IAIS Consultation

Print view of your comments on "Development of Liquidity Metrics: Phase 1 – Exposure Approach" - Date: 07.02.2021, Time: 04:48

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Jurisdiction	International
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Treat my comments as confidential	No

	Question
	Q1 Do you agree with the IAIS' plan for the development of liquidity metrics for monitoring? If not, please explain what changes you recommend and why.
Answer	No
Answer Comment	The IAA does not agree with the use of an enterprise-wide approach to IIM, as it assumes perfect fungibility and zero transaction costs (including no local income taxes) associated with the movement of funds across entities and jurisdictions. Presumably an IIM would allow the IAIS to focus on the largest entities within a jurisdiction, rather than having to evaluate groups that cross jurisdictions. In evaluating liquidity, the location of the funds matters. While a focus on cash flows and investments will likely make the variations in regulatory reporting less of an issue (as "cash" is cash, and most regulatory reporting systems have access to the fair value of invested assets), the IAA acknowledges that current inconsistencies in insurance accounting across jurisdictions may make the use of SWM data difficult. Therefore, the recommends a focus on cash flows (where the data problems hopefully will be minimized) rather than a focus purely on insurance exposure data (where the data problems may be greatest). It is recommended that some guidance be provided to those providing this information with regard to how to deal with different local accounting systems. In short, the IAA recommends a focus on the largest individual entities within a group/jurisdiction (rather than group-wide totals) and a larger focus on cash flow data rather than a pure "exposure" method.
	Q2 Should the IAIS consider any other approaches or alternatives when developing liquidity metrics? If so, please explain.
Answer	Yes
Answer Comment	A better focus on entity cash flow data is recommended. In some cases it may be necessary to make further divisions (e.g., separate accounts). This would be more responsive to the individual company differences in products and cash flows, as opposed to the relatively simplistic approach suggested. The suggested approach is less reflective of company differences than an "individual insurer method" would imply – as it limits the use of individual insurer data in favour of broad cross-jurisdictional metrics.
	Q3 Should the IAIS develop additional liquidity metrics that examine other time horizons? If so, how should these metrics differ from the proposed metric?
Answer	Yes

Answer Comment

The IAA agrees with the use of a longer time horizon than used for banks, and believe that a one year time horizon is a reasonable place to start. In the future it might be worthwhile to also look at shorter time horizons, but advise against any time horizon shorter than 3 to 6 months for non-life insurers. Shorter timeframes may be appropriate for life insurers, depending on the terms under which they have liabilities that can be called. The IAA strongly advises against a banking time horizon of hours or days, at least for non-life insurance, as such are not relevant for insurers whose liabilities are not callable on demand.

As an aside, despite the choice of a one-year time horizon, the rest of the proposal seems to still be based on the short time horizons used for banks. The dynamics of cash demands and sources of cash are very different for a one-year time horizon than for a one-day time horizon, yet the structure of the proposed liquidity ratio does not seem to have reflected this. (For example, for a longer time horizon the regular cash flows of an entity are an important consideration, yet the planned liquidity ratio seems to ignore normal cash flows. Instead, it assumes that all the sources of cash have to come from cash on hand and liquidation of assets – with no recognition of normal cash flow over the one-year time horizon.)

Q4 Do you agree with the exclusion of separate accounts from the ILR? If not, how should separate accounts be incorporated?

Answer

Yes

Answer Comment

The IAA generally agrees, with the exclusion for the reason listed in the consultation document. Separate accounts whose performance accrues to policyholders rather than shareholders (also called ‘unit-linked’ funds in some jurisdictions) should be included in the scope of liquidity monitoring but perhaps not in the ILR per se. The mechanics of such funds often have similarities to the mechanics of mutual funds and other non-insurance open-ended investment funds and these latter vehicles can be exposed to liquidity risks. The IAA recommends that in due course IAIS adopts approaches for these types of accounts that draw on those being developed by others to monitor investment fund liquidity risk. If an ancillary goal of IAIS liquidity monitoring is to understand interconnectedness better, the IAIS may also find it helpful to try to capture how much of these separate accounts are themselves invested in investment funds. The IAA also notes that although liquidity risks faced by separate accounts may commonly be carried by the policyholders there can be cases where the risks may be shared with or occasionally fall principally to shareholders. For example, if the contract terms allow policyholders to withdraw units in these accounts (or to switch them to units in other accounts) at short notice but the investments themselves are illiquid then liquidity support may need to be provided by the insurer to contain reputational risk and/or to avoid the need for a fire-sale of less liquid assets which would impact remaining policyholders. Or the insurer’s cost base may become unsupportable if there is a sudden loss of such funds. Another example of separate account product risks being borne by shareholders relates to variable annuities with substantive investment guarantees. The global financial crisis of 2007-08 severely eroded the capital of life insurers with large portfolios of these products.

Q5 Do you agree with the proposed factors for liquidity sources? If not, please explain.

