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F2: Liquidity Risk
A growing challenge in Insurance

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Agenda

- Introduction
- Current Environment
- Liquidity Management Framework
- Liquidity MI
- Stress Testing
- Looking Forward
- Questions

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Introduction

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Introduction

What is liquidity?

- Investopedia states that liquidity is:

  The ability to convert an asset to cash quickly.

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Introduction

What is liquidity?

Liquidity is a valuable commodity in the market with:

- Investors in less liquid assets demanding additional returns to compensate for the additional risk through illiquidity premia

Introduction

What is liquidity risk?

BANK OF ENGLAND

The PRA defines liquidity risk as:

> *the risk that a **firm**, although solvent, either does not have available sufficient financial resources to enable it to meet its obligations as they fall due, or can secure such resources only at excessive cost*

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Introduction

Insurers' business models typically do not have the same liquidity gearing as banks.:

- Customer liabilities are much less liquid/can be managed
  - Annuities very illiquid
  - Unit Linked policy claims can potentially be deferred / pay forced sale value
  - With Profits policy claims can potentially apply market value adjusters
- Traditionally insurers have held large amount of "liquid assets" to meet their potential liquidity demands.

- This has meant focus for many insurers has been on managing their capital position rather than actively managing their liquidity position.
- Liquidity has not traditionally been seen as a material risk or benefit.

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Current Environment

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Current Environment

“LIQUIDITY PULL” - liquidity is a valuable commodity

The banking crisis has meant:

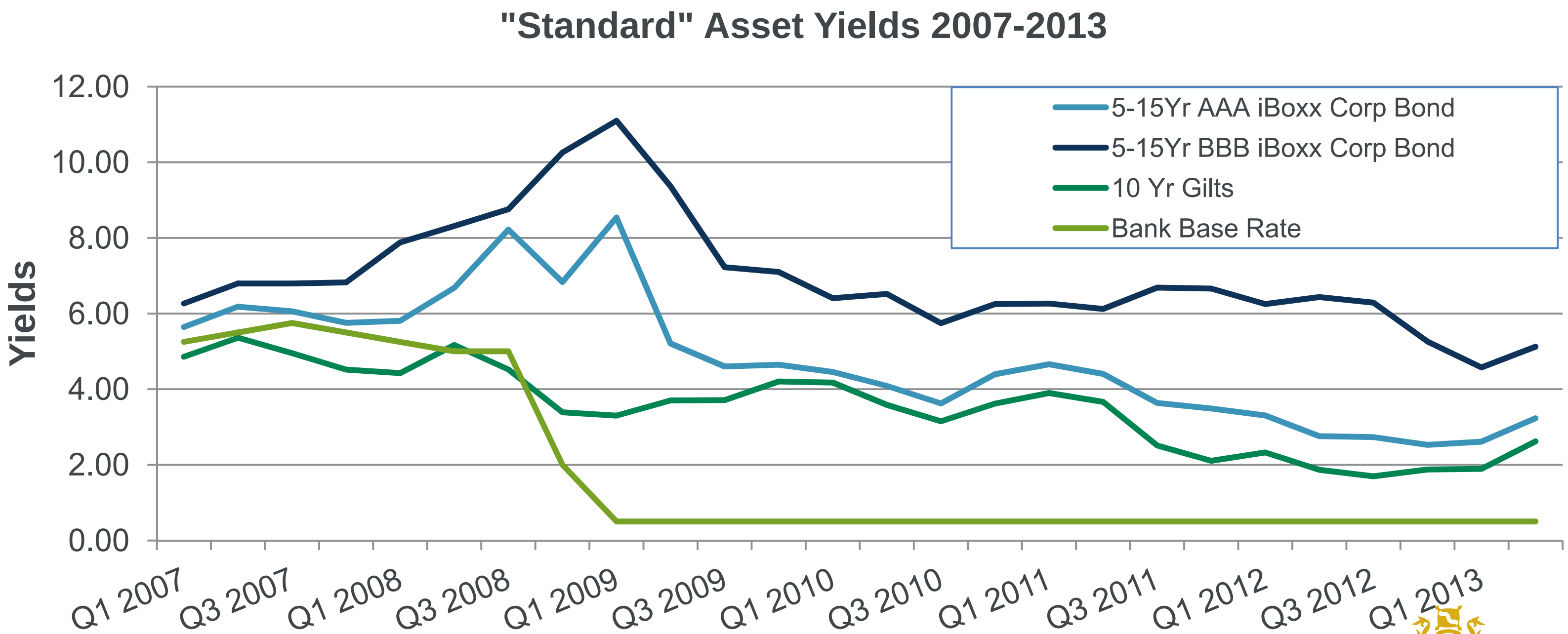
- Banks can no longer afford to take on as much illiquid assets
- Banks now need more liquidity to meet new regulatory environment
- Liquidity is now perceived more than ever as a commodity in its own right

- This is leading to pension schemes and insurers being seen as potential providers of liquidity

Current Environment

“LIQUIDITY PUSH” - there are significant market themes driving insurers to taking less liquid asset strategies:

- The low interest rate environment leading to companies searching for additional asset yield return from alternative higher yielding but less liquid assets.



