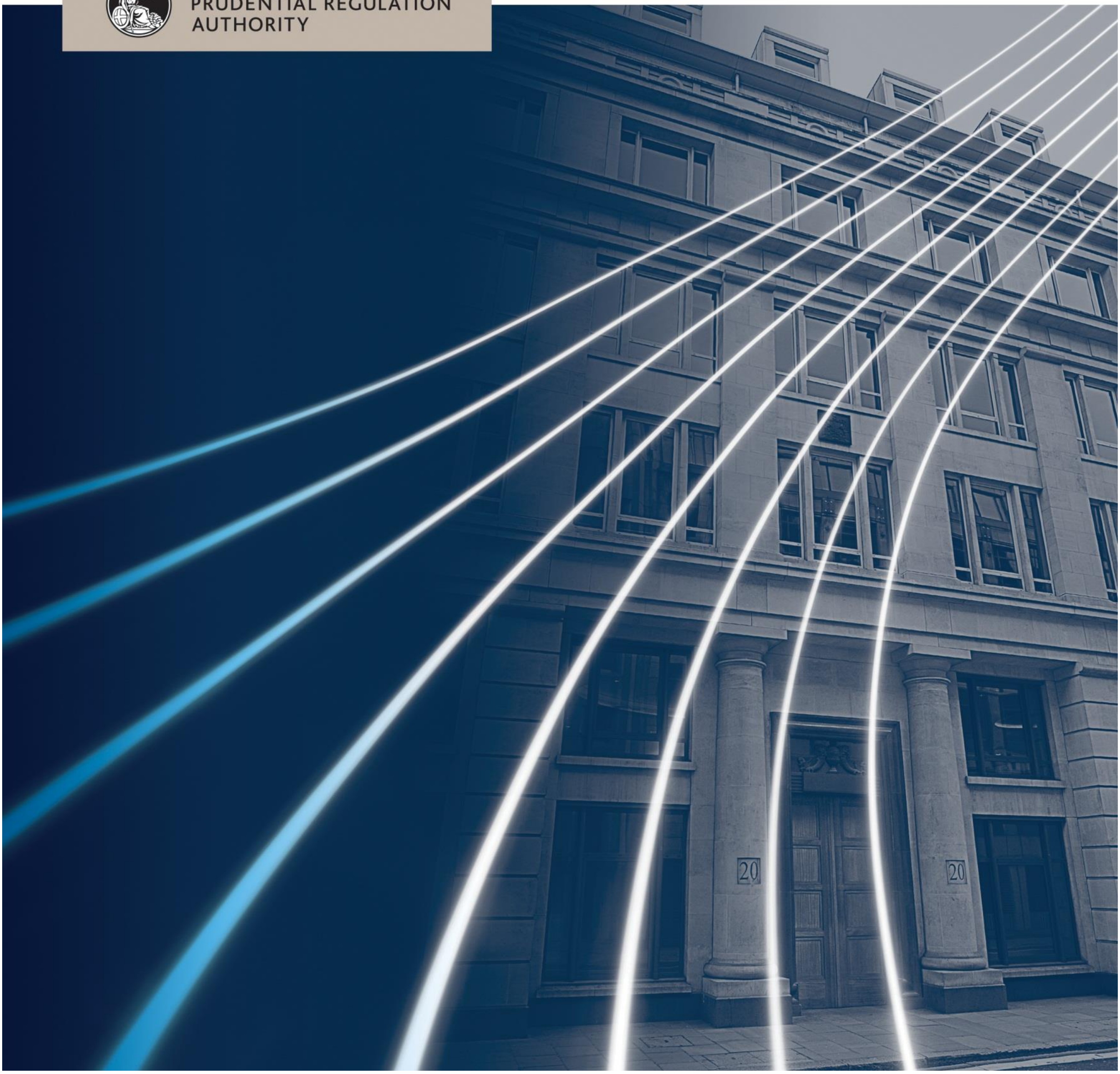
Policy Statement | PS18/19

Liquidity risk management for insurers

September 2019

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY



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Prudential Regulation Authority | 20 Moorgate | London EC2R 6DA

Contents

1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback to responses to Consultation Paper (CP) 4/19 'Liquidity risk management for insurers'.[1] It also contains the PRA's Supervisory Statement (SS) 5/19 'Liquidity risk management for insurers' (Appendix).

