GLOBAL FEDERATION OF INSURANCE ASSOCIATIONS

10 February 2021

Response to IAIS consultation on the development of liquidity metrics — Phase 1 exposure approach

Q1. Do you agree with the IAIS's plan for the development of liquidity metrics for monitoring? If not, please explain what changes you recommend and why.

GFIA welcomes the opportunity to engage with the IAIS on its work on liquidity metrics.

GFIA is not convinced that the nature of the proposed Insurance Liquidity Ratio (ILR) would prove to be a reliable ancillary indicator that would achieve the aims the IAIS has stated, ie, to facilitate the monitoring of potential vulnerabilities, risk drivers and trends in the global insurance industry's liquidity risk.

While the metrics developed for Phase 1 could potentially provide a simplified "early warning" system to identify liquidity risks at the macro-prudential level, they should not be used to identify liquidity risks at the micro-prudential level where company-specific liquidity risk management practices and monitoring are relevant. The contemplated Phase 2 Approach, which will include company projections, could, in GFIA's view, be more valuable as a risk-sensitive exercise. GFIA asks that the Phase 1 Approach concentrates on a simple metric that supervisors can calculate using publicly available information. This will provide consistency and predictability without imposing unnecessary burdens on insurers.

As the IAIS has noted in its Application Paper on Liquidity Risk Management, liquidity risk is very much company- and scenario-specific. The weaknesses of the proposed "exposure approach" include a loss of information on mismatches between liquidity needs and sources as well as less risk sensitivity. A thorough understanding of liquidity sources and needs is required to understand insurers' individual liquidity risk profiles which a blunt factor-based ILR as proposed would fail to do.

Liquidity risk is important for insurers, but it is well managed due to the business model, existing regulatory provisions and insurers' integrated approach to liquidity and risk management. Furthermore, insurance groups have established liquidity risk management practices and liquidity frameworks tailored to the characteristics and nature of their business. These internally developed frameworks have already considered the actual liquidity profile of the business. This has better accuracy than a crude bucketing of assets and, more notably, liabilities.

The IAIS's application paper on Liquidity Risk Management sets out guidance to supervisors on the assessment of insurers' liquidity risk management processes and the effectiveness of their implementation. This should help supervisors arrive at an informed view of the liquidity risk of an individual insurer.

Q2. Should the IAIS consider any other approaches or alternatives when developing liquidity metrics? If so, please explain.

Given the company- and scenario-specific nature of liquidity risk, supervision of insurers' liquidity risk management is the most efficient way of understanding liquidity risks in the insurance sector.

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Supervisors could rely on existing analysis, potentially supplemented by additional public information. For example, the S&P Life Model for the United States and Canada is conducted for all North American life insurers. This has the benefits of simplicity and insurance-tailored design.

Q3. Should the IAIS develop additional liquidity metrics that examine other time horizons? If so, how should these metrics differ from the proposed metric?

No. A metric that uses a one-year time horizon is sufficient; the development of additional liquidity metrics is not necessary.

Q4. Do you agree with the exclusion of separate accounts from the ILR? If not, how should separate accounts be incorporated?

Separate accounts should be considered in isolation and should be a focus of supervision rather than any liquidity metric. However, to ensure appropriate risk sensitivity, the ILR would have to reflect any requirement for shareholder funds to provide capital/liquidity support to policyholder funds in a time of stress.

There are also some accounts, such as operational cash accounts, that are owned by the shareholder but are used to pay claims/receive premiums for policyholder funds. Therefore, consideration of the intra-fund receivables and payables is needed.

Q5. Do you agree with the proposed factors for liquidity sources? If not, please explain.

No. The proposal for liquidity bucketing with prescribed haircuts would result in an over-simplified view of the actual liquidity of assets, and therefore may lead to erroneous interpretations from the ILR. Actual haircuts may depend on a number of factors, including the nature and time horizon of the stress scenario and whether an insurer would actually need to liquidate these assets under the stress scenario.

The IAIS should also consider that the liquidity risk profile of banks and insurers differ and that insurers are less exposed to short-term liquidity stresses due to the characteristics of their liabilities. As stated in the consultation, “For the treatment of assets, the IAIS relied most heavily on bank regulations”. GFIA questions the reliance on bank regulations, which is reflected in the “bucketing” approach with haircuts. Liquidity risk in the banking sector is very different to that which exists in the insurance sector, based in part on the latter’s much lesser susceptibility to short-term runs. Reliance on bank regulation and approaches to liquidity risk could inadvertently raise liquidity risk by, for example, “herding” insurers into certain asset classes that could undermine the benefits of diversity.

