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| **Statement of the need for, expected impact, and intended operation of the proposed framework for liquidity risk management for insurers.**  **Incorporating the updated FSI 6 Liquidity Risk Management standard into the regulatory framework**  **(DRAFT – FOR CONSULTATION)** |

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List of acronyms

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| --- | --- |
| **ALM** | Asset and Liability Management |
| **IAIS** | International Association of Insurance Supervisors |
| **HQLA** | High-Quality Liquid Assets |
| **SLT** | Securities lending transactions |
| **ILR** | Insurance Liquidity Ratio |
| **GME** | Global Monitoring Exercise |
| **ICP** | Insurance Core Principles |
| **ORSA** | Own Risk and Solvency Assessment |
| **HAF** | Head of Actuarial Function |
| **PA** | Prudential Authority |
| **QIS** | Quantitative Impact Study |
| **ZAR** | South African Rand |
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# Introduction

* 1. Liquidity risk refers to the potential scenario where an insurer, despite being solvent, might be unable to fulfil its financial commitments in a timely manner or without bearing substantial unforeseen expenses. It’s crucial to distinguish liquidity from solvency. While both are vital for an insurer’s ongoing viability, liquidity possesses a “real-time” aspect that solvency might lack. This means that liquidity is concerned with the immediate ability to discharge liabilities as they become due.
  2. In June 2020, the IAIS published the Application Paper on Liquidity Risk Management which provides guidance on the supervisory material related to liquidity risk management in the Insurance Core Principles (ICPs) and the Common Framework for the supervision of Internationally Active Insurance Groups (ComFrame).
  3. While the Application Paper is not intended to establish standards or expectations for the implementation of a liquidity risk management framework, it provides for best practice guidance on liquidity risk management.
  4. Traditionally, insurers typically rely on premiums, income from investments, and other sources for liquidity. Nevertheless, insurers must maintain adequate liquidity to fulfil expected and unexpected payment obligations and funding needs. Liquidity risk management is therefore essential to the operation of the insurer, the protection of policyholders, and financial stability.
  5. The updated framework seeks to address concerns that the current liquidity risk framework does not address the non-traditional insurance business activities, which can result in liquidity strain for some insurers. These include collateral and margin calls posted for mark-to-market movements[[1]](#footnote-1) in the value of the contract, securities lending transactions (SLTs) if funds received are reinvested in illiquid assets, and there are sudden recalls of funds, which can result in a forced sale of assets.
  6. The framework sets out the expectations for the management of liquidity risk in terms of identification, assessment, management, reporting, and planning of risk-mitigating decision-making.
  7. Pursuant to the IAIS issuing the Application Paper on Liquidity Risk Management, in June 2020, the Prudential Authority (PA) consulted on Guidance Note 1[[2]](#footnote-2) of 2022 (Guidance Note 1) with the industry in November 2022. The Guidance Notice sets out practices and guidelines aimed at assisting insurers in complying with the requirements of GOI 3 (Risk Management and Internal Controls for Insurers) and GOI 3.1 (Own Risk Solvency Assessment (ORSA) for Insurers.) as these standards apply to liquidity risk management for insurers.
  8. This Report seeks to articulate the rationale for the proposed framework, the cost and benefits of incorporating the liquidity risk management framework into the domestic regulatory framework, and its intended operation.
  9. To gather the necessary qualitative and quantitative information required to assess the expected impact of incorporating the updated FSI 6 Liquidity Risk Management standard into the domestic regulatory framework, the PA is conducting a qualitative impact study (QIS) and soliciting inputs from the industry through a qualitative questionnaire.
  10. The final Statement will consider the industry inputs received.

