INTERNATIONAL ASSOCIATION OF
INSURANCE SUPERVISORS

22 October 2014

Dear IAIS Members:

Please find attached the guidance on liquidity management and planning that was drafted by the IAIS Financial Stability Committee and approved by the IAIS Executive Committee.

This document builds on the G-SII Policy Measures, which were published on the IAIS website on 18 July 2013 (http://www.iaisweb.org/G-SIIs-988) and which state that the group-wide supervisor is responsible for evaluating and monitoring liquidity management and planning on a group-wide basis. The purpose of this document is to provide further guidance to group-wide supervisors on how they could direct G-SIIs to develop their liquidity management.

Not all members are, or may become, group-wide supervisors of G-SIIs. However, it is important that a common understanding develops amongst all supervisors on what is expected from insurers that have been designated as G-SIIs. Furthermore, the cross-border activities of G-SIIs make the guidance on liquidity management and planning also relevant for host jurisdictions/supervisors.

Jurisdictions that are group-wide supervisors of G-SIIs are requested to provide copies of the guidance to those G-SIIs. It is intended that the guidance will be made available on the IAIS public website by early November.

Should you have any questions with respect to the guidance, please refer them to John Maroney, Head of Financial Stability, at the IAIS Secretariat (john.maroney@bis.org).

Best regards

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# Guidance on Liquidity Management and Planning

## 1. Purpose of the guidance

The International Association of Insurance Supervisors (IAIS) released its Policy Measures for global systemically important insurers (G-SIIs) on 18 July 2013 (henceforth: The G-SII Policy Measures document)[1]. It states that group-wide supervisors should require G-SIIs to have adequate arrangements in place to plan for and manage liquidity risk for the whole group[2]. The purpose of this document is to provide guidance to group-wide supervisors in the application of these requirements to G-SIIs. The guidance is principles-based and outlines the key supervisory features that would be expected in the liquidity management planning of a G-SII. These plans should complement any existing liquidity arrangements.

The current guidance addresses the following components which are deemed as the core elements of an effective liquidity management and planning:

- A statement of policy containing the liquidity risk tolerance of the insurer.
- A description of the corporate governance and management that will establish the risk tolerance, manage the level of liquidity risk given that threshold, and monitor the effectiveness of that management.
- A means of assessing the insurer's liquidity adequacy across various suitable time horizons and under current and plausible stress scenarios
- Reporting by the G-SIIs on these activities.

## 2. Rationale

While in the normal course of business insurers[3] typically rely on premiums, income from investment and other sources, they nevertheless need to maintain adequate liquidity to fulfil expected and unexpected payment obligations and meet funding shortfalls. Liquidity management is key to the proper operation of the insurer, the protection of policyholders

[1] Cf. http://www.iaisweb.org/Supervisory-Material/Financial-Stability-Macroprudential-Policy-Surveillance-988

[2] This guidance will also be relevant for the preparation of liquidity risk management plans in the context of recovery and resolution.

[3] Where we refer to insurer in the document, both single entities and groups are meant. Insurance business refers to the business of insurers and reinsurers, including captives.

and financial stability. Accordingly, insurers are expected to exercise sufficient and regular reviews of their liquidity adequacy.

Mismanagement of liquidity and liquidity risks has contributed to distress and failure in the financial services industry. In the past, some instances of insurer distress or failure have been the consequence of concentrated investments in illiquid assets backing liability structures of which the payment obligations accelerated in a time of distress[4]. This exemplifies the risk that otherwise solvent insurers can find themselves short of cash or funding options to meet their liabilities as they fall due. Also, when confronted with stress events, insurers with insufficient liquidity may be forced to take remedial actions that may amplify or accelerate financial stresses through the financial system.

## 3. Concepts

**Liquidity risk** is the uncertainty, emanating from business operations, investments or financing activities, over whether the insurer will have the ability to meet payment obligations in a full and timely manner in current or stressed environments. Liquidity risk is concerned both with assets and liabilities as well as their interplay[5].

**Financing risk** is an important part of liquidity risk; it is specifically the uncertainty of the ability to obtain sufficient funding in due time and on non-punitive terms. Financing risk can arise from external events such as disruption in the markets for commercial paper and securities financing transactions or in other securities markets that may reduce the ability to raise funds. It can arise from internal events such as the loss of sufficient creditworthiness that is needed to access credit markets.