Answer

No

Answer Comment

The IAA disagrees with the proposed factors to be applied to invested assets as we see them as being inconsistent with (and inappropriately conservative for) the proposed one-year time horizon, although they may be more reasonable for very short time horizons.. The proposed factors also do not reflect the remaining maturity of the investments (for the fixed income assets), as the liquidity value for a fixed income asset that is close to maturity is materially different from that of an investment with a longer maturity. At a minimum there would need to be separate recognition of investments due to mature during the selected time horizon. (The IAA notes that both S&P and AM Best acknowledge the differences in asset liquidity over short versus longer term horizons.)

As further support for the position stated above, the proposed factors for invested assets mirror those applied to banking, where the time horizon is hours or days. Such factors are inappropriate where the time horizon is one year.

Q6 Do you agree with the treatment of investment funds? If not, please explain and suggest an alternative treatment.

Answer

No

Answer Comment

If the insurer has a well-diversified portfolio of investment funds with short enough withdrawal notice periods then to assume that liquidity seizes up across nearly all of these funds simultaneously seems rather pessimistic. Ideally the methodology would include some element that captures this insight. At a minimum there also needs to be consideration of the cash flows that would arise from those funds in a one year time horizon

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Q7 Do you agree with the treatment of premiums? If not, please explain how premiums and excluded expenses should be treated in the ILR.

Answer

No

Answer Comment

The IAA disagrees with the treatment of premiums and expenses for an IIM as it seems totally counter to an evaluation of individual company liquidity and to evaluation of liquidity over a one year time horizon. Assuming that net operating cash flow for an insurer is zero would result in treating runoff insurers the same as growing insurers. Runoff insurers would expect to see negative operating cash flow (as the low to non-existent premium cash inflow would be more than offset by expense and claim cash outflows). In contrast, a growing insurer would expect that claim reporting and payment patterns would result in those payments occurring materially later than premium payments (in some cases years or decades later) resulting in very positive net operating cash flows.

It is acknowledged that guidance may be needed in some cases as to how to translate local GAAP into actual cashflows. The IAA notes that the IAIS has not historically collected data on claims and expenses. As the purpose of insurance is to pay claims (and related expenses), the IAA suggests the collection of this data would be a useful addition to the data collection work of the IAIS, regardless of its role in a liquidity ratio.

The IIM should include an estimate of normal operating cash flow (by looking at historical levels of annual premium inflows and annual expense and claim payment outflows, with a potential for reflecting historical trends in those values. This would more closely match how an insurer would estimate its own cash flows and liquidity needs.

Q8 How should instruments issued by financial institutions be treated within the ILR?

Answer

From an insurer solvency perspective, the treatment of financial instruments should reflect the rating of that instrument, with no preferential treatment for instruments issued by financial institutions. Any increased liquidity from financial institution securities would be already reflected in those credit ratings.

Q9 Do you agree with the inclusion of certain encumbered assets as liquidity sources within the ILR or should the IAIS alternatively exclude these encumbered assets and measure certain the related liquidity needs on a net basis? Should any additional liquidity needs be included in the calculation because encumbered assets are included as a liquidity source?

Answer

No

Answer Comment

For securities lending given a one-year time horizon, it is expected that most of these transactions would reverse in the one-year time horizon. It is worth noting the prior situation with AIG. They lent securities, but then invested the collateral in illiquid assets. When they had to return the collateral they did not have the cash. When they found they could not obtain short term cash sources they were faced with liquidating illiquid assets. As a result, the treatment of encumbered assets may need further research to determine when they should be treated as liquidity sources and when they should not.

Q10 Do you agree with the treatment of liquidity risk from surrenders and withdrawals from insurance products in the ILR? If not, please explain how this could be improved.

Answer No

Answer Comment The IAA believes that the time constraints are more of a deterrent than surrender penalties.

Q11 How should the IAIS capture liquidity needs from policy loans? Should these be incorporated into the ILR or be an alternative metric?

Answer The IAA agrees that, as policy loans are an alternative to surrendering policies, they should be brought into any analysis of liquidity risks. The two factors that need to be considered are their availability and the loan terms. Clearly, if policy loans are not actively offered and take-up is not significant then they can be ignored. Similarly, the generosity of the loan terms will drive the loan take-up rate. So this only need to be allowed for where there is a significant take-up rate and then a proxy for a surrender penalty could be derived.

Q12 Do you agree with the factors applied to retail insurance products being half of the factors applied to institutional products? How should the factors applied to retail and institutional policies differ?

Answer Yes

Answer Comment The IAA agrees that there are differences between institutional and retail policyholders, however the indicated factors would be expected to vary by product line. In addition, surrender rates among retail customers can be significantly influenced in the presence of a common agent/broker who influences surrender behavior among his/her clients, e It is recommended that the IAIS pursue both these issues further.

Q13 Do you agree with the treatment of unearned premiums in the ILR? If not, how can it be improved?

