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Liquidity within the Life Insurance industry

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Contents

Liquidity within the Life Insurance industry; a risk or an opportunity?

Introduction

Liquidity risk within the life insurance industry has long since flown under the radar of executive management and regulators alike. This is primarily due to the large quantity of liquid assets traditionally held on life insurers' balance sheets, combined with the long-dated nature of underlying liabilities.

In the last 10 years, however, several factors have led to an increase in the liquidity risk profile of insurers. These include the increased use of derivative transactions, a search for yield uplift in a low interest rate environment, with a resultant increase in investment in illiquid assets, and a significant increase in claims cost due to the COVID-19 pandemic. As a result, the spotlight has started to shift. It has become evident that insurers, though solvent when assessed on the existing capital adequacy framework, may become financially distressed due to an idiosyncratic or systemic event, potentially leading to a material loss of value as a result of inadequate liquidity risk management practices.

Based on this, there has recently been more focus on liquidity risk for insurers both internationally and locally. In September 2019, the Bank of England Prudential Regulation Authority (PRA) published a Supervisory Statement (SS) on liquidity risk management for insurers. In June 2020, the International Association of Insurance Supervisors (IAIS) published their application paper on liquidity risk management. The South African Prudential Authority (PA) is a member of the IAIS and closely monitors global regulatory developments. Most recently, the PA issued, for consultation, a draft guidance notice and revised liquidity return for life insurers[1], setting out practices and guidelines that should be considered in the treatment and management of liquidity risk.

Based on the recommendations in the draft guidance note, life insurers will need to develop and enhance their liquidity risk management capabilities. In doing so, a decision may be taken to implement measures to meet minimum regulatory requirements or, alternatively, to build a "best in practice" capability, depending on the insurer's longer-term objectives. Successful implementation of such a capability will increase resilience to withstand a crisis event. It will also unlock a value generating opportunity for the benefit of both policyholders and shareholders, through the monetisation of excess liquidity on the balance sheet.

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[1] The draft guidance notice is applicable to life and non-life insurers while the proposed return is applicable to life insurers only.

Liquidity within the life insurance industry – managing the risk

Regulatory guidelines outline a variety of key capabilities that are needed for life insurers to appropriately manage liquidity risk. These relate to:

- Liquidity risk identification and assessment
- Liquidity risk measurement
- Liquidity management
- Liquidity monitoring and reporting

Liquidity risk identification and assessment

From an identification and assessment perspective, it is imperative that insurers have processes in place to identify all material sources of liquidity risk. These include, but are not limited to, liability-side risks, asset-side risks, concentration risks, off-balance-sheet risks, funding risks, cross-currency risks, intra-day risks and franchise risks. In addition, any group-specific risks, such as reliance on subsidiaries' cash flows to meet shareholder expectations or debt obligations that require funding, should be clearly understood and assessed.

Contingency funding, guarantees and intra-group facilities are factors which need to be considered as part of a broad strategic funding plan. Careful consideration must be given to the fungibility of available funding options, especially in the context of potential regulatory or jurisdictional obstacles.

Liquidity risk measurement

Measurement of liquidity risk should include the quantification of a liquidity shortfall or surplus over an identified time horizon, given specified stresses. Stress tests need to span a range of severe but plausible liquidity events (including market-wide stresses and insurer-specific stresses) over different time horizons. Insurers' senior management and an appropriate risk committee of the Board should regularly review and approve the approach, time horizon and specific stresses to be applied to ensure their nature and severity remain appropriate.

A comprehensive set of defined metrics and early warning indicators must be monitored, so that changes in observable factors, which may impact the liquidity position of the insurer, can be detected. The chosen methodology should allow for liquidity demand (hair cuts) and supply, as well as quality of supply (e.g. the existence of high quality liquid assets (HQLAs) or impediments to supply which can occur across entities in the group)

Management must define a clear liquidity risk appetite with associated risk limits that considers the total amount of liquidity risk the insurer is willing to accept in pursuit of its strategic objectives. The risk appetite and associated limits are to be approved by the Board[2].

Liquidity management

An insurer's overall approach to managing liquidity is to be set out in a liquidity management strategy. This is expected to cover the insurer's day-to-day and longer-term management of liquidity risk. A crucial component of the strategy is the definition of a Liquidity Contingency Plan, outlining the decision-making process and range of actions that could be taken in response to a liquidity stress event. Clear escalation and prioritisation procedures must be set out, detailing when and how each of the actions can and should be activated, with roles and responsibilities assigned to key decision-makers.

