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PA Draft Standard and Guidance Note

Liquidity risk management for insurers

Discussion Document, July 2024

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Liquidity Risk Management for Insurers

Insurers have traditionally adopted a long-term view and the challenges of modelling cash flows 80 years into the future is not unfamiliar. But the real-time element of meeting short-term cashflow obligations has proven challenging, particularly during periods of market stress. The UK pension fund crisis is a recent example where we have seen how material liquidity stress can manifest over a couple of days, leaving little to no room for remedial activity that was not planned in advance.

The International Association of Insurance Supervisors (IAIS) monitors liquidity risk as part of their Global Monitoring Exercise (GME). They have identified gaps in insurers' liquidity risk practices and have subsequently developed tools and metrics to assess liquidity risk across the global insurance industry. Locally, the Prudential Authority (PA) has published an updated draft Prudential Standard FSI 6 and draft Guidance notice for comment. The draft Standard and proposed Insurance Liquidity Ratio (ILR) references the *Application Paper of Liquidity Risk Management*, published by the IAIS, including some of their principles applied in monitoring liquidity risks.

An important theme emerging from the IAIS and the PA is that they looking for a distinction between solvency and liquidity risk.The PA notes that insufficient liquidity can cause failure in insurers that are otherwise solvent. The tools to monitor and manage solvency and capital adequacy are well established, but these may be inadequate to address liquidity risk. The proposed standards recognises the need to hold sufficient liquid assets and contingent funding sources, particularly in stressed scenarios. Furthermore, these stress scenarios may look different from the stresses typically associated with solvency and capital adequacy.

In this paper we provide an overview of the proposed changes from the existing standard FSI 6 and will expand on the governance, risk management and reporting requirements.

> "Concerns about potential liquidity strains driven by certain insurance activities, such as derivatives and securities lending, have prompted the IAIS and some regulators to emphasise the importance of robust liquidity risk management."
>
> **Prudential Authority, 28 May 2024**
> **Statement of need for, expected impact and intended operation of the proposed amendments to FSI 6, Annexure E.**

Key Information

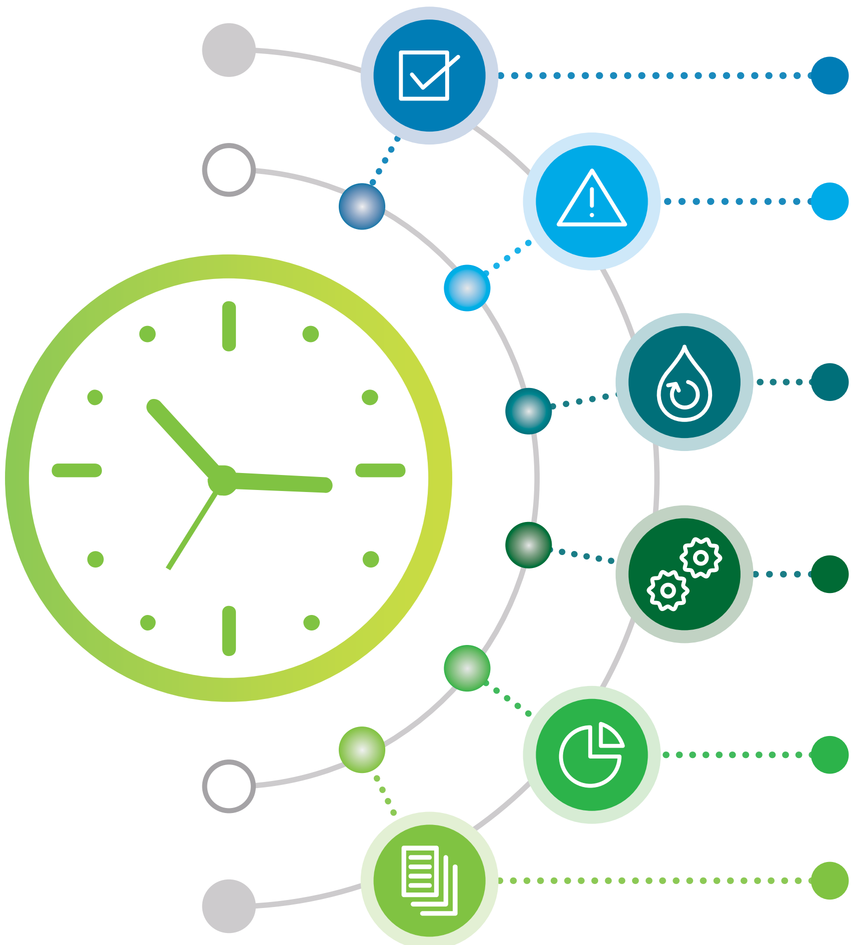
On the 28th of May 2024 the Prudential Authority published a proposed Standard (FSI 6) and Guidance Note on liquidity risk management for insurers.

