IAIS Consultation

Print view of your comments on "Draft Application Paper on Liquidity Risk Management " - Date: 20.01.2020, Time: 16:34

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	Question
	Q1 General Comment on Application Paper on Liquidity Risk Management
Answer	
	Q2 Comment on Section 1: Introduction
Answer	
	Q3 Comment on Paragraph 1
Answer	This introductory paragraph notes that liquidity risk management is part of Enterprise Risk Management (ERM) in ICP 16.8 and 16.9. It also states that it is part of the holistic framework of assessing systemic risk in the insurance sector. However, the paper concentrates on liquidity issues and gives the reader the impression that liquidity should be looked at in isolation from other risks. The paper should note that assumptions, reporting, governance, etc. should be consistent across all risk management functions, and not be developed in isolation for liquidity. This recommendation is mentioned in the detailed comments for applicable paragraphs. The purpose of application papers is to provide advice, illustrations, recommendations or examples of good practice to supervisors. The IAA find that this paper demonstrates some degree of being overly prescriptive. Instead of recommending some alternative practices or giving examples of good practice, the paper seems to mandate a single set of rules for the requirements and exclusions in liquidity risk management for the supervisors. Emphasis on the precise details for insurance company practices may inappropriately restrict the liquidity risk management practices which should be variable depending on the circumstances of particular companies or jurisdictions.
	Q4 Comment on Paragraph 2
Answer	
	Q5 Comment on Paragraph 3

Answer	The third bullet in this paragraph has four sub-bullets which are taken from ICP 16.9. However, the second sub-bullet is not shown in full, since ICP 16.9 reads: “maintenance of a portfolio of unencumbered highly liquid assets in appropriate locations." The word “portfolio" is used 46 times in this paper, but it is not defined in this paper or in the ICP Glossary. As used in this paper, the word portfolio could be interpreted as meaning a separate block of assets that is held solely for liquidity risk purposes and not available for ALM purposes (as suggested by Paragraph 53). The IAA strongly suggest that this paper should include a definition of “portfolio" at the start of the paper. The words “…in appropriate locations." are of importance in interpreting the requirements of this paper since this shows that the liquid assets do not have to be in a block of assets that is held separately from other operational assets and is only to be used for liquidity purposes. This subject is mentioned further in the comments for paragraph 46.
	Q6 Comment on Section 1.1: Rationale
Answer	
	Q7 Comment on Paragraph 4
Answer	
	Q8 Comment on Paragraph 5
Answer	
	Q9 Comment on Paragraph 6
Answer	
	Q10 Comment on Paragraph 7
Answer	
	Q11 Comment on Section 1.2: Terms
Answer	
	Q12 Comment on Paragraph 8
Answer	
	Q13 Comment on Section 1.3: Scope
Answer	
	Q14 Comment on Paragraph 9
Answer	
	Q15 Comment on Paragraph 10
Answer	
	Q16 Comment on Paragraph 11

Answer

This paragraph notes that “timing is a critical dimension to liquidity risk." The IAA suggest that the importance of timing could be enhanced in this paper by recognizing that there is a difference between a day-to-day cash management function and the very infrequent emergence of a material adverse liquidity need event. The first requires appropriate administrative systems to function well operationally. Companies typically manage such day-to-day liquidity over 30, 90, 120, etc. day periods. It is the infrequent large liquidity events that should be the purpose of this paper.

The IAA also notes that sometimes insurers rely on clauses in contracts to delay payment of claims to avoid liquidity issues, for example in property funds. Whilst this may diminish the absolute liquidity risk it can cause reputational risk, or trigger claims of mis-selling / conduct risk, if policyholders were not made aware of the possibility of delays to fund withdrawals. (this is referred to in para 33)

Q17 Comment on Paragraph 12

Answer

Q18 Comment on Section 1.4: Proportionality

Answer

Q19 Comment on Paragraph 13

Answer

Q20 Comment on Paragraph 14

Answer

Q21 Comment on Section 1.5: Supervisory Review

Answer

Q22 Comment on Paragraph 15

Answer

Q23 Comment on Paragraph 16

Answer

Supervisors need also to consider the appropriateness of liquidity facilities with third parties – particularly if the supervisor is aware of more than one insurer relying on the same third party for liquidity – in the same way as they would consider the adequacy of liquidity within groups.