1.2 This PS is relevant to all UK Solvency II firms, including in respect of the Solvency II groups provisions, the Society of Lloyd's ('the Society') and its managing agents, and non-directive insurers (collectively referred to as 'insurers').

Background

1.3 In CP4/19, the PRA sought views on a draft SS designed to set out the PRA's expectations on insurers' approaches to managing liquidity risk. The draft SS covered:

- the components of insurers' liquidity risk management frameworks;
- material sources of liquidity risk, with particular focus on: collateral upgrade transactions; internal funds, such as the matching adjustment portfolio, with-profits fund and unit-linked funds; and group-specific risks;
- the use of liquidity stress testing;
- the maintenance of a liquidity buffer;
- risk monitoring and reporting; and
- the maintenance of a liquidity contingency plan.

Summary of responses

1.4 The PRA received thirteen responses to the CP. Respondents generally welcomed the PRA's proposals, and made a number of observations and requests for clarification. The PRA's feedback to these responses is set out in Chapter 2.

Changes to draft policy

1.5 After considering the responses, the PRA has made some changes to the draft policy. The most significant amendments involve clarifying the PRA's expectations on the definition of risk limits within an insurer's liquidity risk appetite framework and the role of the board in managing liquidity risk. In addition, the function and characteristics of the liquidity buffer have been clarified. Details of the changes are included in Chapter 2.

1.6 A number of editorial amendments were made to improve the clarity of the SS and are not explicitly addressed in this PS.

1.7 The PRA does not consider that these changes and editorial amendments alter the substance of its expectations. Accordingly the impact of the changes for firms is not considered to be significant or to differ in respect of mutuals.

1 March 2019 www.bankofengland.co.uk/prudential-regulation/publication/2019/liquidity-risk-management-for-insurers (Page 2 of 2).

Implementation

1.8 The expectations set out in SS5/19 and the withdrawal of Legacy Supervisory Statement (LSS) 2/13 'Collateral upgrade transactions and asset encumbrance: expectations in relation to firms' risk management practices' have immediate effect.

1.9 The final SS attached to this PS should be read in conjunction with SS1/19 'Non-binding PRA materials, 'The PRA's approach after the UK's withdrawal from the EU'[2] and the joint Bank and PRA Statement of Policy (SoP) 'Interpretation of EU Guidelines and Recommendations: Bank of England and PRA approach after the UK's withdrawal from the EU'.[3]

2 Feedback to responses

2.1 The PRA must consider representations that are made to it in accordance with its duty to consult on its general policies and practise, and must publish in such manner as it thinks fit responses to the representations.[4]

2.2 The sections below have been structured broadly along the same lines as the chapters of the CP, with some areas rearranged to better respond to related issues. The responses have been grouped as follows:

- Liquidity risk management framework.
- Sources of liquidity risk.
- Stress testing.
- Liquidity buffers.
- Risk monitoring and reporting.
- Liquidity contingency planning.
- General comments.

2.3 As well as the responses addressed below, the PRA also received a number of responses asking for minor clarifications. The PRA has made amendments to reflect these in SS where appropriate, but has not separately identified them.

Liquidity risk management framework

2.4 The PRA proposed what it would expect of an insurer regarding the fundamental components of a liquidity risk management framework that is compliant with PRA rules and applicable EU standards.

2.5 Four respondents requested additional clarity on the establishment of risk tolerance limits for liquidity risk, noting that establishing limits for each type of liquidity risk would introduce significant

2 February 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/non-binding-pra-materials-the-pras-approach-after-the-uks-withdrawal-from-the-eu-ss.

3 February 2019: https://www.bankofengland.co.uk/paper/2019/interpretation-of-eu-guidelines-and-recommendations-boe-and-pra-approach-sop.

4 Sections 2L and 2N of the Financial Services and Markets Act 2000 (FSMA).

complexity and could interact with existing risk limits. Two respondents noted that liquidity risk is likely to materialise from a combination of sources rather than a single risk individually.

2.6 After considering the responses, the PRA has updated paragraphs 2.13 and 2.14 the of the SS to clarify that the PRA expects an insurer's senior management to decide what liquidity risk limits need to be set, in accordance with the nature, scale and complexity of the firm's activities, rather than for each material risk to which the insurer may be exposed. The PRA reminds insurers of paragraph 2.5 in the SS, specifically that relevant considerations for capital management may not be relevant for liquidity risk management.