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Current Environment

“LIQUIDITY PUSH” - there are significant market themes driving insurers to taking less liquid asset strategies:

- The low interest rate environment leading to companies searching for additional asset yield return from alternative higher yielding but less liquid assets
- Insurance company boards are now demanding better use of free liquidity
- More efficient management of cash processes allows release of cash buffers
- Clearer understanding of cash positions/cash volatility to allow strategic cash decisions e.g. dividend payments

Current Environment

Several large insurers are making well-publicised moves into less liquid assets

Ageas will improve the diversification of its investment portfolio by investing in corporate loans
Reuters 6 August 2012

Lloyds gets clearance for Scottish Widows asset swap
Reuters 15 October 2012

Zurich Insurance open to 'extra risk'
FT 16 May 2013

Pru plans foray into UK rented housing
FT 31 March 2013

Aviva push into rented housing is 'sea-change'
FT 12 May 2013

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Current Environment

The regulator is also raising the profile of liquidity risk

The PRA's approach to insurance supervision – liquidity and funding

151. *Insurers have failed in other jurisdictions in recent years because of liquidity concerns — for example as access to wholesale funding has dried up.* ***The PRA will take the view that this is potentially a serious risk for the sector, and one that may rise in future if insurers become more closely engaged in providing liquidity for other parts of the financial sector***

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Current Environment

Next steps

Given these emerging fundamental changes in the attitude towards liquidity by insurers, their existing liquidity systems are unlikely to have the appropriate capabilities required to ensure liquidity is sufficiently well managed given the potential increased regulatory focus and increased risk appetite for illiquidity companies may now accept.

This is leading to enhancements in companies Liquidity Management Frameworks.

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Liquidity Management Framework

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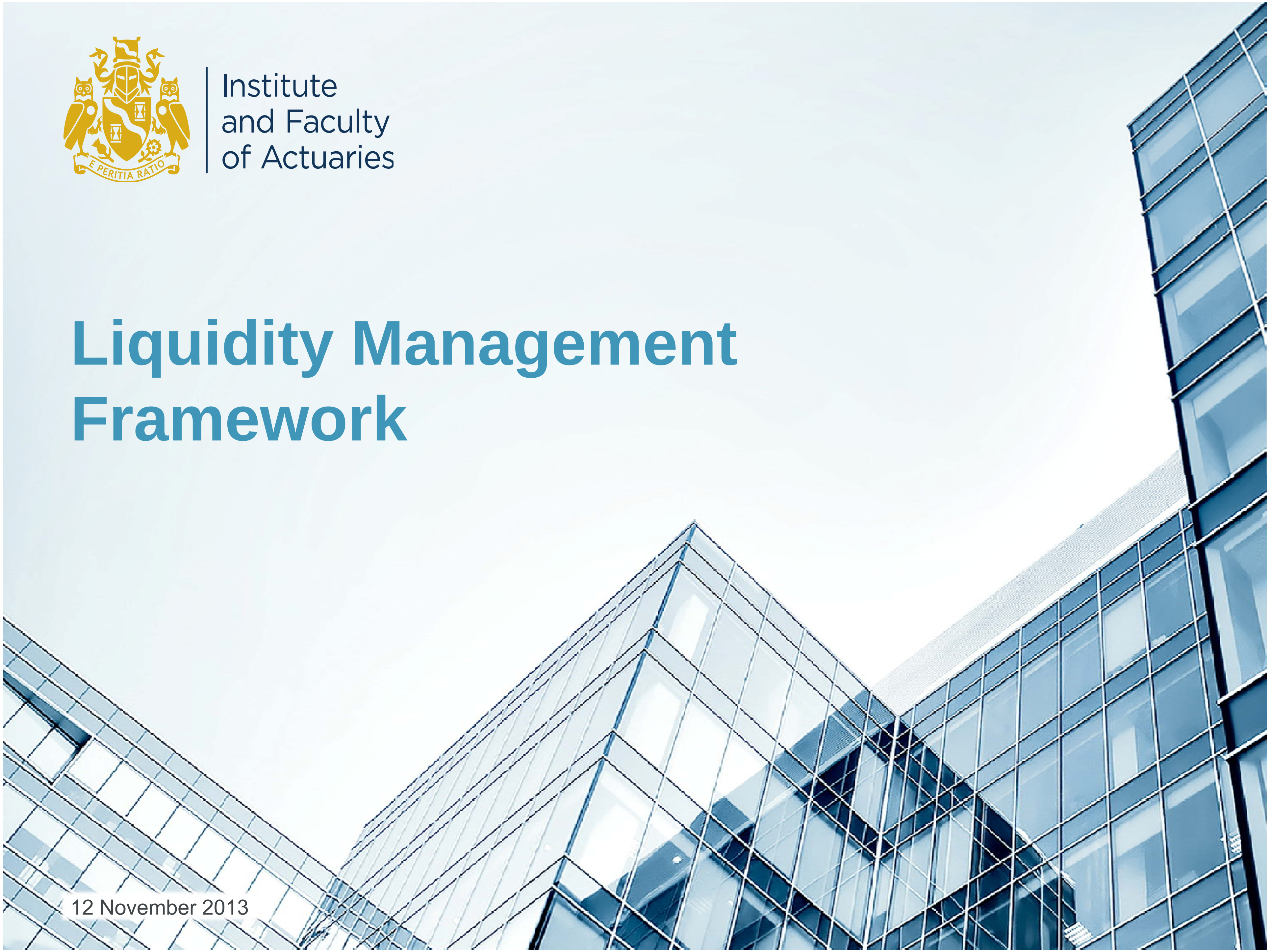

