Stand out for the right reasons

Financial Services Risk and Regulation

FSRR Hot Topic

CP 4/19: Liquidity risk management for insurers

Highlights

Liquidity risk is a key risk for insurers although it has historically been less of a focus than capital. We cover in this paper the considerations for firms with respect to their liquidity risk framework and how they differ from considerations for capital.

Executive Summary

The PRA released its consultation paper CP4/19 on 5th March 2019, seeking views on its draft Supervisory Statement (SS) on *Liquidity risk management for insurers*. This draft SS provides a framework for how the PRA expects insurers to manage their liquidity risk going forwards.

Traditionally, liquidity risk has been less of a focus for insurers given the emphasis on protection of capital, the usually high levels of cash retained and their upfront receipt of premium income which is then used to pay back claims later. However, increased illiquid asset exposure and use of derivatives by some insurers, structural reductions in liquidity in some markets, and the impact of pension reforms on predictability of long-term liabilities, all mean that liquidity risk has increased.

From a regulatory perspective, Solvency II focuses more on capital requirements than liquidity risk management, though liquidity risk is considered e.g. in EIOPA's *Guidelines on system of governance*, and specific requirements apply to *Global Systemically Important Insurers* (G-SIIs). This contrasts with bank regulation; Basel's *Principles for Sound Liquidity Risk Management and Supervision*, for example, was published in September 2008.

This publication considers the areas the PRA has highlighted as key parts of an effective liquidity risk management framework and summarises potential implications.

We note that the draft SS leads to the supersession of SS2/13 on *Collateral upgrade transactions and asset encumbrance: expectations in relation to firms' risk management practices.*

The consultation period for CP 4/19 closes on 5th June, 2019.

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Overview of the proposals

The draft Supervisory Statement provides a framework for how the PRA expects insurers to manage liquidity risk. The PRA has focused on six key areas:

1. Overall liquidity risk management framework
2. Sources of liquidity risk
3. Stress testing
4. Liquidity buffers
5. Risk monitoring and reporting, and
6. Liquidity contingency plan.

These areas are discussed in further detail below.

1. Liquidity risk management framework

The PRA has specific expectations regarding firms' liquidity risk appetite, which is owned by the board, including in respect of timescales, acceptable levels of risk and types of assets deemed liquid. Firms also need to have a liquidity risk management strategy and documented liquidity risk policies. Segregated responsibilities, proper and robust systems to report Management Information (MI), actions in respect of short and long term liquidity risk, clear reporting lines for groups, forward-looking scenario analysis and stress testing, and quantitative metrics and tools to serve as Early Warning Indicators (EWIs) are all considered fundamental.

We note that banks often split liquidity responsibilities between Treasury (first line) and Risk (second line).

The PRA also notes that 'reliance on an existing capital management framework' is not generally sufficient or appropriate for assessing liquidity risk, underlining the importance of liquidity risk management specifically.

Beyond this, being able to meet liquidity needs in base and stress scenarios, effectiveness reviews, and considerations in respect of individual funds (e.g. With Profits) are also expected.

2. Material sources of liquidity risk

The PRA expects each insurer to identify and understand all material sources of liquidity risk to which they are exposed, and specifically highlights the following:

- Liability-side risks, e.g. sudden increases in lapses, surrenders and claims
- Asset-side risks, specifically how assets could be monetised (including collateral), in benign and stressed conditions, haircuts and potential losses from forced sales
- Concentration risks, e.g. exposure to own credit rating, or specific counterparties
- Off-balance sheet risks, e.g. associated with derivatives margin calls, and
- Funding risk, cross-currency risk, intra-day risk and franchise risk.

The PRA also draws attention to collateral upgrade and other transactions (where specific requirements apply), fungibility considerations (e.g. restrictions arising due to Matching Adjustment (MA) or With Profits funds) and unit-linked business (where it also identifies FCA rules on the management of liquidity), and group-specific risks.

3. Stress testing

The PRA sets specific expectations regarding separate and combined stress testing, adequacy of MI, systems and data processes and the need to capture all material, relevant risk drivers.

The PRA states that stress testing should be performed separately on MA and non-MA business, and at group and solo entity levels. Idiosyncratic, market-wide and combined specific stresses should be considered, as should the effects of market disruption and counterparty actions.

Stress tests are expected to span a variety of time horizons, including 7, 30, 90 days and one year. When considering appropriateness of stress calibrations, the PRA reminds firms that capital

is set at a 99.5th percentile level over one year, and that firms need to consider carefully how to apply stresses over shorter time horizons.

Stress testing is intended to inform estimates of future balance sheet growth and premium income, assumptions on margin calls, reliance of committed lines of credit, the continued availability of liquidity, policyholder behaviour, correlations, access to funding, currency convertibility and group-related factors.

The PRA expects an insurer's approach to liquidity stress testing, as well as the stresses and scenarios themselves, to be regularly approved by senior management and the board. The frequency of stress testing is expected to be proportionate to the nature, scale and complexity of an insurer's activities.

4. Liquidity buffers

Liquidity buffers are expected to be tailored to the needs of the business and liquidity risk being faced, and take into account 'assets of primary and secondary liquidity' (e.g. cash/gilts, and corporate bonds respectively), the need for diversification, access and control, the appropriateness of haircuts, and consistency of currency denomination and net outflows.

It is noted that it is good practice for insurers to rely only on assets of primary liquidity for stresses up to 90 days. Restrictions on double-counting of assets also apply, as do requirements on testing of liquidity and consideration of liquidity under stress.

Insurers are expected to 'avoid counting funds committed for future payments or investments used for regular income generation' in their buffers. The precise interpretation of this statement is unclear; insurers are currently permitted to post bonds held to back liabilities against derivative margin calls. Restrictions on this might have significant implications.