Q24 Comment on Paragraph 17

Answer

Q25 Comment on Paragraph 18

Answer

There also needs to be consideration of key judgements/assumptions in underlying models – in particular, consideration given to the potential volatility of modelled cash flows, particularly if the liability cash flows do not consider short term fluctuations because of using (for example) quarterly or even annual time-steps.

The IAA suggest adding “where applicable" to the language in this paragraph after “particularly". Several of those items listed as “particularly" important to the analysis are not relevant to non-life products in the markets the IAA is familiar with (e.g. references to “lapse sensitivity" and “mortality").

The last part of this paragraph mentions the projections and the assumptions used for cash flow projections. It should specifically add that these assumptions should be consistent with the company’s total ERM framework, as required by ICP 16.8. Liquidity testing is a subset of the total ERM framework and not a separate exercise with its own cash flow assumptions. The paper should include specific reference to the need for consistency in this section. The paper currently does mention the need for consistency between capital stress testing, liquidity testing, recovery testing, resolution plans and ORSA in paragraph 81 which deals with reporting to the supervisor. Such a reference to consistency with other risk management functions should also be specifically included in this paragraph.

Q26 Comment on Paragraph 19

Answer

The contingency funding plans for infrequent large adverse liquidity events should be the same as, or at least consistent with, the plans used in the company’s recovery plans (ICP 16.15).

The third sentence of this paragraph implicitly assumes that the supervisor has the authority to dictate what is “allowed in an insurer’s liquidity portfolio". the IAA question whether such authority would exist in many cases. The IAA note that ICP 16.9.5 has a similar statement, but it is at a lower level in the ICP hierarchy such that it does not require supervisory authority to so dictate.

Q27 Comment on Paragraph 20

Answer

The second-to-last sentence requires regular testing of contingency funding plans “to ensure that plans can be executed". While well-intentioned, this requirement is not effective (and hence is not useful). Such testing can be useful, but the paragraph should point out that it is not a panacea. The reason is that any such testing would be performed in a non-stressed environment, and there may be additional issues arising in a stressed environment.

Q28 Comment on Paragraph 21

Answer

Q29 Comment on Paragraph 22

Answer

Q30 Comment on Section 1.6: Structure

Answer

Q31 Comment on Paragraph 23

Answer

Q32 Comment on Section 2: Governance

Answer

Q33 Comment on Paragraph 24

Answer

The comments for Paragraph 18 above also apply to Paragraphs 24 and 25. The governance of liquidity risk should not be in isolation but should be part of the company’s total ERM framework, as required by ICP 16.8. The current wording in these paragraphs suggests that the governance of liquidity risk is as separate function.

Q34 Comment on Paragraph 25

Answer

Q35 Comment on Paragraph 26

Answer

Q36 Comment on Paragraph 27

Answer

Q37 Comment on Section 3: Liquidity stress testing

Answer

In several places the term “material legal entity" is used. In some situations, it would make sense to treat an internal quota-share pool in total as a “material legal entity". This would reflect a common situation for US property/casualty groups where such internal pools are common.

The beginning of this section seems to be overly prescriptive as it presumes material liquidity risks. This is not always appropriate and violates the principle of proportionality mentioned in Section 1.4, Paragraphs 13-14.

Q38 Comment on Paragraph 28

Answer

This paragraph seems to require robust stress testing for everybody, regardless of proportionality issues. This seems to be overly prescriptive and in conflict with the proportionality principle stated earlier. The IAA recommend replacing “comprehensive, robust" with “appropriate".

Q39 Comment on Paragraph 29

Answer

Q40 Comment on Paragraph 30

Answer

When choosing scenarios on cash inflows and outflows, the time lag should be considered. For instance, a reinsurance recovery will normally take place a few months after claim payments, which means that the reinsurance effect should not be included for such period.

Q41 Comment on Paragraph 31

Answer

Q42 Comment on Paragraph 32

Answer

This paragraph states that lines of credit should generally not be assumed to continue to be available in stressed situations. The IAA agree that a total exclusion of lines of credit is not appropriate since at least some may be committed lines from very strong companies. This restriction on lines of credit would also depend on whether the stress is systemic or idiosyncratic. For the latter, lines of credit should still be available. The assumptions for the availability of lines of credit should also be consistent with those in the company’s recovery plans.

