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IAIS Public Consultation on the Development of Liquidity Metrics: Phase 2

The CIA submitted comments to the International Association of Insurance Supervisors (IAIS) on a consultation regarding the development of liquidity metrics (Phase 2) through an online tool. The CIA responded to Phase 1 earlier this year. The CIA responded to select questions, which are presented below.

Q1 Do you agree with the IAIS' general objective and contemplated usage for the liquidity metrics? If not, please explain your rationale.

In general, the development of a multijurisdictional/macroeconomic liquidity metric would appear desirable and useful in order to give an overview of liquidity risks from an international point of view. However, a liquidity metric needs to be of use to supervisors who monitor the operations of insurance companies and are responsible for liquidity risk governance. The liquidity metric as described in this report has some major defects precluding it from being of use to supervisors.

The following is a list of the key issues that we have identified:

- The report proposes that the metric be based on an enterprise-wide group basis. Large insurance groups typically operate in multiple geographic jurisdictions, have a variety of insurance product types and investment policies both within jurisdictions and among jurisdictions, and operate internationally based on their own strategic business plans. Given this diversity, it would be difficult to use a single liquidity metric to good effect for providing a macroeconomic view of international liquidity and provide a comparison of groups of companies.

- The report assumes that there is total fungibility of asset funds within a group. However, history has shown that, if there is a liquidity crisis affecting an insurance group, jurisdictions quickly move to ring-fence the local subsidiary funds to protect local policyholders and creditors. An example of this was when AIG had difficulties during the 2008 financial crisis, with local supervisors protecting the subsidiaries in their jurisdictions from the parent company problem. In a crisis, funds become non-fungible very quickly.

- The proposed liquidity metric does not distinguish between systemic liquidity crises and idiosyncratic liquidity crises. The history of insurance company insolvencies has shown that actual insolvencies have rarely been due to general systemic causes and are usually caused by idiosyncratic issues within insurance companies. As the report notes, insurance liabilities are not as short term as bank deposits and thus idiosyncratic crises for insurance companies have less time sensitivity thereby allowing different capital raising options, different asset sale opportunities, reinsurance options, etc., compared to systemic crises. To be of most use to supervisors, the two types need to be considered separately.

Q2 Do you want to propose an additional liquidity metric in addition to three metrics mentioned in this section? If yes, please describe a proposed metrics.

The following existing metrics already address future company risks, including liquidity:

- ORSA: This methodology addresses company management's view of issues and strategy. This should include liquidity risk if it is significant.
- IMF Financial Sector Assessment Program: This is a periodic assessment of financial operations in a jurisdiction. This includes the insurance industry projected financials based on a consistent set of assumptions required by the IMF.
- Individual companies have ERM and risk management functions, including projections of future financial conditions.

The IAIS's introduction of an additional metric may not appreciatively improve liquidity risk assessment while causing more analysis work to not only produce the new metric but also reconcile the different studies.

Q4 Is there a need to develop supplementary liquidity metrics solely for separate accounts for both EA and CPA? If not, provide suggestions how the IAIS should monitor liquidity related to separate accounts (united-linked products) for both EA and CPA?

We agree that there is no need to develop separate liquidity metrics for separate accounts.

Q5 Do you prefer to collect data and calculate liquidity metrics using fungible liquidity pools approach instead of the current enterprise approach for both EA and CPA? If yes, please provide ideas on approaches to the group-wide aggregation of results.

As mentioned earlier, at the time of a crisis, funds cannot be assumed to be fungible between subsidiaries or jurisdictions. A possible alternative is to test for liquidity risk at the main insurance holding company, and not assume funds in subsidiaries are fungible up to the parent company.

Q6 Does the current enterprise approach lead to significant shortcomings of the liquidity monitoring? If yes, describe these shortcomings and limitations.

See our answer to Q1 for a discussion of shortcomings under the current enterprise approach.

Q7 Do you agree with the proposal to include capital instruments in the CPA and EA metrics calculations as described in this section? If not, please provide rationale and alternative suggestions.

The inclusion of capital depends on whether new capital can be raised during a liquidity crisis. If the need for liquidity happens as a result of a systemic insurance market scenario where there are

depressed values of liquid assets, large policyholder surrenders, and/or limitations on the number of asset sales absorbable by the market, there may also be no sources accessible for raising new capital. However, in an idiosyncratic scenario, orderly liquid asset sales are possible and new capital may be available.

Q9 Do you agree with the above described CPA to calculate the baseline cash flow projection, to apply the liquidity stress test and then to evaluate its impact and potential application of haircuts on assets? If not, please explain and provide suggestions.

We agree with this methodology.

Q10 Do you agree with the proposal to perform the CPA at the holding company level? If not, please explain and provide suggestions.

We do not agree with testing for liquidity at the holding company level. As noted in our answer to Q1, the report assumes that there is total fungibility of asset funds within a group. However, history has shown that, if there is a liquidity crisis affecting an insurance group, jurisdictions quickly move to ring-fence the local subsidiary funds to protect local policyholders and creditors. An example of this was when AIG had difficulties during the 2008 financial crisis, with local supervisors protecting the subsidiaries in their jurisdictions from the parent company problem. In a crisis, funds become non-fungible very quickly.