# Background

* 1. Historically, the nature of the insurance business model, characterised by premium inflows and future claim payments, led to a lower perceived importance of liquidity risk. However, recent developments point to an evolving perspective on liquidity risk within the insurance sector, with stakeholders increasingly acknowledging its potential ramifications.
  2. Concerns about potential liquidity strains driven by certain insurance activities, such as derivatives and securities lending, have prompted the IAIS and some regulators to emphasise the importance of robust liquidity risk management. Recognising gaps in insurers' liquidity risk assessment, management, and monitoring practices, the IAIS and some regulators are calling for stricter measures to ensure financial stability.
  3. The IAIS monitors liquidity risk as part of the Global Monitoring Exercise (GME). The IAIS acknowledges that capturing liquidity risk in the insurance sector can be a complex task due to the many dimensions to consider, including different insurance products and their liquidity profiles, the liquidity needs of various insurance business models (reinsurers, life insurers, and non-life insurers) and the choice of time horizons.[[3]](#footnote-3)
  4. In monitoring the liquidity risk, the IAIS developed liquidity metrics as an ancillary indicator, which serves as a tool to facilitate the monitoring of the global insurance industry’s liquidity risk and for the IAIS to assess the insurers’ liquidity risk exposure. The PA has adopted some of the principles applied by the IAIS in developing the Insurance Liquidity Ratio (ILR).
  5. The PA has, in formulating the updated FSI 6 Liquidity Risk Management standard, referenced principles espoused in the Application Paper on Liquidity Risk Management published by the International Association of Insurance Supervisors (IAIS).

# Salient features of the liquidity risk management framework

* 1. Under the updated liquidity risk management framework, the PA detailed requirements for the identification, assessment, management, reporting, and planning of risk-mitigating decision-making of insurers.
  2. The requirements cover the following principles.

*Table 1: Updated Liquidity Risk Management Principles*

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| **Principle** | **Description** |
| **Requirement for insurers** | |
| Principle 1 | The Prudential Standard applies to all insurers licensed under the Insurance Act, 2017 (the Act), other than micro-insurers, Lloyd’s, and branches of foreign reinsurers. The Standard does not apply to insurance obligations where the policyholder bears the investment risk. |
| Principle 2 | An insurer’s board of directors is ultimately responsible for ensuring that the insurer complies with the principles and requirements of this Standard.  The Head of the Actuarial Function (HAF) and the Chief Risk Officer (CRO) of the insurer are responsible for providing an opinion to the board of directors on the accuracy of the calculations and the appropriateness of the assumptions underlying the insurance liquidity ratio.  An insurer’s auditor must audit the financial soundness of an insurer in accordance with its legal and regulatory obligations. The auditor must report to the board of directors and Prudential Authority any matters identified during the performance of its responsibilities that may cause the insurer to be not financially sound. |
| Principle 3 | The board of directors must ensure the insurer has an adequate governance framework for liquidity risk that supports the identification, assessment, management, reporting, and planning of risk-mitigating decisions.  An insurer must develop a board-approved risk appetite and tolerance for liquidity risk. The board is responsible for the effectiveness of the liquidity risk appetite or tolerance on an ongoing basis. |
| Principle 4 | The insurer must identify and understand the drivers of its liquidity risk exposures and the implications of these liquidity risk drivers on its liquidity position, both under business as usual and stressed conditions. |
| Principle 5 | Insurers must conduct stress tests that encompass a diverse set of severe yet plausible scenarios, encompassing short-term and protracted macroeconomic fluctuations, sector-wide disruptions, idiosyncratic events, and a combination of these factors. These stress tests should accurately reflect the unique characteristics of the insurer's business operations. |
| Principle 6 | An insurer must hold a portfolio of high-quality liquid assets that are sufficient to cover its liquidity needs at a given time horizon, both in business as usual and stressed conditions. |
| Principle 7 | The Insurance Liquidity Ratio (ILR) is an evaluation tool for the Prudential Authority to gauge the extent of liquidity risk faced by an insurer. Insurers are obligated to uphold an ILR of at least 100% over a one-month time horizon. |
| Principle 8 | The insurance company is required to formulate and execute a contingency funding strategy, which has been approved by the board or a sub-committee of the board, to address situations of liquidity stress. |
| Principle 9 | The Prudential Authority shall determine appropriate reporting protocols as these protocols relate to liquidity risk and at the frequency communicated by the Prudential Authority in terms of section 44 of the Insurance Act. The Prudential Authority reserves the right to change the reporting protocol as it deems fit.  The insurer must prepare and submit a liquidity risk management report with the ORSA annually to the Prudential Authority. |