Key dates:

1. Comments and feedback to the PA due by 31 July 2024.
2. Finalisation of FSI 6 yet to be determined.

The draft Standard references principles from the Application Paper of Liquidity Risk Management published by the International Association of Insurance Supervisors (IAIS), June 2020.

Key Aspects of the Draft Prudential Standard



Annual liquidity risk reporting to the PA

Insurers will be required to prepare and submit a detailed liquidity risk report to the PA annually along with their Own Risk and Solvency Assessment (ORSA) report. The current framework requires insurers to report liquidity risks as part of the ORSA only. Additionally, submission of monthly liquidity returns will be required.

Liquidity risk appetite

Insurers must develop a liquidity risk appetite statement. Critically, all sources of liquidity risk should be identified, including (but not limited to) those risks arising from derivatives, securities finance transactions, reinsurance arrangements, customer behaviour, insurable events, FX convertibility, wholesale funding availability, and off-balance sheet structures.

Liquidity stresses

Insurers must develop idiosyncratic stresses and use these to conduct stress testing to determine liquidity risk vulnerabilities. Current liquidity risk measures are based on solvency stresses and and do not require the insurer to have specific liquidity stress scenarios.

Contingency funding plan (CFP)

A CFP is a blueprint which outlines strategies and possible actions for securing emergency funding during a liquidity crisis. A CFP is required for liquidity risk management and must be approved by the Board or approved sub-committee. The CFP must be tested annually. Currently there is no requirement for insurers to have a documented CFP.

Insurance liquidity ratio (ILR)

The proposed prudential Standard incorporates the updated liquidity risk metric, ILR, which is aligned with the new liquidity risk return, to be reported to the PA on monthly basis. The new liquidity risk return is expected to improve reporting on liquidity risks, including those associated with collateral calls on derivatives and the risk arising from securities lending transactions.

High quality liquid asset (HQLA) portfolio construction

The proposed prudential Standard prescribes assets that may be used in the quantification of the HQLA, the numerator of the ILR, including applicable haircuts or discount rates that should be applied to the respective asset market values. Accurate construction of the HQLA portfolio is a crucial component of the liquidity risk assessment process.

Roles and Responsibilities for Liquidity Risk Management

1 Board

Establish governance structures, culture and practices pertaining to liquidity risk management.

Ensure compliance with PA Standard(s) and adherence to the Guidelines.

Ensure adequate governance framework for liquidity risk is in place (supports identification, assessment, management, reporting, planning of risk mitigation and decision-making).

Approval of the liquidity risk appetite (overall level of risk) and tolerances (variability from appetite).

Review liquidity risk practices and performance to ensure liquidity risk management is being managed within board-approved risk appetite and tolerances.

Approval of stress tests scenarios.

Approval of a contingency funding plan.

Board members should be and remain qualified, individually and collectively, for matters pertaining to liquidity risk management.

2 Head of Risk Management and Head of Actuarial Function

Provide the Board with an opinion on the accuracy of the ILR calculations and the appropriateness of the assumptions.

3 Risk Management Function and Internal Audit (IA)

Liquidity risk management should be incorporated within the independent risk management function, under the direction of the chief risk officer.

The risk management function should ensure liquidity risk identification, monitoring and control.

IA should provide independent assurance to the board pertaining to liquidity management practice, and should support the board and senior management in promoting an effective liquidity risk governance process.

IA should review the adequacy and effectiveness of the liquidity risk management framework and ensure that the insurer is operating within Policy (appetite and tolerance).

4 Senior Management

Under direct supervision of the board, senior management should carry out activities consistent with the board's strategy, approved liquidity risk appetite, and liquidity policies approved by the board.

Ensure risk appetite is aligned with strategic objectives and is embedded in the day-to-day operations.

5 Auditors

Obligations include a thorough assessment of the insurer's exposure to liquidity risk, which could potentially impact its ability to meet its financial obligations.

Communicate to the board of directors and the Prudential Authority any issues discovered during the execution of its duties.

Questions for the Board and Management

The questions below are designed to establish a working baseline from which to assess the governance readiness for the proposed Prudential Standard.

- Is the current governance framework for liquidity risk management adequate for identifying, assessing, managing, reporting and mitigating all liquidity risk within the business?
- Is there an established and up-to-date liquidity risk management policy?
- Is the risk appetite statement up to date in terms of the review cycle and correctly reflective of the current operating environment and business?
- Have adequate risk tolerances been established with consistent and robust mechanisms and tools to assess and monitor these tolerances?
- Is there a contingency funding plan in place and is that plan adequate to comply with the Standard?
- Has the contingency funding plan been tested within the last 12 months?
- What are the requirements and best practice for adequate contingency funding plan testing?

