

Statement of the need for, expected impact, and intended operation of the proposed revised framework for liquidity risk management for insurers

Incorporating the updated Prudential Standard FSI 6 on Liquidity Risk Management for Insurers into the regulatory framework

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(DRAFT – FOR CONSULTATION)

Table of Contents

1	Introduction	2
2	Background.....	4
3	Statement of the need — context, and definition of the policy problem	5
4	Salient features of the liquidity risk management framework	6
5	Statement of expected impact—Costs and benefits of implementing the framework	8
6	Statement of intended operation — Implementation and evaluation	10
7	Conclusion	11

1 Introduction

- 1.1 Liquidity risk in insurance business 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 is crucial to distinguish liquidity from solvency. While both are vital for an insurer's ongoing viability, liquidity risk 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.
- 1.2 In June 2020, the International Association of Insurance Supervisors (IAIS) published the Application Paper on Liquidity Risk Management¹ (Application Paper) which provides guidance on supervision related to liquidity risk management in line with the Insurance Core Principles (ICPs) and the Common Framework for the supervision of Internationally Active Insurance Groups.
- 1.3 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 for insurers.
- 1.4 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 insurance business, the protection of policyholders, and financial stability.
- 1.5 The Prudential Authority (PA) issued Prudential Standard FSI 6: Liquidity Risk Assessment in 2018. That Standard sets out the calculation of a liquidity shortfall indicator, which measures potential liquidity risk under stress for insurers operating in South Africa..
- 1.6 While the existing Prudential Standard provides a framework for evaluating liquidity risk within the insurance sector, several limitations have been identified. As such, the PA proposes to address these limitations through proposed revisions to

¹ <https://www.iais.org/uploads/2022/01/200629-Application-Paper-on-Liquidity-Risk-Management.pdf>

Prudential Standard FSI 6 to better align with international best practices and the evolving nature of insurance business models.

- 1.7 Notable concerns are that the existing standard fails to address the liquidity risks arising from 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 movements² 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.
- 1.8 The revised framework introduces comprehensive expectations for the management of liquidity risk which include the identification, assessment, management and planning of risk-mitigating decision-making. The proposed revisions aim to strengthen the resilience of insurers and their preparedness for liquidity risk.
- 1.9 Pursuant to the IAIS issuing the Application Paper, in June 2020, the PA consulted on Guidance Note 1³ of 2022 (Guidance Note 1) with the industry in November 2022. Guidance Note 1 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 and Solvency Assessment (ORSA) for Insurers) as these standards apply to liquidity risk management for insurers.
- 1.10 This report is made in fulfilment of section 98 of the FSR Act and accompanies the draft revised Prudential Standard FSI 6. It seeks to provide the rationale for incorporating the revised Prudential Standard FSI 6 on Liquidity Risk Management into the domestic regulatory framework. Furthermore, the report also seeks to provide the cost and benefits of incorporating the revised framework, as well as its intended operation.
- 1.11 To gather the necessary qualitative and quantitative information required to assess the expected impact of incorporating the revised Prudential Standard FSI 6 into the

² 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.

³ [Guidance Notice 1 of 2022 \(resbank.co.za\)](https://resbank.co.za).

domestic regulatory framework, the PA conducted a impact study and solicited inputs from the industry through a qualitative questionnaire.

2 Background

- 2.1 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 the potential challenges liquidity risks can pose, particularly under stressed market conditions.
- 2.2 Concerns about potential liquidity strains driven by certain insurance activities, such as derivatives and securities lending, have prompted the IAIS and various regulators to emphasise the importance of robust liquidity risk management practices. Recognising gaps in insurers' liquidity risk assessment, management, and monitoring practices have highlighted the need to strengthen regulatory oversight to safeguard financial stability.
- 2.3 The IAIS monitors liquidity risk across the global insurance sector as part of the Global Monitoring Exercise (GME). 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.⁴
- 2.4 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).
- 2.5 The PA has, in formulating the revised Prudential Standard FSI 6 referenced principles espoused in the Application Paper to strengthen the resilience of the South African insurance sector.

