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South African Reserve Bank
Prudential Authority

Insurance Act, 2017

Guidance on liquidity risk management of insurers (Insurance Act, 2017: GOI Risk Management for Insurers)

Objectives of this Guidance Notice

The GOI Guidance Notice is a regulatory instrument aimed at assisting insurers in complying with the requirements outlined in the Governance and Operational Standards for Insurers. Standards enjoy legal standing and are intended to establish minimum requirements with which insurers must comply. Guidance Notices whilst not having the same legal standing as Standards in terms of enforceability nonetheless provide clarity on the application of the respective Standards. Insurers are not obliged to adopt or adhere to the proposed application methodology offered by the Guidance Notice and are free to demonstrate that the requirements of the Standards have otherwise been met through the use of alternative application methologies .

This 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) & 3.1 (Own Risk Solvency Assessment (ORSA) for Insurers.) as these standards apply to liquidity risk management for insurers. This Guidance Notice is aimed specifically at illustrating approaches that should be considered in the treatment and management of an insurers liquidity risk. Some elements of this Guidance Notice may not be relevant to all insurers in terms of the application of practices or guidelines,while other aspects may need to be varied based on an insurer's individual circumstances and characteristics.

The Guidance Notice may reference specific provisions within GOI standards and as such must be read in conjunction with the respective standards cited.

Table of contents

1. Introduction

1.1 This guidance is not in itself an exhaustive guide on liquidity risk management but an expectation from the Prudential Authority (PA). Therefore, it is recommended for each insurer to understand the liquidity risk it faces and apply the guidance in proportion to its nature, size and complexity.

1.2 This guidance notice should be read in conjunction with the Governance and Operational Standards (GO): GOI 3 Risk Management and Internal Controls for Insurers and GOI 3.1. Own Risk Solvency Assessment (ORSA) for Insurers.

1.3 The purpose of the guidance notice is to provide guidelines to insurers and reinsurers, both on a solo and group basis, on the expectation from the Prudential Authority on liquidity risk management to protect policyholders in their dealings with insurers as required in section 62(1) (b) of the Insurance Act, 2017.

2. Background

2.1 Traditionally, insurers typically rely on premiums, income from investments, and other sources for liquidity. Nevertheless, they need to maintain adequate liquidity to fulfil expected and unexpected payment obligations and funding needs. Therefore, liquidity risk management is essential to the proper operation of the insurer, the protection of policyholders, and financial stability.

2.2 Past experience has demonstrated that even solvent insurers may experience material financial distress, including failure, if liquidity is not managed prudently. Moreover, although the majority of an insurer's liabilities are long-term in nature or contingent on the occurrence of an event, certain activities may create significant and unanticipated demands for liquidity. Insurers with insufficient liquidity may therefore be forced to take remedial actions that can amplify or accelerate stresses through the financial system when confronted with stress events.

2.3 Liquidity risk is the risk that an insurer, although solvent, will not be able to meet its financial obligations as and when they fall due, without incurring significant unexpected costs. Liquidity is fundamentally different from solvency in that while both are essential to remain a going concern, liquidity has a "real-time" dimension that solvency may not have.

2.4 Insufficient liquidity can cause "sudden death" in insurers that are otherwise solvent. As a result, the insurer's capital management framework may be inadequate to address liquidity risk. Liquidity risk is not mitigated through capital holding; it is mitigated through investment in liquid assets.

2.5 Apart from ensuring the insurer’s solvency and financial stability, integrated liquidity risk management can provide insight into strategic initiatives, product design and pricing, investment allocation, and operational resilience.

3 Governance

3.1 An insurer should have an adequate governance system for liquidity risk, which supports identification, assessment, management, reporting, and planning of risk-mitigating decision-making. The governance and risk management system should be proportionate to the nature, size, and complexity of the insurer’s business.

DRAFT

3.2 An insurer should develop a risk appetite or tolerance for liquidity risk, that should be approved by the insurer's Board. The Board should be responsible for the effectiveness of the risk appetite or tolerance on an ongoing basis. In performing its responsibilities, the Board should periodically review the insurer's liquidity risk practices and performance to determine if it is operating within the approved risk appetite. The Board may delegate these responsibilities to a board sub-committee. However, this does not absolve the Board of its responsibility.