Q6. Do you agree with the treatment of investment funds? If not, please explain and suggest an alternative treatment.

No, investment funds should be included. Their inclusion could be based on a segregation of categories of investment funds (eg, money market funds, exchange-traded funds and mutual funds) and tailored haircuts considered based on additional analysis.

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Q7. Do you agree with the treatment of premiums? If not, please explain how premiums and excluded expenses should be treated in the ILR.

The approach appears to be broadly reasonable from a practical perspective.

Dependent on the maturity profile of the business, net cash flows can provide a stable and material source of liquidity, or alternatively could indicate material short-term restrictions on liquidity. The question should also be asked whether these cash flows should be treated on a gross basis as opposed to a net-zero basis.

Q8. How should instruments issued by financial institutions be treated within the ILR?

Instruments issued by financial institutions should be included in any liquidity metric in a consistent approach with non-financial institution instruments, ie, taking into consideration their quality and the time horizon.

It is recognised that when assessing liquidity under stress there may be scenario specificities that influence the availability of financial institution instruments, but these should only be considered within the given scenario and not result in pre-exclusion.

GFIA also highlights that extensive risk mitigation for derivatives, such as centralised clearing, has been implemented globally, which mitigate the risks arising from derivative exposures within financial institutions. This supports GFIA's view that it is unnecessary to separate financial institutions and non-financial institutions in the Exposure Approach, taking into account that this is a simple method.

Q9. Do you agree with the inclusion of certain encumbered assets as liquidity sources within the ILR or should the IAIS alternatively exclude these encumbered assets and measure certain the related liquidity needs on a net basis? Should any additional liquidity needs be included in the calculation because encumbered assets are included as a liquidity source?

The basis for liquidity resources and liquidity needs should be consistent. GFIA considers a net approach to be more realistic than a gross approach, as encumbered assets are by definition unavailable.

Q10. Do you agree with the treatment of liquidity risk from surrenders and withdrawals from insurance products in the ILR? If not, please explain how this could be improved.

No. The approach focusing only on economic penalty and time restraints is too simplistic and therefore unlikely to reflect the individual characteristics of insurers' liquidity risk or enable meaningful interpretations to be drawn from the ILR.

The risk factor is also high overall and should be reduced significantly according to the actual risk regarding insurance liabilities.

- Since the likelihood of policyholder runs occurring are lowered by various factors, as described in the document, GFIA does not anticipate high surrender rates. For instance, when the economic penalty is Low (no economic penalty) and the time restraints to cancel are Low (less than one week), the factor for retail contracts is set at 50%. However, GFIA is not aware of cases in which insurers faced such high surrender rates.

- Specifically, it is proposed that the highest risk factor of insurance liabilities for individuals is 50% and that for corporations it is 100%, but GFIA considers that this should be lower than the lowest risk factor of retail/commercial deposits (25%/50%).

Overestimating the liquidity risk of insurers' liabilities may also limit the ability of insurers to provide stable finance for risk assets. From this perspective, the liquidity risk of insurance liabilities should be carefully assessed and significantly reduced from current levels to match the actual risk of insurance products.

The IAIS acknowledges that policyholders' behaviours are based on the complex interaction of many factors. GFIA does not consider that only selecting two of these factors that are measurable through the IIM data will provide a representative view.

While a standardised liquidity ratio may make sense in the banking industry, given its business profile and heightened liquidity risk, it is inappropriate for the insurance sector given that there is much lower liquidity risk and that it will depend on the individual liquidity profiles of different businesses and the scenarios in which they may be vulnerable. Because of this, liquidity risk needs to be supervised and assessed as part of an insurer's wider ERM framework.

Q12. Do you agree with the factors applied to retail insurance products being half of the factors applied to institutional products? How should the factors applied to retail and institutional policies differ?

No. The double-weighting factors for institutional business is a purely theoretical assumption that is not justified with any supporting analysis or documentation. GFIA is not aware of any empirical support for the proposed 2-1 relationship between retail and institutional liabilities. Additional work is needed to identify and justify any differentiation.

See also response to question 10.

Q13. Do you agree with the treatment of unearned premiums in the ILR? If not, how can it be improved?

No. A certain percentage of unearned premiums is included in Liquidity Needs on the assumption that insurance policies will be cancelled in the future. However, given that the impact by cancellation refunds is small in general insurance, whose products are mainly one-year policies, GFIA does not agree with this calculation method.