Identifying and Measuring Liquidity Risk

Insurers need to ensure all drivers of liquidity risk are identified. Some of the examples covered in the Guidance note include:

- Derivatives
- Securities lending transactions
- Liquid liabilities backed by illiquid assets
- Collateral on reinsurance arrangements
- Impact from off-balance sheet exposures
- HQLA jurisdiction fungibility
- Correlation and concentration of funding sources
- Reduction in wholesale funding
- FX convertibility
- Legal restrictions on assets
- Credit rating changes
- Customer behaviours and possible withdrawals
- Exposure to insurable events (and reliance on reinsurance)

Liquidity stress testing is a key role in effective liquidity risk management. Stress testing must include a diverse set of severe yet plausible scenarios that are not limited to historical events. The scenarios should include macroeconomic fluctuations over different time horizons, sector-wide disruptions, idiosyncratic events, and a combination of these factors. These stress tests should accurately reflect the unique characteristics of the insurer's business operations. The PA provides a (non-exhaustive) list of scenarios.

High Quality Liquid Asset Portfolio (HQLA)

- Assets included in the HQLA portfolio must be highly liquid and readily convertible into cash, either through direct sale or repurchase agreements (repos), with minimal or no cost incurred.
- HQLA assets must be categorised in relation to level of liquidity against specific categories (level 1, 2a and 2b).
- Highest liquidity level (level 1) > 60%.
- Ratings and assessed liquidity inform the haircut discount to apply to the fair market value of the eligible assets.
- PA prescribes the specific category composition and discount rates that must be applied.
- In calculating the HQLA value insurers must avoid double counting cash inflows in the denominator.
- Assets included in the HQLA must not be encumbered and overly concentrated to one asset class.

$$\text{ILR} = \frac{\textit{Adjusted HQLA}}{\textit{Net Stressed Cash Flows}}$$

Net Stressed Cash Flows

- Defined as the total expected cash outflows minus total expected cash inflows in a specified stress scenario for the subsequent 30 calendar days.
- Total cash inflows must be capped at 75% of total cash outflows.
- Besides the 30-day ILR, monthly liquidity returns also require reporting and monitoring of a 90-day ILR and a 12-month ILR.
- The insurer should assess the impact of its chosen scenarios on cash flows both at the individual entity level and group level and over different time horizons.
- Time horizon examples include next day, 2-7 days, 8 days to 1 month, more than 1 month to 2 months, more than 2 months to 3 months, more than 3 months to 6 months, more than 6 months to 12 months.

Contingency Planning and Reporting

Contingency Funding Plan (CFP)

The insurer must implement a board-approved contingency funding plan that is designed to respond to liquidity stress events. The plan should clearly articulate the response function to situations where the insurer's liquid assets are insufficient or unexpectedly become illiquid. The plan must include management actions that could be realistically taken during a stress scenario to ensure that the insurers have sufficient liquidity to maintain business-as-usual operations and to continue to meet all financial obligations.

The following bullet points highlight key considerations for a contingency funding plan:

- Include realistic actions an insurer could take to ensure sources of liquidity are sufficient (including collateral obligations).
- The CFP should be tested annually and amended to cater to changing liquidity requirements of the business.
- The CFP must include viable, diversified and available management actions.
- Quantitative metrics and early warning triggers should be clearly defined in the CFP.
- Based on the above-mentioned metrics, the CFP should define a variety of circumstances in which it would be invoked.
- Clear allocation of roles and responsibilities, as well as escalation and communication processes, is required.

Reporting

- Monthly liquidity returns.
- Annual liquidity risk management report. The PA has prescribed specific requirements for the liquidity risk management report. Examples include risk appetite, liquidity risk limits, the approach to stress testing and results thereof, a management discussion on current vulnerabilities, the extent of entities that fall within the liquidity risk scope, and any working groups and additional items.
- Annual ORSA report.

"Liquidity risk is not mitigated through capital holding; it is mitigated through investment in liquid assets and having contingent funding sources readily available." – Proposed guidance notice on liquidity risk management for insurers"

Prudential Authority, 28 May 2024
Proposed guidance notice on liquidity risk management for insurers,

Questions for the Board and Management

The questions below are designed to establish a working baseline from which to assess the management and reporting readiness for the changing Prudential Standard.

- Have all liquidity risk drivers been identified and does the liquidity risk management policy adequately cover all sources of liquidity risks?
- What assumptions are required that will underpin the ILR calculation for the specific business?
- Are the current systems adequate to achieve monthly liquidity returns?
- What is the cost of complying with the Standard, and how can these be minimised through efficiencies?
- Have the key priorities for change been identified?

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