**Liquidity adequacy** is a measure or assessment of the ability of the insurer to meet payment obligations in a full and timely manner. It is a function of its sources of liquidity relative to its liquidity needs. **Liquidity sources** can be internal and external and include all funds, assets and arrangements that allow an insurer to meet its liquidity needs.

**Liquidity needs** include all payment obligations, including on- and off-balance sheet obligations.

**Contingency funding plan** should include the strategies for responding to any liquidity gap under stressed circumstances. This should consist of establishing lines of authority, procedures to trigger the emergency plans, and guidance to manage funding needs across a range of stressed conditions.

A comprehensive understanding of the insurer's sources and needs of liquidity and the interplay thereof are instrumental in liquidity management. An insurer should have a sound understanding of the ways in which its activities and decisions affect its liquidity risk profile under current and stressed conditions, and how outside influences may affect its liquidity risk position. A pre-condition for an effective liquidity measurement is for a

[4] Cf. Annex of IAIS (2011): Insurance and Financial Stability

[5] This is distinct from Asset/Liability Matching, which focuses on duration.

firm to continually assess its liquidity sources and liquidity needs and to maintain a complete **inventory** thereof, including their characteristics. For instance, aggravated or stressed conditions will affect liquidity sources and needs differently.

Current and possible future liquidity inflows and outflows, notably those from business, investment and (re-) financing activities, are to be categorised into liquidity sources and liquidity needs. Liquidity sources include, among others, the following:

- Cash
- Cash flows from financial assets and sales of financial assets
- Inflows from business operations, such as premium payments and reinsurance recoverables
- Access to short-term credit markets, for instance by means of commercial paper and securities financing transactions (security lending or reverse repo) and established lines of credit
- Receipt of liquid assets as collateral for derivatives and other transactions
- Collateral held under reinsurance arrangements

The level of liquidity of those sources varies and can be circumstance-specific. For example, encumbered assets, such as those used as collateral for reinsurance and derivative transactions, cannot be counted as liquidity sources but for the purpose of the gap analysis can be used to offset liquidity needs of the underlying contract commitment

Liquidity needs include, among others, the following:

- On balance sheet liabilities, such as those required to meet (re-) insurance and benefit payment obligations
- Other outflows from business operations
- Off balance sheet contingent claims and obligations, such as derivatives payments and collateral (margin) calls
- Assets purchased but not settled, repos
- Debt service (principle and interest)
- Corporate and other taxes.
- Pensions liabilities (on- or off-balance sheet)
- Additional liquidity requirements for capitalisation (or other purposes) of group entities
- Dividend declared but unpaid

An insurer should consider not only its current liquidity position, but how existing activities and operational/management decisions may affect its liquidity profile in the future. Projected future liquidity adequacy should consider several potential states of the world and not restrict itself to historical data. Hence, the insurer should look at different scenarios, covering both current and stressed conditions, and considering both internal events and external market conditions that may trigger changes in the insurer's liquidity profile.

An assessment of liquidity risk should include the following considerations. The list is non-exhaustive and the importance of each will vary across insurers.

- Nature, frequency, and severity of exposures to insurable events, including catastrophic events
- Features of insurance policies and products
- Depth and liquidity of capital markets, including liquidity characteristics of the assets

- (Changes in) behaviour of policy holders and other market participants, both gradual and sudden
- (Changes in) market conditions that will affect payment obligations
- Risk of non-convertibility of currencies
- Concentration in exposure in certain assets and to certain counterparties; having particular regard to the illiquidity of assets and counterparties with lower credit ratings under stressed conditions
- (Changes in) own credit worthiness, including rating downgrades; both gradual and sudden
- Trigger clauses and other contingent obligations for cash or collateral
- Encumbrances on assets and re-hypothecation of assets
- The specific liquidity characteristics of any non-traditional or non-insurance activities
- Interaction (potential correlation) of liquidity sources and liquidity needs

In addition to the above, a liquidity assessment should consider the legal organisation of the insurer and intra-group transactions (including reinsurance transactions). In particular, potential legal and economic impediments to inter-affiliate transactions both vertically and horizontally should be considered. The extent to which liquidity is fungible or not within the G-SII (within and across jurisdictions), currently and during times of stress, needs to be considered. For G-SIIs a prudent assumption should be that under stressed conditions liquidity is non-transferable across legal entities, unless the G-SII is able to provide robust rationale for alternative assumptions such as the existence of written and legally binding documents. These assumptions should be discussed and agreed between the group-wide supervisor (GWS) and the relevant national supervisors before recognising any fungibility claimed by the G-SII. In addition, national supervisors should be consulted by the GWS with respect to other requirements as well where applicable.