Q43 Comment on Paragraph 33

Answer

Q44 Comment on Paragraph 34

Answer

Q45 Comment on Paragraph 35

Answer

Q46 Comment on Section 3.1: Liquidity risk drivers

Answer

Q47 Comment on Paragraph 36

Answer

Q48 Comment on Paragraph 37

Answer

Even if there are collateral arrangements, these assets need to be sufficiently liquid and reinsureds need to consider the possibility that the collateral is inadequate.

Q49 Comment on Paragraph 38

Answer

The IAA note that policyholder behaviour often does not have a material impact on liquidity for non-life products. The IAA recommend that this requirement be changed to a requirement to reflect materiality, perhaps by adding “(where material to the analysis)" at the end of the first sentence.

Q50 Comment on Paragraph 39

Answer

Q51 Comment on Paragraph 40

Answer

This should include consideration of debt repayments or reinsurance re-capture being triggered where appropriate.

Q52 Comment on Paragraph 41

Answer

Q53 Comment on Paragraph 42

Answer

This paragraph states that: “…with-profits funds or matching adjustment portfolios…should only be included as cash flow sources to back cash flow needs arising from these same products." The IAA agree that this should be the case for day-to-day cash flow management and ALM. However, in the event of a large adverse liquidity event it is the entity as a whole that could face insolvency. Therefore, to avoid this, cash and liquid assets available in any asset blocks should be considered to be available to meet an unexpected event. An exception to this is if such a transfer is not legally allowed in a jurisdiction. Such exceptional transfers between blocks could result in a temporary mismatch of assets and liabilities contrary to the company’s ALM policy and would need to be subsequently rectified forthwith. The IAA also note that ICS 2.0 ignores the impact of such ring-fencing - the IAA see the impact of ring-fencing as more than just a liquidity issue.

Q54 Comment on Paragraph 43

Answer

Q55 Comment on Paragraph 44

Answer

Q56 Comment on Paragraph 45

Answer

Q57 Comment on Section 4: Liquidity portfolio

Answer

Q58 Comment on Section 4.1: Scope of liquidity portfolio

Answer

Q59 Comment on Paragraph 46

Answer

The wording in this paragraph suggests that the liquid assets should be in a separate block of assets maintained by the company solely for the purpose of meeting a material liquidity event. This type of conclusion could result from the use of the term “liquidity portfolio" throughout this paper. In practice, liquid assets could be operationally held in separate asset segments to facilitate asset-liability matching under a company’s ALM policy. These liquid assets from separate segments are all available to meet unexpected liquidity needs at the total company level. To clarify this, the paper should include a definition of the term “liquidity portfolio" at the start of the paper.

Q60 Comment on Section 4.2: Composition

Answer

Q61 Comment on Paragraph 47

Answer

This paragraph and Paragraph 49 state that the liquid assets should have a “low market risk". The IAA believe this requirement should not be included. If a liquid asset has a market risk, it should still be available to meet liquidity needs. For example, take the case of a 20-year government bond that has a ready liquid market and thus meets the criteria for a liquid asset. If the liquidity event is triggered by a large sudden increase in interest rates, the market value of the bond will decrease. However, it is still readily cashable, but for a lower market value than before the event. The stress testing should include this decrease in value when testing for the effects of the adverse scenarios. These comments are also recognized in paragraph 55 later in the paper.

Q62 Comment on Paragraph 48

Answer

Q63 Comment on Paragraph 49

Answer

With regard to item viii, the IAA note that common equity shares may typically be liquid but often cannot be sold without a loss of value in a liquidity crisis. So, the IAA suggest there is a caveat in this paragraph as well as that given in Paragraph 51.

Q64 Comment on Paragraph 50

Answer

This paragraph makes the point that there are limits on the ability to monetize even those assets designated as being “liquid". This depends on the nature of the scenario that leads to an adverse liquidity event. For instance, there is a significant difference between the effects on liquidity in a systemic scenario and an idiosyncratic scenario. The key issue is whether there is a ready market available in which to monetize the assets.

