this.

"Typically, collateral is posted in the form of a letter of credit. The current banking regime from a regulation standpoint means that letters of credit, which are a very common form of financial instrument, are now treated as drawn capital which reduces credit availability to the client," Roseman said.

Here's a quick example to illustrate Roseman's point. Say you have a $12 million lending facility and you've asked your bank for a $3 million letter of credit to satisfy your carrier. "That means you've lost 25% of your liquidity that you would otherwise have used to run your business," Roseman said.

CHALLENGES ACROSS LINES

Workers' comp isn't the only line or exposure that is being affected by this. General and commercial auto are additional pain points. To make the problem worse, recent years have seen marked premium increases, which are forcing carriers to push for higher collateral requirements.

This doesn't stem from opportunism on the part of the underwriters. They have bottom lines to defend just like every other business does.

The continued robust mergers and acquisitions environment is yet another factor that is putting pressure on treasuries to come up with more and more insurance collateral.

Organic growth, or footprint expansion due to an acquisition both equate to the need for more collateral.

"Typically, by the time we meet companies, they are deep into their loss-sensitive collateral program, they are years into it," Roseman said.

"The company is acquisitive or they've grown organically," Roseman said. "They've grown their headcount, or perhaps they've grown their fleet," he said.

"We tend to focus on workers' comp, commercial auto and general liability," said Roseman.

"Since most companies are motivated to grow, along with that growth comes the need for more collateral. That's the pain point we are solving for."

Aside from letters of credit, surety bonds are another option that business owners might traditionally have investigated to get some liquidity relief.

"The 1970 Group approach lets corporations use our balance sheet so they can free up their own."
— ***Stephen Roseman,*** CFA
Chairman & CEO, The 1970 Group

But just as with letters of credit, surety bonds have their limitations. Sureties issue bonds that are bound by certain prohibitions and restrictions. For example, they might require a portion to be cash collateralized.

"Surety bonds are a helpful tool, but they don't provide a complete solution," said Roseman. "They often face restrictions and may even require companies to set cash aside in escrow, so that cash is no longer available to the company."

Combine the lack of flexibility created by loss of liquidity with the time and cost required to arrange alternative financing, and the frictional costs of insurance collateral obligations have become more and more prohibitive.

So what's the solution? Roseman's 1970 Group thinks it has hit the nail on the head.

FLEXIBILITY, SPEED AND OFF-BALANCE SHEET

The 1970 Group product was incubated for four years by a group of executives with extensive experience in insurance and finance and went live in 2020.

Working with a network of partner banks to backstop letters of credit issued on the clients' behalf in order to satisfy insurer requirements, the collateral obligation is transferred from the client's balance sheet to the 1970 Group's — as the guarantor — thus freeing up the insured's lending facility and access to liquidity.

"The 1970 Group approach lets corporations use our balance sheet so they can free up their own," said Roseman. "We guarantee the bank-issued LOC on a corporation's behalf,

which is thereby removed from their balance sheet.

"Partner banks issuing LOCs on our clients' behalf are admitted and approved by the National Association of Insurance Commissioners (NAIC). The credit structure is arranged by a global law firm, leveraging years of extensive experience in structured finance."

Key benefits of the 1970 Group solution are that it's quick to set up, competitive in terms of capital cost and flexible based on the collateral amounts required at renewal. Importantly, it is also off-balance sheet financing, which means it is treated as an insurance cost and typically excluded from financial covenants. This is a big advantage for companies, and it is already reaping results.

One client which had a borrowing facility in excess of $60 million was previously putting up $20 million in collateral held as a LOC issued by its bank. That was a serious limitation on their financial flexibility and ability to invest in their business. By working with 1970 Group, they were able to eliminate this constraint from their balance sheet and regained access to their full borrowing facility.

"Our solution is better because it's fast and effective," Roseman said.

"We're able to have this put into place in a matter of weeks, it is off-balance sheet and it is cost-competitive with the client's existing cost of capital," he said.

It's also flexible.

"Collateral amounts tend to fluctuate from year to year," Roseman said.

"If your company started with $3 million in collateral and it increased the following year, we'll just post the larger amount," he said.

On the other hand, if a company, say, sells a division and has fewer collateral requirements the following year, the solution is flexible and adjusts to that obligation level.

The product is already proving itself in the market.

Another 1970 Group client was close to finalizing an acquisition but needed slightly more capital. Turning to the 1970 Group's solution, it was able to free up the required capital to complete the deal.

Another client's insurers wouldn't accept LOCs from non-NAIC admitted banks, so they had to pay for two LOCs – for both their bank and an NAIC admitted bank. But because the 1970 Group uses only a network of NAIC approved banks, it was able to overcome this problem for the client and do it in a timely manner.

"This is a very flexible, cost-effective solution compared to any other alternative the client would have come across," Roseman said.

To learn more about 1970 Group's Substitute Insurance Collateral Agreement, visit **https://www.1970group.com**.