2.7 Four respondents requested additional clarity on the way in which groups should implement the provisions of the SS. Three requested clarity around 'consistent' application of the risk management framework or use of metrics, noting that insurers may have reasons for differences in risk management between entities. Three respondents felt that the SS discouraged group management of liquidity and liquidity risk.

2.8 The PRA confirms that, in the context of this SS, the risk management framework, including the metrics used to monitor risk, should be fit for purpose across individual entities within a group. The risk management frameworks of the solo entities, as well as that at the level of the group, where liquidity risk is managed on a group basis, should not contradict each other. In addition, the SS does not prescribe how liquidity risk must be managed, whether on a solo entity basis or centrally. Managing liquidity on a group basis, however, carries risks that the PRA expects insurers within the group to manage and plan for; specifically the risk that support from other entities within the group may not be readily available. Further guidance on this can be found in SS4/18 'Financial management and planning by insurers'.[5]

2.9 Three respondents commented that the expectations laid out in this chapter could lead to some duplication of existing documentation that achieved similar outcomes, but were not necessarily of the same form. One respondent suggested that insurers implement the liquidity risk appetite considerations as part of their overall risk appetite framework.

2.10 The PRA has considered these responses, and has amended paragraphs 2.17 and 2.18 of the SS to reduce the emphasis on the specific location of the relevant material. It confirms that existing documentation need not be duplicated: relevant documentation need only be accessible from one place (for instance, by including references to their location in relevant documents), in line with paragraph 2.19 of the SS. This is to ensure that management and relevant members of the board can effectively oversee and implement the insurer's liquidity risk management framework. The PRA has no preference regarding the form of documentation, though it expects that the insurer is able to demonstrate a liquidity risk appetite, risk management strategy and relevant policies from one or more documents. Where an insurer has integrated its liquidity risk appetite into its overall risk appetite framework, the PRA expects that the liquidity risk appetite statement will be explicitly identified to ensure that it is given the necessary consideration.

2.11 Two respondents requested additional guidance on the 'segregation of responsibilities', as noted in paragraph 2.3 of the draft SS.

2.12 The PRA refers the reader to Guideline 5 of the European Insurance and Occupational Pensions Authority (EIOPA) Guidelines on system of governance (Allocation and segregation of duties and

5 May 2018: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/financial-management-and-planning-by-insurers-ss.

responsibilities) when applying this element of the SS. The PRA notes, however, that this is a broader governance requirement in the PRA Rulebook and therefore exceeds the scope of the SS.

Sources of liquidity risk

2.13 The PRA proposed a number of sources of liquidity risk for an insurer to consider as part of their risk management. However, the PRA noted that the sources of liquidity risk will vary from business to business, and therefore the list was not exhaustive. An insurer is expected to understand the sources of liquidity risk it faces, and to assess those risks in light of the scale, nature and complexity of its activities.

2.14 Four respondents requested additional guidance on intra-day risk, noting that it is typically not material for insurers, with one additional respondent requesting more emphasis be placed on intra-day risk. One respondent noted that the delivery-versus-payment model that is used for securities settlement substantially reduces intra-day risk.

2.15 After considering the feedback, the PRA has included additional guidance in paragraph 3.2 of the SS that provides some examples of where intra-day risk may arise for insurers, specifically intra-day margin calls on derivatives, (reverse-) repurchase and stock lending/borrowing transactions, and securities settlements that are partially or fully funded by intra-day credit. The PRA considers that, while the delivery-versus-payment may reduce settlement risk in securities trades to the extent that the insurer has, in anticipation of future cash in-flows, borrowed to provide funding for a transaction, it may still be exposed to liquidity risk. In addition, the PRA confirms that an insurer is expected to have systems to monitor intra-day exposure and conduct stress testing on intra-day horizons where relevant to its activities.

2.16 Two respondents requested additional guidance on risks relating predominantly to non-life insurers, such as natural catastrophe and regulatory funding requirements, such as trusts. Another two respondents requested guidance on the treatment of risks that could arise over a longer time horizon. The PRA has added additional guidance to paragraph 3.2 of the SS to make these risks clearer to insurers that may be exposed.