The IAA think the chart with this paragraph should be removed from the paper. The chart in this paragraph which classifies types of assets as Primary, Secondary and Tertiary is overly restrictive and can be misleading depending on the adverse scenario. For instance, in the 2008-2009 financial crisis, some asset types that the chart shows as rated AA and primary were actually frozen and not available for liquidity purposes. The key consideration should not be the type or rating of an asset before an adverse event, but whether there continues to be a readily available market for an asset after the event. The emphasis should be on deciding whether an asset could still be liquid given the circumstances of the adverse event and the company's specific situation.

Q65 Comment on Paragraph 51

Answer

The comments shown for paragraph 50 also apply to paragraph 51.

Q66 Comment on Paragraph 52

Answer

The restriction on instruments issued by other financial institutions appears to borrow guidance from that for bank supervisors and may not fully reflect the long-term nature of life insurance liabilities. In Canada, for example, financial institutions represent 30% of the investment grade corporate bond index. Excluding this category of liquidity will introduce greater risk since it would result in more single-name concentration in alternative available assets.

Q67 Comment on Paragraph 53

Answer

The IAA do not agree that liquidity testing should disallow considering any bonds paying coupons which are used in the company's ALM cash flow management. While it makes sense not to double-count something, the second sentence in this paragraph could be better worded. If there were a liquidity event, all available liquid assets would be available to meet this immediate need in order to avoid company insolvency. Maintaining an asset-liability match is secondary in this event and can be corrected when normal conditions return. There may be a cost for temporarily not maintaining a desired ALM position, but this should be part of the costs in scenario testing.

Q68 Comment on Section 4.3: Other portfolio considerations

Answer

Q69 Comment on Paragraph 54

Answer

The IAA note a portfolio entirely of government bonds is not "diversified" even though it would be highly liquid and highly unlikely to overwhelm any market for such bonds when sold. (That is assuming a government bond of an industrialized country such that those bonds are highly rated.)

Q70 Comment on Paragraph 55

Answer

Q71 Comment on Paragraph 56

Answer

The IAA disagree that an actual sale is required as a test, as suggested by this paragraph. The extra expense is not justified.

Q72 Comment on Paragraph 57

Answer

Agree with this paragraph, although the IAA note that ICS 2.0 currently ignores fungibility issues. The lack of access to funds is not just a liquidity issue, it is also a capitalization issue. The ICS 2.0 treats all funds as fully fungible within the group and as such it can overlook a material solvency issue within the group.

	Q73 Comment on Paragraph 58
Answer	
	Q74 Comment on Section 5: Contingency funding plan
Answer	
	Q75 Comment on Paragraph 59
Answer	This paragraph is overly prescriptive and does not recognise the reality that conditions that occur during emergencies may be very different to those considered when the plan was conceived. Emergency situations frequently are accompanied by a disruption of normal markets and relationships. As such, any plan that outlines “clear steps" that would be taken in an emergency is unlikely to be executable as originally conceived. Detailing possible options in an emergency situation, including the chain of responsibility (and backups) is useful. Specific detailed action plans required to be followed in case of an emergency may cause delay in responding to the emergency due to attempt to fulfil plans that are no longer feasible or optimal (due to a change in the underlying conditions). Consequently, the IAA would suggest changing “would" to “could“ in the second sentence. The IAA also suggest that it would be worth stating that the contingency funding plan in this paragraph should be consistent with the company’s recovery plan under ICP 16.15.
	Q76 Comment on Paragraph 60
Answer	
	Q77 Comment on Paragraph 61
Answer	
	Q78 Comment on Paragraph 62
Answer	While the IAA agree with the section of the paragraph describing overall governance issues (e.g., responsibilities, lines of communication), the IAA disagree with the first sentence requiring a set of specific actions to take at specific times. Such a dictate would impair the ability of management to reflect the particular facts and circumstances of the emergency (which generally cannot be fully anticipated). the IAA recommend deleting the first sentence of this paragraph or that the plan may include a range of actions and criteria for when action should be considered, recognising that the specific action may need to be amended depending on the specific circumstances.
	Q79 Comment on Paragraph 63
Answer	
	Q80 Comment on Paragraph 64
Answer	
	Q81 Comment on Section 6: Liquidity risk management report
Answer	
	Q82 Comment on Paragraph 65
Answer	
	Q83 Comment on Paragraph 66