First line management activity is to be overseen by independent second- and third-line risk functions, responsible for defining liquidity policies, risk appetite and risk policies covering identification, measurement, management, monitoring and reporting across the full value chain. The role of the Head of the Actuarial Function (HAF) is pivotal in the management of risks that emerge from the insurance products and in asset/liability management. The HAF will be critical in assessing the liquidity risk management in these domains for life insurance companies and would have insight into policy specific risk such as:

- The shift to pure risk products over the last 20 years, which represent illiquid assets at inception,
- Cash-back products that may create a liquidity strain, requiring benefit payments while the policies represent illiquid assets.

Liquidity monitoring and reporting

Liquidity risk should be monitored and reviewed at both a business function and committee (management and Board) level. Being able to report management information that is timely and adequate will require robust IT systems and reporting procedures, as well as an effective system for ensuring that information can be aggregated, analysed, and reported on both at a solo entity and group level. The liquidity risk profile and approach to liquidity risk management should be referenced in appropriate detail in the Own Risk and Solvency Assessment (ORSA). This will identify where the broader liquidity risk management approach might impact on overall funding and consequently capital within the insurer.

Meeting the above requirements is expected to have a significant impact on insurers. In many instances, enhancements to models, reporting processes, governance structures and the underlying data and systems will be required. One such example relates to a potential modelling enhancement to enable undiscounted underlying liability cash flows to be calculated and stored. This is different from the more common practice of storing present value vectors of cash flows. This enhancement will impact data and system requirements, as well as actuarial modelling requirements.

[2] While the Board may delegate these responsibilities to a Board sub-committee, this does not absolve the Board of its responsibility.

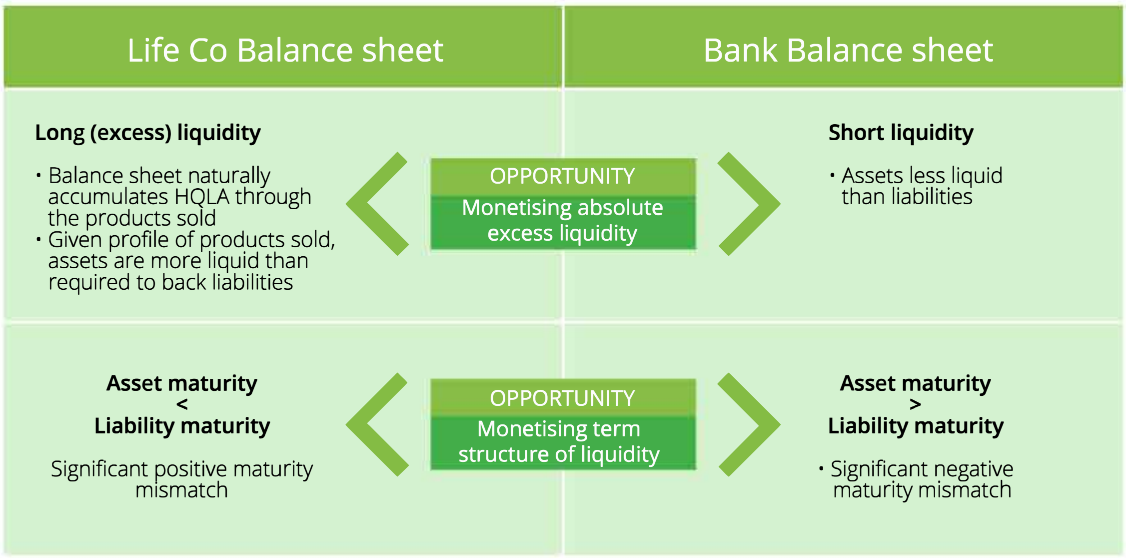
Liquidity within the life insurance industry – seizing the opportunity

The structural nature of a long-term insurers balance sheet is different to that of a traditional bank. This coupled with shifting market dynamics[3] and a structural increase in the demand for high quality liquid assets[4] following the Global Financial Crisis, presents an interesting opportunity for insurers to generate value through liquidity optimisation and transformation.