The PRA also defines 'high quality liquid assets', broadly analogous to 'HQLA' for banks. Requirements apply in relation to money market funds, and third party funding arrangements.

5. Risk monitoring and reporting

Insurers are expected to define risk metrics over a number of time horizons, in line with governance standards, with board approval.

The PRA suggests several metrics insurers may consider, in particular:

1. 'Liquidity coverage ratio'; high quality liquid assets divided by 'net stressed cash outflows'. This is broadly analogous to the LCR metric employed by banks, though 'net stressed cash outflows' is not explicitly defined.
2. 'Excess liquidity metrics': high quality liquid assets less 'net stressed cash outflows.

Low-point analysis, rather than end-point analysis, is expected. Stress testing is expected to be subject to periodic review and revision, and regularly monitored.

The PRA sets expectations in relation to stress tests and:

- Reporting results to management (at least monthly) and senior management and the board, and any board risk committee, including at group level
- Integration into business planning processes
- Setting internal risk limits and establishing risk monitoring metrics
- Updating insurers' risk management strategies and policies, and
- Informing insurers' plans to deal with changes in expected cash flows, and their contingency plans.

Adherence to liquidity risk appetite and risk tolerance limits are expected to be considered regularly during board meetings. There are also requirements regarding concentrations on a group basis.

6. Liquidity contingency plan

The PRA expects most insurers to draw up a liquidity contingency plan to ensure continuity and to recognise and address a liquidity stress. This should include strategies for preserving liquidity and making up cash flow shortfalls in adverse scenarios.

Liquidity contingency plans should set out alternative sources of funding (including the amounts and timing), the process to invoke the plan (including identification of a stress event using EWIs), a decision-making process including actions to take under stress, roles and responsibilities and clear communication plans for internal and external stakeholders.

The PRA also sets out items to take into account in developing liquidity contingency plans, requirements in relation to testing and periodically updating plans, and group-related considerations.

What does this mean for firms?

- If adopted as drafted, the SS may require significant attention from life and non-life insurers in relation to their liquidity risk management approach. This may have far reaching implications, impacting not only how they manage their insurance liabilities and investments, but also raising a number of additional governance, organisational and operational considerations (e.g. around treasury, ALM, investment, risk, actuarial and finance functions, as discussed above).

- Definition, composition and magnitude of liquidity buffers may be a particular focus, given the specific proposals being made. Insurers may wish to consider whether these proposals impose significant constraints on their investment strategies. For instance, is the requirement to cover stressed outflows up to 90 days with assets of primary liquidity onerous, in relation to derivative margin calls where other assets may also be eligible collateral?

- Metrics may need particular focus. For instance, insurers may choose to adopt a liquidity coverage ratio, an excess liquidity metric, or something else. These metrics behave differently under different conditions, the consequences of which need to be fully understood.

- Insurers may consider collateral optimisation or other strategies to maintain or enhance their liquidity positions, similarly to how banks optimise their collateral positions.

- Insurers may seek to engage with their boards and senior stakeholders in different ways than they do currently. They may also seek to allocate and segregate responsibilities for liquidity management differently.

- Insurers will need to consider whether reporting systems provide timely and adequate MI, and whether enhancements may be required.

- Some insurers may ultimately determine that they have excess liquidity. This may prompt them to consider alternative uses of liquidity, e.g. investment shifts from government bonds or cash into corporate bonds, potentially increasing investment returns.

How can PwC help?

- PwC has breadth and depth of experience in liquidity, gained through working with a wide variety of firms. Besides working with many insurers on liquidity (e.g. supporting firms in developing liquidity risk management frameworks and liquidity plans for Matching Adjustment applications), we have experience across banks and corporates, from the largest international and investment banks to corporates and SMEs. This is particularly relevant given the proposed SS shares common themes with existing bank regulation.

- We can provide tailored support, leveraging insight from the wider market, including:
  - Undertaking gap analysis and putting in place action plans to address any shortcomings
  - Developing liquidity risk frameworks including risk appetite setting, strategy and policies, governance etc
  - Tailored risk identification across the various sources of liquidity risk
  - Designing and calibrating scenario analysis and stress testing (e.g. idiosyncratic, market-wide and combined)
  - Supporting with the design and calibration of liquidity buffers
  - Development of metrics to reflect liquidity risk
  - Board training regarding liquidity risk, and
  - Design and implementation of liquidity contingency plans.

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Stand out for the right reasons

Financial services risk and regulation is an opportunity

Alert

Protect

Adapt

Repair

At PwC we work with you to embrace change in a way that delivers value to your customers, and long-term growth and profits for your business. With our help, you won't just avoid potential problems, you'll also get ahead.

We support you in four key areas.

- By alerting you to financial and regulatory risks we help you to understand the position you're in and how to comply with regulations. You can then turn risk and regulation to your advantage.
- We help you to prepare for issues such as technical difficulties, operational failure or cyber attacks. By working with you to develop the systems and processes that protect your business you can become more resilient, reliable and effective.
- Adapting your business to achieve cultural change is right for your customers and your people. By equipping you with the insights and tools you need, we will help transform your business and turn uncertainty into opportunity.
- Even the best processes or products sometimes fail. We help repair any damage swiftly to build even greater levels of trust and confidence.

Working with PwC brings a clearer understanding of where you are and where you want to be. Together, we can develop transparent and compelling business strategies for customers, regulators, employees and stakeholders. By adding our skills, experience and expertise to yours, your business can stand out for the right reasons.

For more information on how we can help you to stand out visit *www.pwc.co.uk*