Answer

Q84 Comment on Paragraph 67

Answer

Q85 Comment on Section 6.1: Risk appetite and risk limits

Answer

Q86 Comment on Paragraph 68

Answer

Q87 Comment on Paragraph 69

Answer

Q88 Comment on Paragraph 70

Answer

Item (iv) simply mentions the liquidity risk arising from insurance liabilities. This could be split out more into the different aspects of this e.g., ALM, fund switching, other policyholder optionality etc.

Q89 Comment on Paragraph 71

Answer

Q90 Comment on Paragraph 72

Answer

Q91 Comment on Section 6.2: Liquidity risk management framework

Answer

Q92 Comment on Paragraph 73

Answer

Q93 Comment on Paragraph 74

Answer

Q94 Comment on Paragraph 75

Answer

There is a typo here – the phrase “securities financing transactions" is repeated in the first sentence. One occurrence should be deleted.

The first sentence presumes that all reinsurance results in collateral needs. This is incorrect, as many reinsurance contracts do not result in collateral requirements or needs. Suggest changing “reinsurance" to “certain reinsurance agreements".

Q95 Comment on Paragraph 76

Answer

The IAA suggest changing “challenges" to “considerations" in the first sentence. Groups may actually face fewer challenges due to greater operational flexibility and resources than single entity operations.

Q96 Comment on Section 6.3: Analysis of the insurer's liquidity profile

Answer

The IAA note that much of this section is not relevant to non-life policies. The IAA are concerned that overly broad guidance that applies even where not relevant may result in increased compliance costs that increase the price to consumers at no benefit to consumers.

Q97 Comment on Paragraph 77

Answer

The insurer should also monitor hedging efficiency / basis risk.

Q98 Comment on Paragraph 78

Answer

The first sentence says “the supervisor should also require the insurer to consider means of raising cash". The IAA see this phrase as ambiguous and potential misleading (as liquidity management deals with both sources and uses of cash, and this phrase seems to imply a focus only on finding new sources). This phrase may also be read to imply that insurer’s existing sources are inadequate.

The IAA suggest instead that insurer’s liquidity management plans be required to document the various ways they envision raising cash levels when needed, i.e., through some combination of reducing cash uses, increasing cash from existing sources or finding new sources. With regard to cash uses, a few ways insurers can raise cash levels are to delay or cancel stock buybacks, and to hold back on immediately investing premiums from new/renewal non-life policies. The latter strategy is very easily implemented for non-life companies with a geographic spread, as claims for many product lines are not paid until several months or years after the policy is initiated, and an imminent catastrophe typically only affects a limited portion of an insurer’s geographic spread. The IAA recommend that the first half of this paragraph be rewritten to reflect this new focus on how cash levels can be raised (through a combination of actions reflecting both sources and uses of cash).

Q99 Comment on Paragraph 79

Answer

The insurer should consider different scenarios in the cash flow analysis particularly where there is significant uncertainty or volatility in the cash flow projections.

The IAA recommend adding the phrase “, where relevant and material" after the word “incorporate". Some of the items in the list are not always relevant and may not be material. For example, non-life products typically do not have policy loans.

Q100 Comment on Section 6.4: Reporting to the supervisor

Answer

Q101 Comment on Paragraph 80

Answer

Q102 Comment on Paragraph 81

Answer

Q103 Comment on Paragraph 82

Answer	This requirement to report the ratio of the liquidity portfolio to net stressed cash outflows “under each time horizon, as produced by the stress test(s)" appears to be punitive and overkill for many types of non-life companies. Applying the proportionality principle - for non-life companies with liabilities that have no call provisions, have high levels of liquid assets, and are not exposed to high levels of possible immediate cash demands, such a requirement is inappropriate. The IAA recommend that the supervisor’s judgement be relied upon for determining the level and extent (if any) of any stress test reporting.
	Q104 Comment on Paragraph 83
Answer	In the first bullet after Paragraph 83 there is a typo. “insures" should be “insurers".