* 1. The proposed draft liquidity risk standard enhances and augments the following key aspects of liquidity risk management:
     + Insurers will have to develop a liquidity risk appetite statement.
     + Insurers must develop idiosyncratic stresses and conduct stress testing to determine liquidity risk vulnerabilities.
     + The proposed draft standard prescribes assets to be accounted for as HQLA after applying discount rates.
     + The draft standard incorporates the updated liquidity risk metric, aligned with the new liquidity risk return, to be reported to the PA.
     + Contingency funding planning is required for liquidity risk management.
     + Insurers will be required to prepare and submit a detailed liquidity risk report to the PA annually.

# Statement of the need ― context, and definition of the policy problem

* 1. Under this section of the Statement, the liquidity risk management framework is analysed with respect to the context and definition of the challenges sought to be addressed by the framework as follows:

*The need to incorporate idiosyncratic stress testing in the measurement of liquidity risk.*

* 1. The existing liquidity risk framework measures liquidity risk based on solvency stresses, which include Underwriting, Market, and Operational risk. This approach does not necessitate the insurer to have specific liquidity stress scenarios. However, it’s important to note that solvency stresses might not always expose the insurer’s potential vulnerabilities in terms of liquidity risk.
  2. The current framework fails to incorporate the business-as-usual properly and stresses cash flows. Failure to properly incorporate business-as-usual and stressed cash flows may result in insurers not fully accounting for the vulnerabilities they are exposed to from a liquidity risk perspective.

# The need to quantify an Insurance Liquidity Ratio

* + 1. The updated liquidity risk management framework seeks to ensure that insurers hold a portfolio of high-quality liquid assets after applying discount rates to meet liquidity shortfalls when they arise. Furthermore, insurers are required to quantify an Insurance Liquidity Ratio (ILR), the ratio of Total Available Liquidity to Stressed Liquidity Requirements.

# The need to accurately measure liquidity risk arising from margin and collateral calls

* + 1. The current return does not allow insurers to measure and report the liquidity risk from margin and collateral calls when derivatives are used. There may be instances where insurers face unexpected liquidity requirements due to these margin and collateral calls, which should be considered. Consequently, incorporating this aspect of liquidity risks will provide a comprehensive understanding of the liquidity vulnerabilities of insurers.

# The need to accurately measure liquidity risk arising from securities lending transactions (SLTs)

* + 1. Current return does not allow insurers to quantify and report on liquidity risk arising from securities lending transactions (SLTs). Insurers may be exposed to sudden liquidity needs from recalls of funds received from SLTs. Therefore, this needs to be accounted for. Including these liquidity exposures will result in a complete view of insurers' liquidity vulnerabilities.

# The need to develop and implement a board or board sub-committee-approved contingency funding plan

* + 1. The current framework does not require insurers to document a contingency funding plan, which should help the insurer address stress scenarios in which its liquid assets are insufficient or unexpectedly become illiquid.

# The need to prepare and submit a liquidity risk management PA annually

* + 1. The current framework requires reporting on liquidity risk as part of the ORSA, where relevant. This means that some insurers who consider liquidity risk as not relevant do not report on liquidity risk on the ORSA. Requiring insurers to prepare and submit a report[[4]](#footnote-4) on liquidity risk annually will ensure that insurers sufficiently assess their liquidity risk positions and report in accordance with the nature, scale, and complexity of their business.