Stress testing

2.17 The PRA proposed that an insurer, as part of its liquidity risk management framework, conduct liquidity stress tests and have in place appropriate systems and data processes to enable it to carry out stress testing.

2.18 Seven respondents requested additional clarification regarding the stress horizons listed for consideration in paragraph 4.8 of the draft SS. One of the respondents noted that demographic risks for life insurers could arise over a longer time horizon than those listed. Another respondent requested guidance, possibly through examples of existing supervisory-led stress testing exercises, on how to define the duration, types and severity of liquidity stresses. Five respondents noted that the durations listed for consideration may not be appropriate for some insurers.

2.19 After considering these responses the PRA confirms that the periods listed for consideration are indicative, and has clarified this in paragraph 4.8 of the SS. It has also added additional guidance for insurers writing longer-term business. The PRA acknowledges that insurers maintain different business models that are exposed to different risk, and confirms that it is the insurer's responsibility to define the duration, severity and types of stresses that should be set in line with its risk appetite. The PRA reminds insurers, however, that liquidity risk can emerge over a number of timeframes and that liquidity stress tests are expected to span a variety of liquidity events over different time horizons.

2.20 Two respondents requested additional guidance on the treatment of individual funds within a life insurer's portfolio, noting that, as different funds have different liquidity risk characteristics, stress testing should be undertaken individually on different funds.

2.21 After considering this feedback the PRA has clarified in paragraph 4.4 of the SS that, in line with paragraph 2.7 of the SS, it expects stress testing to be conducted both in the portfolio as a whole as well as on individual funds. The PRA expects, however, that insurers will be aware of any potential interconnections between funds that may create spill over effects. Specifically with regard to with-profits funds, insurers should refer to SS14/15 'With-profits'[6] and the Conduct of Business Sourcebook chapter 20 (COBS 20) in the FCA Handbook[7] for additional guidance. The PRA emphasises, however, that assets in the with-profits fund are not available to cover the risks of the rest of the insurer. With regard to the matching adjustment portfolio, the PRA reiterates the restriction on selling assets from an MA portfolio to generate liquidity and that an insurer is expected to be aware of how the liquidity management for the matching adjustment portfolio interacts with that of the rest of the firm.

Liquidity buffers

2.22 The PRA proposed elements for an insurer to consider when determining which assets to hold as part of its liquidity buffer.

2.23 Two respondents requested clarification on the purpose of the liquidity buffer, in particular the interaction between the liquidity buffer and funds that had been committed for known future cash flows. One of these also requested that the PRA clarify that the assets included in the buffer relate to the time horizon being covered.

2.24 The PRA has clarified in paragraph 5.2 of the SS that the purpose of the liquidity buffer is to meet any gaps between cash out-flows and in-flows arising over a particular time horizon. The insurer is expected to be able to monetise assets in the liquidity buffer in order to meet cash flow needs in the chosen time horizon. Where monetising these assets could conflict with existing business or risk management strategies, for example where funds have been committed to future payments or investments are used for regular income generation, the insurer may be less willing or able to monetise them, and therefore such assets may not be available to meet cash flow gaps. As such, the PRA considers that including such assets in the liquidity buffer would not meet the objectives of the SS.

2.25 Six respondents requested clarity regarding the PRA's classification of assets of primary and secondary liquidity. Some noted that the terms seemed to be interchangeable with 'high quality liquid assets' or 'liquid assets'. Three respondents found the examples provided to be too prescriptive and requested that they be removed. Two respondents requested additional clarification on how pooled vehicles were treated under the classification.

2.26 In paragraphs 5.9 and 5.10 of the SS, the PRA has clarified the definitions of assets of primary and secondary liquidity to assist insurers in understanding the rationale behind their distinction. It does not however consider it appropriate to remove the asset classes listed, as it views them as helpful in understanding the concept and implementing the guidance contained in Chapter 5 of the SS. The PRA confirms, however, that assets included in paragraphs 5.9 and 5.10 are not necessarily appropriate for the buffer and that assets not included may be: an insurer is expected to be in a position to demonstrate that it operates in line with the principles in paragraph 5.8. With regard to

6 March 2015: www.bankofengland.co.uk/prudential-regulation/publication/2015/with-profits-ss.
7 https://www.handbook.fca.org.uk/handbook/COBS/20/?view=chapter.

pooled vehicles, the PRA has also clarified in paragraphs 5.15 and 5.16 that it would expect a fund's own risk management strategies, as detailed in their prospectus, to be considered, particularly a funds ability to limit or stop withdrawals and has provided further guidance on how pooled vehicles may be assessed for inclusion in the liquidity buffer.