Liquidity Management Framework

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Liquidity MI

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Liquidity MI

What are we trying to do?

- Avoid feast and famine despite uncertainties

- Not an uncommon problem….
  - Think of energy companies
  - Think of demand for seasonal items on the high street
  - Think of water supply in Southern England

- Solution must in part be good planning

- Good planning requires expert understanding of uncertainties

- Good MI translates technical uncertainties into insight

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Liquidity MI

- Uncertainties for liquidity
- How illiquid are your assets?
  - The stakes are high, think of Lehmans….
  - What else do you have?
- How might demand for liquidity change?
  - Claims
  - Creditors
  - Corporate transactions
  - Collateral
- Do you have liquidity in all your entities; if not, is it moveable?
- How bad could it get?
- Short term versus long term: which is the more difficult to manage?

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Liquidity MI

What is good liquidity MI?

- Understand the purpose
- Base versus Stress scenario
- Give insight on the sensitivities
- RAG
- Contingent actions

But easier said than done…

- Pulling the MI together is likely to be complex
- Multiple sources
- Controls/RACI/sign-offs
- Time to produce

Liquidity MI

“Cash Management”

- Daily cash positions across businesses/long term business funds
- Explanations of cash volatility
- Utilisation of overdrafts / breaches of cash counterparty limits
- Actual cash management outflows vs predicted
- ...

“Medium Term to Long Term”

- Projected future benefit outgos
- Projected future costs / budget payments
- Projected future assets/asset income
- Projected future corporate payments or large expected one-offs
- Restrictions such as collateral positions
- Stressed results and comparisons with risk appetite
- ...

Analysis and Trends are key

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Stress Testing

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Stress Testing

Regulatory liquidity stress testing in the Banking sector is much more evolved than in Insurance. The PRA stipulate three scenarios for 2013 that banking firms undertake and incorporate within their reporting:

- PRA Firm Specific – Unforeseen name specific event such as a profit warning resulting in a two notch long term downgrade and one notch short term downgrade.
- PRA Market Wide – Uncertainty as to whether firms will be able to meet their liabilities as they fall due results in long term wholesale market liquidity stress lasting for three months.
- PRA Combined Scenario – Combination of the FSA Firm Specific Scenario and the FSA Market Wide Scenario

The PRA has highlighted, as part of their recent FRR visits with firms, the importance they place on tailored stress testing for insurance firms so that firm-specific risks are fully and properly understood.

Stress testing

Insurance companies must understand the risk of the firm-specific liquidity difficulties, for Life firms this is usually:

- Insurance Risk
- Collateral
- Operational Risk
- Liquidity implications of Credit Default Risk

Liquidity stress scenarios must also be understood and considered for:

- Dividend payments
- Repayment of debt requirements
- Intra-Group transactions

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Looking Forward

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Looking Forward

Key developments for the industry

- Embedding liquidity frameworks into the business (planning etc...)
- Understanding and managing cash supply & demand
- Developing more efficient cash management processes
- Increased regulatory focus on liquidity stress and scenario testing and expectations around cohesive risk management implementations
- Continued focus on alternative assets (less liquid)
- Enhanced collateral management processes

Questions

Comments

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenters.

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