In their simplest form, revenue generating opportunities can be categorised as:

- Monetising absolute excess liquidity – Long-term insurers (as well as pension funds) have traditionally held large quantities of liquid assets. This is due to the role they play in financial markets and the nature of the products they sell; and
- Monetising term structure of liquidity – Due to the long-dated nature of liabilities, long-term insurers typically have a positive maturity mismatch. This means that asset maturity is generally less than liability maturity.

This is illustrated in the diagram below.



Life Co Balance sheet

Bank Balance sheet

Long (excess) liquidity

- Balance sheet naturally accumulates HQLA through the products sold
- Given profile of products sold, assets are more liquid than required to back liabilities

OPPORTUNITY

Monetising absolute excess liquidity

Short liquidity

- Assets less liquid than liabilities

Asset maturity
<
Liability maturity

Significant positive maturity mismatch

OPPORTUNITY

Monetising term structure of liquidity

Asset maturity
>
Liability maturity

- Significant negative maturity mismatch

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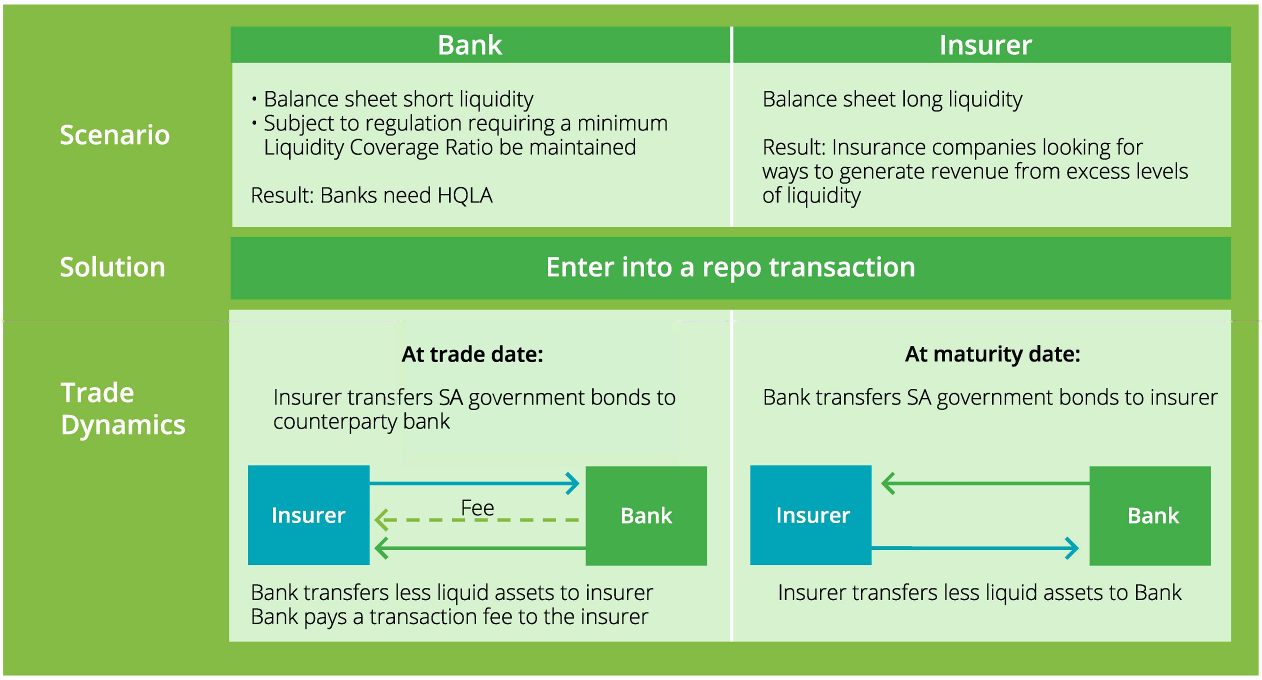
[3] For example, the decrease in credit risk appetite for unsecured banking exposure

[4] Largely as a result of the introduction of a handful of regulatory reforms

The simplified examples below serve to illustrate the value creation opportunities that exist through the implementation of a liquidity risk management capability.