Risk monitoring and reporting

2.27 The PRA proposed that an insurer should define its own risk metrics for measuring and monitoring liquidity risk. It expects that these metrics would also include an assessment by the insurer of its available liquidity sources against stressed liquidity needs, as defined by its stress test scenarios. Regardless of the metric chosen, the PRA would expect an insurer to be able to justify its use and, where applicable, to apply it consistently group-wide. The PRA also proposed that general risk monitoring metrics, along with stress test results, be produced regularly and with more frequent reporting to senior management and any risk committee of the board in the event of changes in the insurer's activities or the operational environment.

2.28 Four respondents commented on the frequency of reporting and monitoring discussed in this chapter, noting that 30 days may not be appropriate for some business models.

2.29 The PRA considers that liquidity is a fast-moving risk, and that reporting only when it becomes a material issue will be too late to address it. To ensure that reporting is proportionate to the activities of individual insurers, however, the PRA has clarified in paragraph 6.4 of the SS that it would expect reporting on liquidity to occur at an appropriate frequency to allow the insurer to soundly and prudently manage its business, taking into account its business model and activities.

2.30 Three respondents raised concerns about the level of board involvement in the management of liquidity risk, noting that it was disproportionate relative to other risks.

2.31 The PRA has considered these responses and has clarified in paragraphs 6.4 - 6.6 that appropriate oversight for liquidity risk management may generally be conducted by any risk committee of the board. As the insurer's liquidity risk appetite is owned by the Board, however, where the insurer approaches or breaches its liquidity risk appetite, the PRA expects that the issue will be escalated to the board and that the PRA will be informed.

Liquidity contingency planning

2.32 The PRA proposed that an insurer, other than a small non-directive insurer,[8] maintain a clear process for recognising and addressing a liquidity stress, which includes maintaining a documented liquidity contingency plan that details how the insurer would respond to a liquidity stress event.

2.33 Two respondents noted that contingency planning requirements have been set across different jurisdictions and requested that the PRA recognise these requirements to ensure consistency of approach and reduce compliance burden.

2.34 The PRA remains cognisant of requirements imposed in other jurisdictions, but notes that other jurisdictions may have different objectives or approaches to supervision, and that the PRA will act in a way that advances its own objectives.

8 As defined in the Glossary of the PRA Rulebook. Available at www.prarulebook.co.uk/rulebook/Glossary/FullDefinition/77374.

General comments

2.35 Three respondents noted that there is an element of unknowable liquidity risk, with two specifically commenting that testing (ie stress testing or testing access to credit facilities) conducted during normal conditions cannot provide assurances of what could happen during a market stress.

2.36 The PRA acknowledges that risk management practices do not entirely eliminate risk, but considers testing to be a valuable tool to identify gaps in existing risk management practices. Insurers are expected to periodically reassess what risks they are exposed to and, in this light, the PRA reminds insurers of their obligation to regularly review their policies and adapt them in view of any significant changes to ensure that any emerging risks are taken into account.

2.37 Two respondents requested a transitional period to comply with the guidance.

2.38 The PRA has considered these responses but does not consider that a transition period is appropriate. The PRA has developed this SS to set out how an insurer might be able to demonstrate compliance with PRA Rules and relevant EU standards. A particular insurer may be able to demonstrate compliance by other means, taking into account its risk profile. The PRA reiterates that it expects an insurer to understand the drivers of the liquidity risk it faces and to apply the guidance contained in this SS in light of the scale, nature and complexity of its activities.

2.39 No response was received in connection with the PRA’s proposal to withdraw LSS2/13. The PRA has also decided to withdraw the application of LSS2/13 in respect of banks on the basis that it receives information akin to that provided for by LSS2/13 through other means.

Appendix

SS5/19 'Liquidity risk management for insurers', available at:
https://www.bankofengland.co.uk/prudential-regulation/publication/2019/liquidity-risk-management-for-insurers-ss