Q14. Should the IAIS apply standardised factors to insurers' projected ultimate catastrophe losses or rely on company projections for the speed of catastrophe payments and reinsurance recoveries?

There is no need to consider a lower factor for reinsurance recoveries capturing potential risk arising from exposure to the reinsurer counterparty.

Q15. Do you agree with the proposed treatment of catastrophe insurance claims? If not, how can it be improved?

Yes, this appears to be a reasonable approach.

An alternative approach would be to use standardised factors applied to the insurers' final catastrophe loss predictions.

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Q16. Should the proposed treatment of deposit liabilities include more or less granularity? If so, what additional dimensions (eg, the presence of an effective deposit insurance scheme) should be captured or left out?

Deposit taking forms a significant part of banking activity and therefore a significant part of the risks relating to that sector. This is not the case for insurance companies, as most insurers do not control a licensed banking subsidiary and activities are funded via other means. Therefore, deposit holdings are minimal, and treatment within the ILR should be proportionate to the recognised risk, ie, exclude both the liquidity sources and liquidity needs of any licensed banking subsidiary.

If an insurer has a licensed banking subsidiary, the liquidity risk management will be monitored by the banking regulatory bodies.

Q17. Should the proposed factors be modified? If so, please explain how and why.

The risk factor for bank deposits proposed in the document is set at 25% for retail deposits and 50% or 100% for commercial deposits, applying factors close to the upper limit of the risk factor for deposits in banking regulations. However, the liquidity risk of insurance liabilities is considered to be lower than that of bank deposits, and therefore, in terms of consistency with the actual state, the highest risk factor applicable to insurance liabilities should be lower than the lowest risk factor applicable to bank deposits.

Q18. Should insurance contracts without significant exposure to insurance events be captured by these factors, or included with other policyholder liabilities?

GFIA believes no insurance contracts should be captured by these factors.

Q19. Do you agree with the treatment of derivatives? If not, please explain and suggest an alternative treatment.

Derivatives are a fundamental part of an insurer's ALM. As such, any assessment of liquidity associated with the use of derivatives by insurers should differentiate between insurer risk profiles. A meaningful assessment of liquidity risk associated with the use of derivatives cannot be achieved by applying simplified factors to one side of the balance sheet. Instead, a separate focus is needed on collateral management by insurers that supports the liquidity needs of its derivatives.

The ratio is more reflective of the balance sheet and the funding requirements than liquidity and cashflows. As a liquidity metric, the ILR should focus on applying a defined liquidity stress to the derivatives held by the insurer at that moment in time, in order to calculate the additional collateral that needs to be posted.

For this reason, a more risk-based approach should be considered for ILR purposes, such as VaR or by applying prescribed hikes in market-risk parameters against the sensitivities/market value of the derivative portfolio.

Q20. How should the ILR treat debt with financial covenants that may be triggered under stress?

The treatment would need to consider the severity of the stress applied and whether that would be likely to breach the covenant. In most cases, this would only happen in extreme circumstances and not under a moderate stress.

This would be difficult to capture through a factor-based ILR but would be something that insurers' own stress and scenario-testing as part of their liquidity risk management should consider.

Q21. How should the ILR assess potential liquidity needs from a downgrade?

Potential collateral requirements at different downgrade levels can be dealt with through different options, eg, the use of letters of credit from third parties, and the negotiation of different collateral provisions is possible as well. Therefore, a 100% weighting factor on related exposures to derive potential liquidity needs is not realistic.

With regard to ILR Funding Liability Factors (Table 8), it is not realistic to assume a 25% weighting factor on "Pledged contingent funding including credit facilities" based on ROW 12.1 of the IIM — this row correspond to all commitments given, including the significant (gross) amounts of pledged assets that are common in the insurance industry. The IAIS does not provide any justification for this factor ("investors are assumed to exercise any options that would shorten the maturity of outstanding debt or draw upon any contingent funding the insurer provides"). A pledged asset is not a form of contingent funding. Furthermore, this approach would be biased, as it does not consider any commitment received (eg, received pledged assets).

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About GFIA

The Global Federation of Insurance Associations (GFIA), established in October 2012, represents through its 41 member associations and 1 observer association the interests of insurers and reinsurers in 64 countries. These companies account for 89% of total insurance premiums worldwide, amounting to more than $4 trillion. GFIA is incorporated in Switzerland and its secretariat is based in Brussels.