If the G-SII is a group, strategic considerations regarding the provision of liquidity to specific group entities in times of stress should be aligned with the recovery and resolution plans. To that effect, the liquidity assessment should consider if and to what extent entities or sub-groups of entities within the group are self-sufficient or dependent on liquidity support from other parts of the group (before and after any off-setting transactions). Complex group structures may require liquidity plans for both the group and its entities or sub-group of entities to allow a full understanding of the group's liquidity risk.

## 4. Liquidity management and planning

Firms may achieve effective liquidity management and planning in various ways accounting for differences in scale, nature and complexity of the insurer and its business mix..

The insurer, at the minimum addresses the following aspects of liquidity management as described further in this guidance:

- Statement of objectives: This would typically be in the form of liquidity risk policy(ies) and would include a clear articulation of risk tolerance and the governance arrangements around liquidity management. Depending on the insurer's funding structure, such policies could be articulated at the level of the group, entity or other subset of the group.

- Plans for execution: This would include liquidity risks management plan(s) and cover all aspects of identification, measurement, monitoring and mitigation of liquidity risk, as well as contingency funding plans.

## 4.1. Statement of objectives

Liquidity Policy

The G-SII needs to establish and maintain a policy for the day-to-day and long-term management of liquidity risk. The policy should state the G-SII's risk tolerance in regard to liquidity, including quantitative targets, such as excess liquidity and liquidity coverage ratio, and qualitative objectives. It should also explain how it ties in with the insurer's overall risk tolerance. The policy should explain how breaches of targets are escalated within the group.

The policy should address both liquidity sources and liquidity needs. It should also address how assumptions and expert judgment under normal and stressed conditions (e.g. market haircuts, management decisions like capital repatriations and dividends) are documented and justified. The policy should address responsibility for decisions on critical assumptions, the nature of risk tolerance and responsibility for contingency funding plans. The policy should be communicated to all relevant functions within the insurer.

Governance

The G-SII's Board should approve the liquidity risk policy and is responsible for its effectiveness on an on-going basis. It should also approve the liquidity contingency funding plans. Execution and elements of the liquidity risk framework, for instance day-to-day monitoring of its effectiveness, may be delegated to risk committee/investment committee/executive management, as appropriate to the structure and complexity of the G-SII. The relevant committee should report to the Board on a regular basis, including any significant changes to the liquidity risk profile of the G-SII.

The G-SII should establish and document a clear allocation of responsibilities regarding the management of liquidity risk, including reporting lines. In addition, internal controls and governance requirements related to liquidity should also be documented.

The G-SII shall demonstrate how the liquidity risk policy is applied, in particular how it integrates into the risk management of the firm and how it informs business decisions ("use test").

## 4.2. Plans for execution

The liquidity risk management plan should consist of both quantitative and qualitative elements. In doing so, the plan should state and justify all assumptions, in particular those underlying "liquidity impairments", scenarios and projections and the judgements applied in the scenarios that are to be used for liquidity planning. In particular, it should include an assessment of the arrangements the G-SII has in place to manage, mitigate or reduce liquidity risks.

The G-SII Policy Measures document focuses on a liquidity gap analysis[6], which cumulatively determines both liquidity sources and liquidity needs at specific points in time under current and stressed conditions. The plan should consider stress scenarios that are forward looking and not based entirely on historical data. In particular, G-SII's should construct idiosyncratic, market-wide and combined stress scenarios relevant to their business, noting that stress testing work for capital purposes may not be relevant or adequate for liquidity purposes.

<u>Liquidity analysis</u>

A liquidity gap analysis is an effective tool to identify, measure and manage liquidity risk in insurance. By providing this guidance and focussing on the liquidity gap analysis as a common deliverable for all G-SIIs, the IAIS aims to facilitate the interaction of the G-SII and its GWS as well as among supervisors involved in Crisis Management Groups (CMGs) and/or Colleges. This does not preclude the use of other risk factors, risk metrics or policy tools that could supplement the gap analysis. The analysis should include consideration of the location of material liquidity gaps within the G-SII (e.g. individual entities or sub-group of entities).

