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Public Consultation on the draft Application Paper on Liquidity Risk Management

Thank you for your interest in the public consultation on the draft Application Paper on Liquidity Risk Management. The Consultation Tool is available on the IAIS website from 19 November 2019.

Please do not submit this document to the IAIS. All responses to the Consultation Document must be made via the Consultation Tool to enable those responses to be considered.

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Consultation Tool on the draft Application Paper on Liquidity Risk Management

Q1 General Comment on Application Paper on Liquidity Risk Management

This paper is a very useful addition to understanding the need for liquidity management by insurance companies. We commend the work that has been done on this subject.

Q2 Comment on Section 1: Introduction

Comment Box

Q3 Comment on Paragraph 1

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 for 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. We 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 that are considered acceptable, which instead should be variable depending on the circumstances of particular companies or jurisdictions. It thus may discourage the use of judgement by supervisors.

Q4 Comment on Paragraph 2

Comment Box

Q5 Comment on Paragraph 3

The second 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 asset-liability management (ALM) purposes (as suggested by paragraph 53). We 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 (Q59).

Q6 Comment on Section 1.1: Rationale

Comment Box

Q7 Comment on Paragraph 4

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Q8 Comment on Paragraph 5

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Q9 Comment on Paragraph 6

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Q10 Comment on Paragraph 7

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Q11 Comment on Section 1.2: Terms

Comment Box

Q12 Comment on Paragraph 8

Comment Box

Q13 Comment on Section 1.3: Scope

Comment Box

Q14 Comment on Paragraph 9

Comment Box

Q15 Comment on Paragraph 10

Comment Box

Q16 Comment on Paragraph 11

The second bullet is entitled “securities lending transactions.” There is a possibility that readers may interpret the entry, which is about a mismatch between assets and liabilities where the assets are illiquid and the liabilities are liquid, does not pertain to “securities lending.” Suggest reconsidering this wording.

Q17 Comment on Paragraph 12

Comment Box

Q18 Comment on Section 1.4: Proportionality

Comment Box

Q19 Comment on Paragraph 13

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Q20 Comment on Paragraph 14

Comment Box

Q21 Comment on Section 1.5: Supervisory Review

Comment Box

Q22 Comment on Paragraph 15

Comment Box

Q23 Comment on Paragraph 16

This paragraph notes that "timing is a critical dimension to liquidity risk." We 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 need events that should be the focus of this paper.

Q24 Comment on Paragraph 17

Comment Box

Q25 Comment on Paragraph 18

The last part of this paragraph mentions the time horizons 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

Comment Box

Q27 Comment on Paragraph 20

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).

Q28 Comment on Paragraph 21

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Comment Box

Q29 Comment on Paragraph 22

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Q30 Comment on Section 1.6: Structure

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Q31 Comment on Paragraph 23

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Q32 Comment on Section 2: Governance

Comment Box

Q33 Comment on Paragraph 24

The comments for paragraph 18 (Q25) 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 a separate function.

Q34 Comment on Paragraph 25

See answers to Q25 and Q33.

Q35 Comment on Paragraph 26

Comment Box

Q36 Comment on Paragraph 27

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Q37 Comment on Section 3: Liquidity stress testing

Comment Box

Q38 Comment on Paragraph 28

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Q39 Comment on Paragraph 29

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Q40 Comment on Paragraph 30

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Q41 Comment on Paragraph 31

Comment Box

Q42 Comment on Paragraph 32

This paragraph states that lines of credit should not be assumed to continue to be available in stressed situations. 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

Comment Box

Q44 Comment on Paragraph 34

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Q45 Comment on Paragraph 35

Comment Box

Q46 Comment on Section 3.1: Liquidity risk drivers

Comment Box

Q47 Comment on Paragraph 36

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Q48 Comment on Paragraph 37

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Q49 Comment on Paragraph 38

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Q50 Comment on Paragraph 39

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Q51 Comment on Paragraph 40

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Q52 Comment on Paragraph 41

Comment Box

Q53 Comment on Paragraph 42

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 accounts." We 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.

Q54 Comment on Paragraph 43

Comment Box

Q55 Comment on Paragraph 44

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Q56 Comment on Paragraph 45

Comment Box

Q57 Comment on Section 4: Liquidity portfolio

Comment Box

Q58 Comment on Section 4.1: Scope of liquidity portfolio

Comment Box

Q59 Comment on Paragraph 46

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

Comment Box

Q61 Comment on Paragraph 47

This paragraph and paragraph 49 state that the liquid assets should have a “low market risk.” We 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 consistent with the guidance in paragraph 55.

Q62 Comment on Paragraph 48

Comment Box

Q63 Comment on Paragraph 49

An overly prescriptive list does not permit the future innovation of capital markets and may not fully recognize specific assets held by companies which are not on this list but which offer good liquidity.

Q64 Comment on Paragraph 50

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.

We recommend the table with this paragraph be removed from the paper. The table, 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 to liquify. The key should not be the type or rating of an asset before an adverse event, but whether there will likely continue 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

The comments in Q64 (paragraph 50) also apply here.

Q66 Comment on Paragraph 52

The restriction on instruments issued by other financial institutions appears to borrow guidance from the bank supervisors and may not fully reflect the long-term nature of life insurance liabilities. In Canada 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

We do not agree with this paragraph saying liquidity testing should disallow considering any bonds paying coupons which are used in the company’s ALM cash flow management. If there is a liquidity event, all liquid assets should be considered to 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 reflected in scenario testing.

Q68 Comment on Section 4.3: Other portfolio considerations

Comment Box

Q69 Comment on Paragraph 54

Comment Box

Q70 Comment on Paragraph 55

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Q71 Comment on Paragraph 56

We 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

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Q73 Comment on Paragraph 58

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Q74 Comment on Section 5: Contingency funding plan

Comment Box

Q75 Comment on Paragraph 59

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

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Q77 Comment on Paragraph 61

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Q78 Comment on Paragraph 62

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Q79 Comment on Paragraph 63

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Q80 Comment on Paragraph 64

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Q81 Comment on Section 6: Liquidity risk management report

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Q82 Comment on Paragraph 65

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Q83 Comment on Paragraph 66

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Q84 Comment on Paragraph 67

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Q85 Comment on Section 6.1: Risk appetite and risk limits

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Q86 Comment on Paragraph 68

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Q87 Comment on Paragraph 69

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Q88 Comment on Paragraph 70

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Q89 Comment on Paragraph 71

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Q90 Comment on Paragraph 72

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Q91 Comment on Section 6.2: Liquidity risk management framework

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Q92 Comment on Paragraph 73

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Q93 Comment on Paragraph 74

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Q94 Comment on Paragraph 75

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Q95 Comment on Paragraph 76

Comment Box

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

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Q97 Comment on Paragraph 77

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Q98 Comment on Paragraph 78

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Q99 Comment on Paragraph 79

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Q100 Comment on Section 6.4: Reporting to the supervisor

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Q101 Comment on Paragraph 80

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Q102 Comment on Paragraph 81

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Q103 Comment on Paragraph 82

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Q104 Comment on Paragraph 83

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