A possible alternative is to test for liquidity risk at the main parent insurance company, and not assume funds in subsidiaries are fungible up to the parent company.

Q12 Do you agree with using haircuts from the ILR for assets to be applied if there is a cash flow deficit? If not, provide your explanation and suggestions.

We agree that using haircuts applied to assets is appropriate. We do not have an opinion about the factors shown in the report. The factors should be dependent on the financial environment of each jurisdiction.

Q13 Do you prefer to collect and analyse only high-level cash flow projections, ie. aggregate cash inflows and outflows of the three categories mentioned above? If yes, provide your clarification.

More detailed information than just the three categories is necessary to understand the reasons for any unexpected cash flow deviations.

Q15 Do you have any suggestions for changes or additions to the inflows and outflows as listed in Annex 2?

The results of interest and currency derivatives are not shown.

Q16 Do you agree with the proposed main types of cash outflows as specified in this section? If not, please provide clarification and suggestions for other outflows that should be considered.

We agree.

Q17 Do you agree with the three proposed time horizons (30 days, 90 days and 1-year) for the CPA? If not, please explain and provide your suggestions.

When an unexpected liquidity crisis appears, it is key to know what short-term (e.g., 30-day) actions can be immediately taken by the company to avoid defaulting on guaranteed payments. As mentioned earlier, the company's available actions will depend on whether the liquidity crisis is systemic or idiosyncratic. The 90-day time horizon will show the additional actions available to the company. The one-year time horizon should be part of the company's ERM function and included in the ORSA analysis.

Q18 Do you think the investing section of the cash flow statement should be stressed in the LST? Would you add or subtract certain investing cash inflows or outflows as listed in Annex 2?

All of the investing, operating, and financing sections should be stressed.

Q21 Do you agree with the selected adverse liquidity stress scenario? If not, provide clarification.

In our opinion, the number of parameters in Table 3 is excessive. The principal parameters affecting insurance company liquidity projections are interest rates, asset credit downgrades, and policyholder actions. For short-term liquidity scenarios, the very detailed information in Table 3 is not necessary.

Q24 Do you agree that CPA adverse scenario should contain adverse parameters related to insurance liabilities? If yes, do you have any suggestions for adverse parameters for cash outflows related to insurance liabilities?

A liquidity crisis may cause the insurance company to liquidate longer-term assets to meet short term payment needs. For a company that operates using the ALM strategy, this may affect the size of the policyholder liabilities, which may, in turn, cause supervisory financial statement issues.

Q29 Do you agree with the consideration of differences in liquidity profiles of life insurers, non-life insurers and reinsurers in the ILR liquidity needs factors? If not, please explain and provide your suggestions.

We agree there should be differences for the three principal types of insurance companies.

Q30 Do you agree with the use of two time horizons for the EA: 1-year and 3-month time horizons? If not, please explain and provide your suggestions.

See our answer to Q17.

Q31 Do you prefer to calculate 3-month time horizon similarly to the BCBS' LCR, ie. 3-month ILR liquidity sources (as defined in the Table 5) will be divided by net 3-month cash outflows (a difference between cash outflows and inflows from all operating, financing and funding activities as defined in the Chapter 2)? If not provide your comments.

The report noted (in Section 1.3.2) that banks and insurance companies have fundamental differences in their products, resulting in insurance companies having less risk of an immediate need for cash to meet demands from customers. The time horizon should thus not be directly the same as that of banks.

Q32 Do you agree with the proposed approach to financials? If not, please explain and provide your suggestions.

We agree.

Q33 Do you agree with the proposed approach to investment funds? If not, please explain and provide your suggestions.

We agree.

Q34 Do you agree with the proposed factors for sovereign/PSE/GSE debt instruments? If not, please explain and provide your suggestions.

We agree.

Q35 Do you agree with the proposed factors for non-financial corporate debt instruments (including covered bonds)? If not, please explain and provide your suggestions.

The amounts of liquidity that can be realized from corporate debt instruments vary significantly depending on whether the liquidity crisis is systemic or idiosyncratic. For a three-month period, the more adverse of the two situations should be used.

The factors for corporate bonds should be split between publicly marketable bonds and private debt bonds. The latter would not be marketable in a three-month period.

Q36 Do you agree with the proposed factors for financial corporate debt instruments? If not, please explain and provide your suggestions.

During a systemic liquidity crisis, it would be more appropriate to not take any credit for investments in other financial institutions, such as banks, which would also be stressed at the same time. If the crisis is idiosyncratic, investments in other financial institutions would remain of value.

Q37 Do you agree with the proposed factors for common equity (both financials and non-financials)? If not, please explain and provide your suggestions.

See our answer to Q35.

Q41 Do you agree with the proposed factors differentiation between 3-month and 1-year time horizons? If not, please explain and provide your suggestions.

See our answer to Q17.