Liquidity sources and liquidity needs as maintained in the inventory serve as a basis for the gap analysis (cf. section 4).

The gap analysis should include, at a minimum, the following:

- A projection over time of liquidity sources under current conditions and future stress scenarios (based on the insurer's liquidity sources).
    - All encumbered cash and other assets should be excluded from liquidity sources.
    - All ring-fenced cash and other assets (e.g. those belonging to Unit Linked funds, With Profit Funds) should be excluded as liquidity sources. However, the share belonging to the insurer can be considered.
    - The haircut on collateral posted in secured borrowings should be consistent with those levels at which the insurers' counterparties are willing to lend at, in adverse market conditions.
    - The availability of new unsecured market borrowings and rollovers should be assumed as zero under idiosyncratic and combined stress scenarios for the full time horizon.
    - Regarding existing borrowing agreements, their degree of liquidity should consider whether there are contingencies.
- A projection over time of liquidity needs under current conditions and future stress scenarios should consider such situations as high rates of surrenders, cancellations or lapses, at the legal entity level and – where applicable - acceleration of liquidity needs at the group level (e.g. holding company obligation to repay its loans due to a credit rating trigger).
- Projections of both liquidity availability and needs must be based on consistent assumptions.

[6] Please refer to the Annex for a stylised example of a gap analysis

- G-SII's should be required to substantiate that the contingency funding plans are reasonable and have a likelihood of success under stressed conditions.
- Time intervals and overall time horizon needs to be appropriate for the business model. G-SII's should be encouraged to use a number of time horizons; particularly short term (which addresses the potential problems in collateral margin, money market funds freeze risk, etc.) and long term (which could be one year or longer).

Liquidity sources and liquidity needs should be presented separately under different time horizons and scenarios. The difference between liquidity sources and needs constitutes the respective **excess liquidity (or shortfall thereof)** of the insurer, in the time intervals. The ratio of the liquidity sources and liquidity needs on the other hand constitutes the **coverage ratio**[7] in the time intervals. Both excess liquidity and coverage ratio should be calculated for each scenario and time horizon. 'Early warning indicators', which could be expressed as coverage ratios or other quantitative criteria, should be part of regular monitoring.

Additional, insurer specific considerations to be taken into account:

- Target liquidity maintenance levels, i.e. minimum standard, that an insurer sets for its liquidity management and planning
- Capital planning: capital repatriation, dividends, etc.
- Haircuts applied to securities under current and stressed conditions for use in funding and sale
- Other liquidity risk metrics that are of specific interest to internal management or supervisors

If any mitigating conditions, measures or management actions impact the liquidity risk of the insurer, these should be included and their role explained. In particular, any assumptions relating to "monetisation" of future cash flows need to be justified. Furthermore, the plan should provide results before and after application of risk mitigating measures, and the resilience of these measures under stressed conditions.

## 5. Reporting to group-wide supervisor

The G-SII should report at least annually on its liquidity management and planning or more frequently in the event of any major changes[8] to its policy or liquidity risk profile. The frequency of reporting should reflect the distinctive nature, scale, and complexity of the group. The G-SII should be able to respond to ad-hoc requests from the group-wide supervisor (GWS) on its current liquidity condition at any time.

The GWS should share the information within supervisory colleges and with the Crisis Management Group.

[7] Depending on the nature of the activities and the manner in which they are funded, it may be appropriate to determine a number of liquidity coverage ratios.
[8] The GWS in consultation with the G-SII may define major changes if deemed appropriate.

**Annex 1** Illustrative example of a gap analysis[9]

Time horizon

| | End of period balance sheet (e.g. quarter) | Current | 3 months | 6 months | 12 months | 2 years | n years |
|---|---|---|---|---|---|---|---|
| Liquidity sources (1)<br><br>Cash<br>Lines of credit<br>…… | | | | | | | |
| Liquidity needs (2)<br><br>Contingent claims<br>Asset purchases<br>Operating expenses<br>……. | | | | | | | |
| Excess Liquidity | (1) – (2) | (1) – (2) | (1) – (2) | (1) – (2) | (1) – (2) | (1) – (2) | (1) – (2) |
| Coverage Ratio | (1)/(2) | (1)/(2) | (1)/(2) | (1)/(2) | (1)/(2) | (1)/(2) | (1)/(2) |

Assessments should be done for different scenarios, with respective implications on liquidity sources and needs and the corresponding liquidity measures. This assessment could be supported by charts. Complex structures may also justify an additional assessment at entity level to fully reflect the level of liquidity resources or the constraints thereof.

