Institute and Faculty of Actuaries

CP4/19: Liquidity risk management for insurers

IFoA response to the Prudential Regulation Authority

05 June 2019

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We strive to act in the public interest by speaking out on issues where actuaries have the expertise to provide analysis and insight on public policy issues. To fulfil the requirements of our Charter, the IFoA maintains a Public Affairs function, which represents the views of the profession to Government, policymakers, regulators and other stakeholders, in order to shape public policy.

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Institute
and Faculty
of Actuaries

CP 4/19
Frederick Schneider
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

5 June 2019

Dear Frederick,

IFoA response to Consultation Paper CP4/19: Liquidity risk management for insurers

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the PRA's consultation paper (CP) on liquidity risk management for insurers. Given the CP subject matter, a range of IFoA Committees and Boards have been involved in the drafting of this response: our Life and General Insurance Standards and Consultations sub-Committees, and Finance & Investment, Life and General Insurance Boards. Members of the Committees and Boards are actively involved in liquidity management, including for non-life as well as life insurers.

General Comments

2. The IFoA welcomes the PRA's proposals with respect to liquidity management for insurers. The proposals are very sensible and they address an important risk for many insurers. Furthermore, the draft Supervisory Statement (SS) provides a detailed guide to the various aspects of liquidity risk that firms should work through.

3. We note the draft SS helpfully recognises that material liquidity risks can vary and be bespoke to an individual firm. It is important that the PRA's expectations regarding liquidity management are applied in a manner that is proportionate to the nature of the liquidity risks that firms face on both the asset and liability side of their balance sheet.

4. Although inferred within the CP, the draft SS could acknowledge explicitly that an insurer should balance liquidity risk management with other objectives for the firm; liquidity is just one risk which the insurer will consider within its risk framework. In particular, it would not normally be desirable that insurers become so liquidity risk-sensitive that it then constrains them from investing into less liquid assets (these may yield higher returns and still fit within overall risk appetite by matching certain longer liabilities). If investment returns are unduly constrained, due to focusing on liquidity above all else, then the products insurers offer to policyholders may become more expensive.

5. Outside of the SS, it may be useful for the PRA to provide some anonymised examples of what they see as being good approaches to liquidity risk management by PRA-regulated firms.

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6. Although liquidity may have been a lower risk for many non-life firms than other risk exposures in the past, it is often of greater prominence now. In the current low interest rate environment, some non-life insurers have sacrificed liquidity for yield, and it is therefore important that non-life insurers model and properly understand their liquidity requirements in normal and stressed environments.

7. The CP does note that, as part of its liquidity risk management strategy, a firm should assess its overall liquidity needs over various durations. We agree with this, but it may be helpful to refer to specific issues with longer term durations as they create different considerations in terms of liquidity. For example, some firms could potentially have a concentration of illiquid assets which in run-off could give rise to future liquidity problems over the longer-term, such as equity release mortgages held to back annuity liabilities. Longer duration business therefore needs long term projections and key assumptions on factors such as dividend policies. We also note that long term illiquidity issues could also arise in a non-life context, such as with periodical payment order liabilities.

Comments on draft Supervisory Statement SS 'Liquidity risk management for insurers'

8. Chapter 2 (the section on liquidity risk management strategy) and also Chapter 5 acknowledge that an insurer should take into account any potential costs or financial losses arising from forced sales of illiquid assets. Such costs (and any associated losses) may be more pronounced under stressed conditions, and it would be helpful to refer to this explicitly within the SS.

9. It would be useful if section 3.2 could include at least one source of liquidity risk for the non-life industry, such as natural catastrophe; there are already several sources of illiquidity given for life firms.

10. Although section 3.2 refers to reinsurers, it would also be helpful to note that a systemic industry event could put simultaneous liquidity pressure on multiple insurers and reinsurers.

11. Furthermore, it would be useful within section 3.2 to mention trust funds, which may need to be separately funded and could affect non-life firms. *Alternatively this could be mentioned in paragraphs 3.10-3.13.*

12. Paragraph 3.12 explains that firms should be mindful of the liquidity implications for with-profits funds. We suggest that when assessing liquidity strategy and risk in a with-profits fund, regard should be given to intergenerational fairness and the SS could note this. A specific point is that where a with-profits fund considers higher risk assets as a source of liquidity, selling these when values are depressed could mean that the relevant policyholders lose out from any potential for these assets to recover.

13. Paragraph 4.8 is very specific in mentioning 7, 30, 90 days and 1 year, and expecting that liquidity stresses are considered over each of these timeframes. For some insurers these may not be the appropriate durations on which to perform the stress tests. Instead, it may be better to use these durations as guides rather than formal requirements, and ask that insurers apply liquidity stresses that align with other key durations as determined by internal analysis and/or the ORSA.

14. The terms 'assets of primary liquidity' and 'assets of secondary liquidity' are introduced in paragraph 5.5, including mapping of specific asset classes to these categories. We do not think these additional terms are strictly necessary. The draft SS refers to 'liquid assets' and 'high quality liquid assets'. These references are principles-based, reflecting the

characteristics of the asset (or asset class). This seems to us to be sufficient to allow firms to assess which assets they deem appropriate to meet stress events over different periods (which could include a proportion of certain asset holdings, rather than all or nothing). In addition, the liquidity of different asset classes is a spectrum, has overlaps (certain covered or corporate bonds will be more liquid that certain sovereigns), and varies over time.

15. Paragraph 5.14 relates to insurers' access to liquidity in money market funds potentially being limited in stress. The paragraph refers to collective investment undertakings, but it could be generalised to include assets held within any pooled vehicles. It would then be useful to provide guidance on expectations of firms on assessing the liquidity of these holdings. This could include assessment of the legal terms and conditions (particularly on redemptions), look-through to the asset holdings (and their liquidity), and potentially the liquidity risk management strategy of the fund itself.

16. Consideration of short and long term horizons is referred to in paragraph 6.1. It would be useful to understand how these horizons relate to the 7, 30, 90 days and 1 year time frames mentioned in paragraph 4.8.

Should you wish to discuss any of the points raised in further detail please contact Steven Graham, Technical Policy Manager (steven.graham@actuaries.org.uk / 0207 632 2146) in the first instance.

Yours sincerely

Marjorie Ngwenya

M. Ngwenya

Immediate Past President
Institute and Faculty of Actuaries