# Statement of expected impact―Costs & benefits of implementing the framework

* 1. Under this section of the Statement, the impact, benefits, and areas of concern for the updated liquidity risk management framework will be analysed. The final quantification of the costs and benefits will be finalised once the QIS results are received from insurers.

## Scope and sample of the impact study

* 1. The purpose of the impact study is to allow the PA to assess the impact of the updated liquidity risk management framework on insurers operating in South Africa, with specific reference to:

1. Business-as-usual and stressed cash flows;
2. Insurance Liquidity Ratio;
3. Derivatives exposures;
4. Securities lending transactions;
5. Contingency funding plan;
6. Liquidity risk management report;

## Methodology

* 1. The assessment of the impact will be carried out once the completed QIS templates are received from insurers.
  2. Impact of implementing the updated FSI 6 liquidity risk management in South Africa
     1. During the consultation on the guidance notice 1 of 2022, the industry concurred that there is a need to update and review the liquidity risk management framework in South Africa. The current framework does not fully address the liquidity risk faced by insurers.
     2. However, the industry raised concerns that additional system configuration and enhancements would be required to cater to the newly updated reporting. Furthermore, some insurers raised concerns that the proposed requirements are extremely onerous, especially requiring an insurer to report monthly, and that consideration should be given to the nature, scale, and complexity of the insurer.
     3. The industry further raised concerns about the lack of prescription by the PA of the stresses to be applied, emphasising that this will result in inconsistencies in reporting to the PA. Some insurers were of the view that the current approach taken by the PA, of not prescribing stresses, will be beneficial for the insurance sector since the business models differ.
  3. Overall liquidity risk management implementation costs
     1. Implementing the updated liquidity risk management framework in South Africa is expected to result in additional costs and administrative requirements associated with system configurations, model enhancements, and additional reporting. The implementation cost for the insurance sector is yet to be determined.

# Statement of intended operation ― Implementation and evaluation

* 1. The FSI 6 liquidity risk management standard applies to all insurers operating in South Africa, other than micro-insurers, Lloyd’s, and branches of foreign reinsurers, and the framework will be incorporated into the domestic regulatory framework through amendments to the FSI 6 Liquidity Risk Assessment standard.
  2. The envisaged commencement date for the liquidity risk management framework is yet to be communicated.
  3. The QIS undertaken by the PA is aimed at assessing the impact of the proposed regulatory reforms and understanding the impact of the proposed framework before it is implemented on South African insurers.
  4. Following the implementation of the liquidity risk management framework, the PA will monitor, assess, and evaluate the effect of the proposed reforms continuously as part of its regulatory and supervisory responsibilities to mitigate any unintended consequences of implementing the framework.

# Conclusion

This Statement covers the need for, expected impact, and intended operation of the proposed liquidity risk management framework and will consider all the responses that will be received through the QIS and the questionnaire. Following the public consultation process, the PA will make the necessary changes to the proposed amended standard as well as this Statement, considering all submissions received.

1. Collateral and margin calls posted for mark-to-market movements refer to the requirement for an investor/borrower to add additional funds or securities to their margin account when the market value of their open position decreases significantly. This ensures that the investor has sufficient collateral to cover potential losses. [↑](#footnote-ref-1)
2. [Guidance Notice 1 of 2022 (resbank.co.za)](https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-documents-issued-for-consultation/2022/Guidance-Notice-1-of-2022) [↑](#footnote-ref-2)
3. [Public Consultation on the Development of Liquidity Metrics: Phase 2 - International Association of Insurance Supervisors (iaisweb.org)](https://www.iaisweb.org/2021/11/public-consultation-on-the-development-of-liquidity-metrics-phase-2/) [↑](#footnote-ref-3)
4. Kindly be aware that this report is not the same as the monthly return. Instead, it is an annual detailed report that covers the insurer’s liquidity activities from both a funding and market liquidity standpoint. [↑](#footnote-ref-4)