[9] This is a generic illustration only and does not take into account any firm specificities or other aspects a G-SII may want to consider.

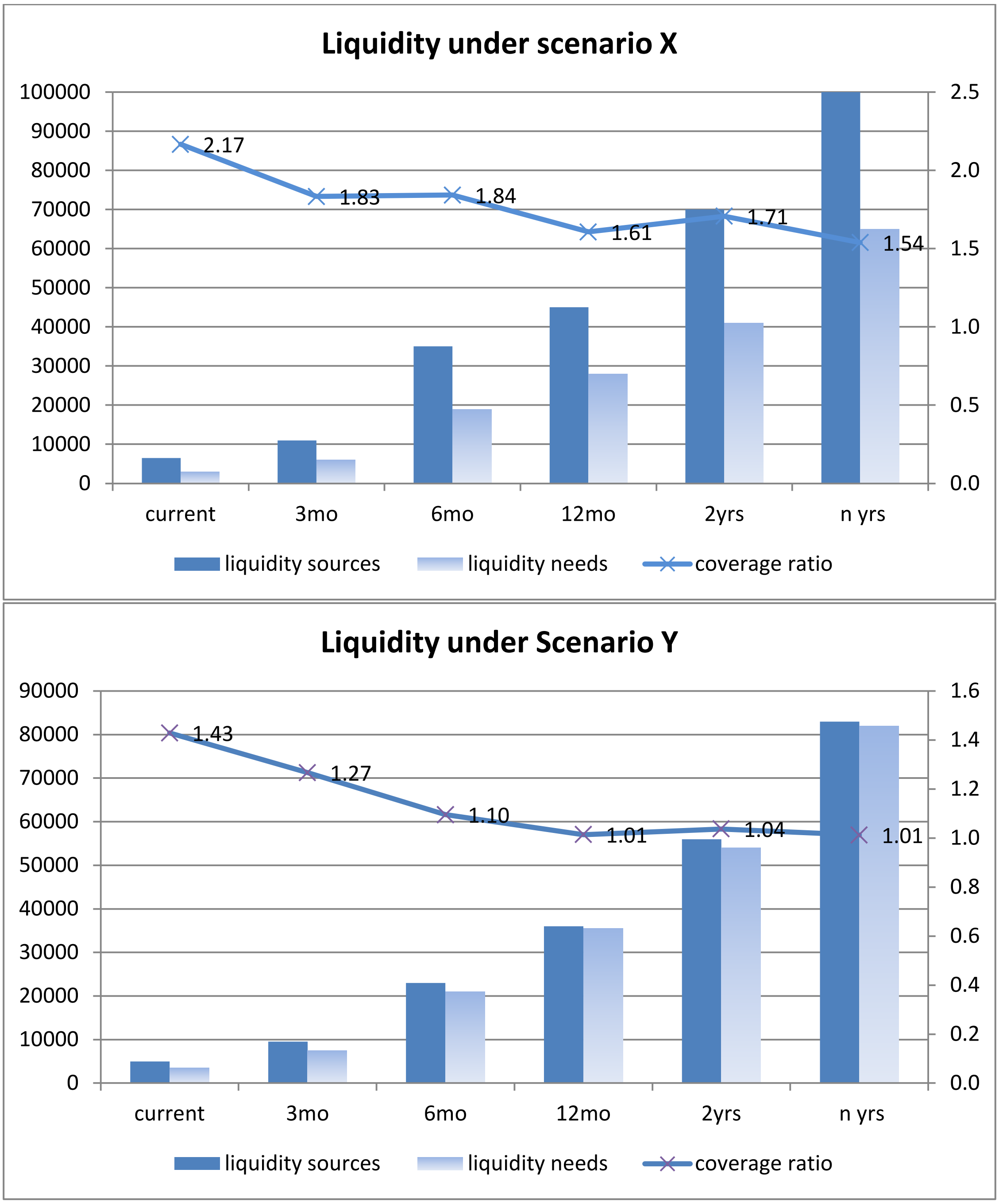


**Figure 1: Illustration of liquidity position under different scenarios**