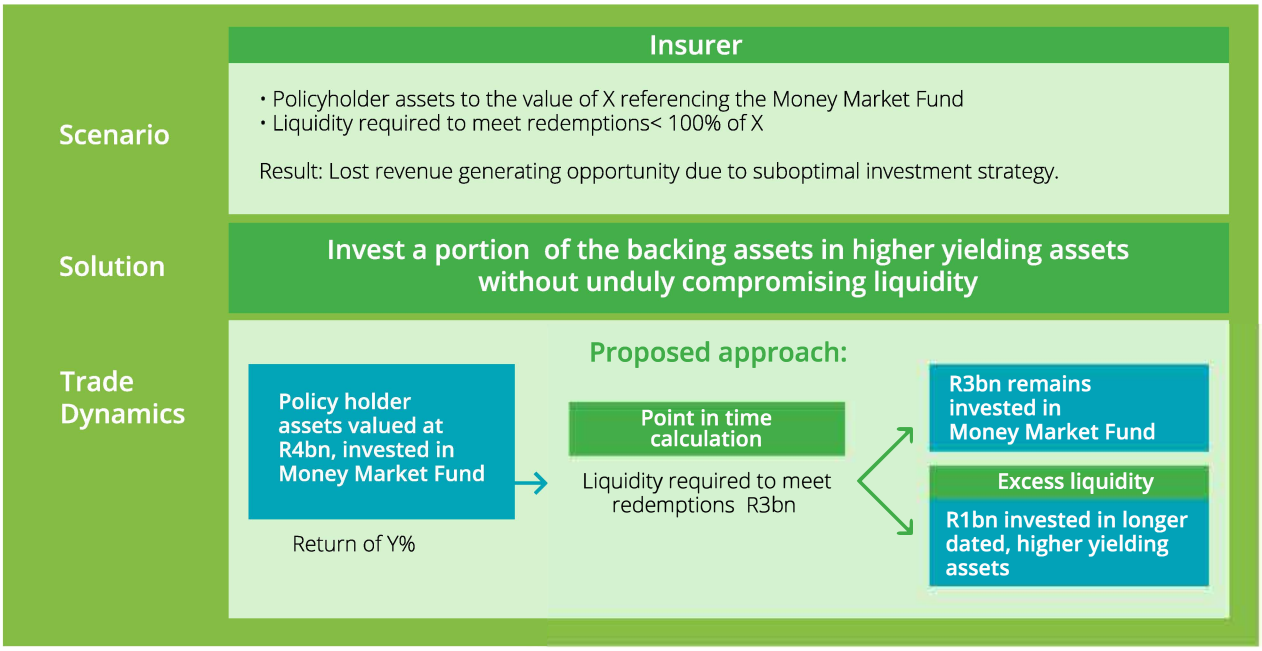
Example 1: Monetising absolute excess liquidity



NOTE:

- The repo transaction will generally be short term in nature (less than 1 year in maturity) with the ability to unwind at any point in time
- There is limited credit risk due to collateral received
- The insurer maintains economic exposure to the bond throughout the period of the transaction (i.e. market risk neutral)
- The insurer will earn a fee which can be shared between shareholders and/or policyholders

Example 2: Monetising term structure of liquidity



NOTE:

- Excess liquidity invested in local bank NCD's, tenor up to 5 years or structured notes issued by foreign banks (Maturity < 1 year) all referencing 3M JIBAR
- Additional return generated can be shared between shareholders and/or policyholders

Depending on the strategic objectives of the organisation, the degree to which liquidity optimisation and transformation strategies are employed may need a "best in practice" liquidity management capability. Such a capability can be used to support more advanced, complex structures and strategies for extracting benefit, ensuring opportunities are approached in a prudent and responsible manner.

strategies for extracting benefit, ensuring opportunities are approached in a prudent and responsible manner.

Conclusion

The PA's expectations of South African insurers will continue to evolve and develop as global regulators gain traction in their effort to increase oversight of liquidity risk at insurers.

While this will result in a need to develop or enhance liquidity risk management practices across the industry, it also presents a silver lining, as organisations can use these enhanced practices to drive their value creation ambitions.

In a low interest rate environment, long-term insurers and investors alike are looking for yield enhancement. Investing in a liquidity risk management capability will not only increase resilience to withstand a crisis event but could also hold the key to unlocking new value generating opportunities for the benefit of both shareholders and policyholders.

Incorporating such a capability into a robust "three-manager model" construct will enable insurers to further enhance balance sheet management capabilities in the second manager and increase the potential benefits from this.

Details regarding the guidance note, as well as the purpose and construct of a "three-manager model", will be discussed in later papers.

References

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