Answer No

Answer Comment The IAA disagrees with the proposed factors for unearned premiums, and recommend that the IAIS investigate more recent experience than that from a specialty insurer's experience over 85 years ago. The IAA recommends against treating factors from life insurance (which has long duration policies that contain a savings element and callable liabilities) as a basis for the risk factor applied to short duration policies that contain no savings element. Recent experience is that cancelation of existing short duration (i.e., one year or less) non-life policies is a low risk, with the larger risk being the loss of the customer upon expiration of existing policies. (Note that loss of the customer upon expiration is called "non-renewal" in the non-life industry in many countries, resulting in a different meaning of this term than is common for life insurance.)

The IAA expects that more recent experience would indicate factors much lower than proposed, as non-renewal (in the non-life context) is usually the result of losing faith in one's current insurer. This is partly because cancelation of existing non-life contracts takes time, as the contracts provide needed protection that the insured needs to replace before cancelation of the existing contract. In addition, the existence of guarantee funds and other policyholder protections for customers of troubled insurers reduces any urgency for the insurer's customers, so this risk may vary greatly by jurisdiction.

Q14 Should the IAIS apply standardised factors to insurers projected ultimate catastrophe losses or rely on company projections for the speed of catastrophe payments and reinsurance recoveries?

Answer No

Answer Comment The IAA recommends the use of company projections. Exposure to catastrophes and the extent of reinsurance protection is a major part of non-life insurers' risk management function and strategic plan. Attempts to come up with standardized factors for this risk were unsuccessful and deemed ill-advised during the development of the U.S. RBC formula, which now uses catastrophe modelling based on the insurer-specific exposures for this regulatory capital requirement. A similar approach of using company-specific catastrophe risk levels is used by Solvency II and the proposed IAIS Insurance Capital Standard (ICS).

The IAA also advises against the use of a risk factor (such as the 50% factor mentioned) for non-life catastrophe reinsurance recoverables that is based on what is applied to life insurers. The issue of reinsurance recoverability from catastrophe reinsurance covers has been recently discussed at the NAIC (which has been using a 5% haircut), with the tentative decision to lower than haircut. The IAA notes that much of the catastrophe reinsurance market for the largest tail events has moved to the capital markets (in the form of cat bonds, or Insurance Linked Securities – ILSs). These bonds are 100% secured, implying a 0% or otherwise very small haircut would be justified.

Q15 Do you agree with the proposed treatment of catastrophe insurance claims? If not, how can it be improved?

Answer

No

Answer Comment

The IAA believes that the use of company projections here is reasonable, although it is recommended that the comparability of estimates (across companies) as to the amount of the event paid in one year be evaluated. One difficulty is that the IIM is currently asking for this metric for a 1-in-250 scenario. Thankfully there are no recent events that fit this description, so the best that can be done is to extrapolate from the more recent extreme events.

The IAA also notes that this payment percentage is likely to vary by product and peril. Damage experiences by residencies and personal autos tends to be more commodity-like, making quantification and recovery easier to measure and less time-consuming to accomplish. In particular, it also takes less time to replace a personal auto than to rebuild a personal home. In contrast, it can take several quarters to replace a specialized commercial vehicle and many years to repair a commercial building.

With regard to perils, it is noted that damage from a windstorm tends to be more obvious than damage from earthquakes, with the latter sometimes producing structure damage that may take a year or more to be discovered or fully appreciated. These differences in claim discovery and payment by product and peril point out why a standardized approach is ill-advised, and why a company-specific approach is needed for this risk.

Q16 Should the proposed treatment of deposit liabilities include more or less granularity? If so, what additional dimensions (eg the presence of an effective deposit insurance scheme) should be captured or left out?

Answer

Q17 Should the proposed factors be modified? If so, please explain how and why.

Answer

Q18 Should insurance contracts without significant exposure to insurance events be captured by these factors, or included with other policyholder liabilities?

Answer

Q19 Do you agree with the treatment of derivatives? If not, please explain and suggest an alternative treatment.

Answer

Q20 How should the ILR treat debt with financial covenants that may be triggered under stress?

Answer

This issue is connected to the issue of debt with regard to the ICS. A key question with regard to evaluating liquidity risk for insurers is the entity that issued the debt and whether the insurance entities can be forced to help fund that obligation.

Another issue is that it is generally not in a counterparty's best interest to create a liquidity crisis despite a contractual ability to do so. As such, execution of a debt covenant should not be assumed to be a probable cause of a liquidity event, but a possible increase to the severity of a liquidity event.

	Q21 How should the ILR assess potential liquidity needs from a downgrade?
Answer	
	Q22 Do you agree with the discussed limitations and mitigations of the ILR? What other limitations should the IAIS consider and how can these be mitigated when the IAIS monitors liquidity risk?
Answer	Yes
Answer Comment	The IAA agrees with the limitations discussed, and suggests that other possible future sources of liquidity are not included in the ILR. A strong franchise that faces a liquidity shortfall over a one-year time horizon would probably have access to the capital markets and other external sources of liquidity. This might not be a possibility under the time horizons envisioned by a bank liquidity test, but would be available under the time horizons being suggested for insurance industry liquidity testing.
	Q23 General comments on the Public Consultation Document on the Development of Liquidity Metrics: Phase 1 - Exposure Approach
Answer	