⁴ <https://www.iais.org/uploads/2022/11/Level-2-document-Liquidity-Metrics-as-an-ancillary-indicator.pdf>

3 Statement of the need — context, and definition of the policy problem

3.1 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:

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

3.2.1 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 is important to note that solvency stresses might not always expose the insurer's potential vulnerabilities in terms of liquidity risk. As such, there is a need to incorporate idiosyncratic stress testing that simulates stress scenarios specific to an insurer.

3.2.2 The existing framework fails to incorporate business-as-usual and stressed cash flows. Failure to adequately 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.

3.3 *The need to quantify an Insurance Liquidity Ratio*

3.3.1 The revised framework requires insurers to hold a portfolio of high-quality liquid assets, after haircuts, sufficient to meet stressed liquidity needs. Insurers must calculate an ILR, being total adjusted HQLA divided by net cash flows under stress over the subsequent 30 calendar days, with inflows capped at 75% of outflows.

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

3.4.1 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.

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

3.5.1 The current return does not allow insurers to quantify and report on liquidity risk arising from 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.

3.6 *The need to develop and implement a board or board-subcommittee-approved contingency funding plan*

3.6.1 The existing 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.

4 **Salient features of the liquidity risk management framework**

4.1 Under the updated liquidity risk management framework, the PA detailed requirements for the identification, assessment, management and mitigation of liquidity risk.

4.2 The requirements cover the following principles contained in Table 1 below.

Table 1: Updated Liquidity Risk Management Principles

Principle	Description
Requirement for insurers	
Principle 1	The Prudential Standard applies to all insurers licensed under the Insurance Act, 2017, other than microinsurers, Lloyd's and branches of foreign reinsurers. Cash flows on unit-linked liabilities where the policyholder bears the investment risk are excluded from ILR.
Principle 2	An insurer's board is ultimately responsible for ensuring compliance with the Standard. The head of actuarial function must provide the board with an opinion on the accuracy of the ILR calculations and the appropriateness of the underlying assumptions. An auditor appointed under section 32 of the Insurance Act must obtain sufficient and appropriate audit evidence on the composition of the HQLA portfolio and the calculation of the ILR, and must report

	any material non-compliance to the insurer's audit committee and, where section 32(4) applies, to the Authority.
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	Insurers must maintain an ILR of at least 100%, with an appropriate buffer, over a 30-calendar-day horizon. The ILR is calculated as total adjusted HQLA divided by net cash flows under stress, as set out in paragraph 7 of FSI 6.
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.

4.3 The proposed revisions to Prudential Standard FSI 6 enhance and augment 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 draft Prudential Standard FSI 6 incorporates the updated liquidity risk metric, aligned with the new liquidity risk return, to be submitted to the PA.
- Contingency funding planning is required for liquidity risk management.

5 Statement of expected impact—Costs and benefits of implementing the framework

5.1 Under this section of the Statement, the impact, benefits, and areas of concern for the updated liquidity risk management framework will be analysed.

Scope and sample of the impact study

5.2 The purpose of the impact study is to allow the PA to assess the impact of the draft revised liquidity risk management framework on insurers operating in South Africa.

Methodology

5.3 As part of the process to assess the expected impact of implementing the revised Prudential Standard FSI 6, the PA conducted a QIS and solicited industry inputs through a questionnaire.

5.4 However, the response rate was low. Given the low response rate, the results may not be representative of the impact of the draft revised Prudential Standard FSI 6 on the insurance sector. This low response rate limits the ability to draw conclusions on the impact.

5.5 To address this limitation, the PA will make use of the public consultation period to further engage with the sector. The aim is to solicit additional quantitative data and insights on the potential impact of the proposed revisions to the Prudential Standard FSI 6, thereby enhancing the robustness of the final assessment. Specifically, the PA will seek to assess the impact of the proposed revisions with respect to the following:

- (a) Business-as-usual and stressed cash flows;
- (b) Insurance Liquidity Ratio;
- (c) Derivatives exposures;
- (d) Securities lending transactions; and
- (e) Contingency funding plan.

- 5.6 The PA also received qualitative responses which were reviewed to identify common themes and concerns regarding the revisions to Liquidity Risk Management framework. These insights provide valuable context on how insurers perceive the practical implications of the revised requirements.
- 5.7 The insights presented in this report reflect the views of insurers who submitted responses to the PA and do not represent the aggregate position of the industry on the impact of the draft revised Prudential Standard FSI 6.
- 5.8 The following challenges and concerns of implementing the revised FSI 6 Liquidity Risk Management framework in South Africa are noted:
- 5.8.1 **Resource constraints:** Insurers raised concerns that the implementation of the revised Liquidity Risk Management framework would result in additional costs, particularly related to system configuration, enhancements and the need for skilled personnel. Insurers also identified the granularity of reporting as increasing operational complexity and cost. Some insurers noted that the resource burden may not be proportionate to the liquidity risks they face. A request was that consideration be given to the nature, scale, and complexity of the insurer.
- 5.8.2 **Data quality and stress scenario clarity:** Respondents raised concerns related to the availability and reliability of data that would be required to obtain business as usual and stressed cash flow projections. Insurers also noted the lack of prescription by the PA of the stress scenarios to be applied, emphasising that this will result in inconsistencies in reporting to the PA and reduced comparability across the industry. Some insurers were of the view that the current approach taken by the PA of not prescribing stress scenarios will be beneficial for the insurance sector since the business models differ.
- 5.8.3 **Applicability to linked insurers:** Views were raised that the proposed framework is not appropriate for the business model of linked insurers, given that policyholders bear the investment risk and shareholder liquidity risk is minimal. Proposals were to consider exemptions or tailored requirements for these insurers to avoid imposing undue costs and governance burdens.
- 5.8.3.1 The revised Standard addresses that concern without a blanket exemption. Cash flows on unit-linked liabilities where the policyholder bears the investment risk are

excluded from the ILR. Residual liquidity risk remains in scope. Paragraph 8.10 allows an insurer writing unit-linked business to seek the Authority's approval for a Level 1 share below the 60% minimum, subject to stress-testing evidence.

5.8.4 **Governance implications:** Concerns were raised relating to the cost of auditing liquidity risk reports. Some insurers also noted potential misalignment between the proposed governance requirements and their existing internal structures and noted that these could pose challenges.

5.8.5 **ILR methodology and comparability:** Some respondents raised concerns about the computation of the ILR noting that it could result in artificial liquidity shortfalls or misaligned incentives. Concerns were also raised about the comparability of ILR results due to the reliance on assumptions of stress scenario calibrations.

5.9 **Overall liquidity risk management implementation costs:** 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.

5.10 The following advantages and benefits of implementing the revised Prudential Standard FSI 6 in South Africa are noted:

5.10.1 **Improved regulatory oversight:** Respondents noted support for the ILR as an additional metric that could enhance comparability across the sector. Some insurers noted that the ILR would complement existing internal metrics and provide a useful benchmark for assessing liquidity.

5.10.2 **Contingency planning and governance:** The requirement for a contingency funding plan was viewed positively by a number of respondents who indicated that it would improve an insurer's preparedness and provide a structured response framework during a liquidity crisis.

6 Statement of intended operation — Implementation and evaluation

6.1 The revised Prudential Standard FSI 6 applies to all insurers licensed under the Insurance Act, 2017, other than microinsurers, Lloyd's and branches of foreign

reinsurers. The framework will be incorporated into the domestic regulatory framework through amendments to the Prudential Standard FSI 6.

- 6.2 The envisaged commencement date for the liquidity risk management framework is yet to be communicated.
- 6.3 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 on South African insurers before it is implemented.
- 6.4 The PA will determine the applicable haircuts for asset classes and prescribe the form, manner, and period for regulatory reporting of liquidity risk management frameworks. Such determinations may be amended, as and when necessary, to ensure alignment with regulatory and supervisory objectives.
- 6.5 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.

7 Conclusion

- 7.1 This Statement is compiled in terms of section 98 of the FSR Act and outlines the need for, expected impact, and intended operation of the proposed revisions of the Liquidity Risk framework for insurers operating in South Africa. The Statement highlights the limitations of the current Prudential Standard FSI 6 Liquidity Risk Assessment and motivates the rationale for a more comprehensive approach to liquidity management that is aligned to international best practices and evolving insurance business models.
- 7.2 The revised Prudential Standard FSI 6 aims to strengthen insurers' resilience to liquidity risk through enhanced governance requirements, stress testing, and contingency planning requirements. The revised Prudential Standard FSI 6 will contribute to the overall safety and soundness of the insurance sector.