3.3 The following elements are critical components of an insurer's liquidity risk management:

3.3.1 Clearly defined liquidity risk appetite statement and limits approved by the Board;
3.3.2 Documented liquidity risk policies and liquidity risk management strategy;
3.3.3 Processes aligned with the liquidity risk appetite and risk management strategy;
3.3.4 Adequate allocation of resources and appropriate segregation of responsibilities;
3.3.5 Appropriate systems and reporting procedures to report to management information in a timely and adequate manner, to measure, assess and monitor all material sources of liquidity risk both at solo and group structures;
3.3.6 Forward-looking scenario analysis and liquidity stress testing programs based on severe but plausible assumptions;
3.3.7 Defined metrics and tools for measuring liquidity risk drivers and early warning indicators.

3.4 Senior Management is responsible for applying the insurer's risk appetite in line with its strategic objectives and should ensure that it is integrated into the day-to-day activities of the insurer.

3.5 The insurer's liquidity risk management framework should be reviewed for adequacy and effectiveness by individuals not involved in the day-to-day liquidity risk management to ensure that the insurer is operating within the liquidity risk appetite and in line with the liquidity risk policy and procedures.

3.6 The insurer should establish and maintain an appropriate process for monitoring liquidity. This should include a process for management reporting, which provides clear, concise, timely, and accurate liquidity risk reports to relevant functions within the insurer. Reports on liquidity risk should be provided regularly to the insurer's Board or the relevant subcommittee, Senior Management, and other appropriate personnel. Reports to the insurer's Board or the relevant subcommittee may be less detailed and less frequent than reports to senior management responsible for managing liquidity risk.

3.7 Senior Management should receive timely and precise information from all material entities on the respective entities' liquidity position and emerging liquidity stress events for group companies. Senior Management should report periodically to the insurer’s Board or the relevant subcommittee on the current liquidity risk position, any emerging liquidity stress events, and the stress testing results, highlighting any vulnerabilities identified and proposing remedial actions for the group and material entities.

3.8 In developing a liquidity risk appetite statement, the insurer should identify the duration, types, and severity of liquidity stresses it aims to survive and, in doing so, define:

3.8.1 Timescales over which the identified risks are expected to materialise with multiple tenors considered;

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3.8.2 Types and values of assets which the insurer included in its high-quality liquid assets portfolio; and

3.8.3 The minimum level of the high-quality liquid assets portfolio that the insurer intends to hold relative to liquidity needs in the time horizon considered in the different scenarios.

3.9 The insurer should regularly review its limits and adjust as appropriate, and as the risk tolerance changes, it is expected that this review is done at least annually and as and when conditions materially change.

3.10 An insurer should detail its liquidity risk profile and approach to liquidity risk management in its Own Risk and Solvency Assessment (ORSA) and business plan.

4 Identification of material liquidity risk drivers

4.1 The insurer should understand the sources of liquidity risk it is exposed to and the implications of these risks on its liquidity position both under normal and stressed conditions. Liquidity risk drivers are specific to the insurer's business and thus should be identified relative to each insurer and its business lines.

4.2 Some activities may increase the insurer's exposure to liquidity risk by generating unexpected liquidity needs. When not properly managed, these activities can cause the insurer's failure and, in certain circumstances, contribute to systemic risk[1]. These include, but are not limited to:

4.2.1 Derivatives: Some derivatives contracts require collateral or a margin to be posted for mark-to-market declines in the value of the contract. These derivatives used to hedge market risk arising from investments and liabilities introduce potential liquidity risk on the insurer’s balance sheet. A significant macroeconomic shock against hedges, while potentially improving an insurer's capital position, could trigger calls for additional margins or collateral, forcing insurers to raise liquidity.

4.2.2 Securities lending transactions: If funds received are reinvested in illiquid assets, sudden recalls of these funds could force the insurer to sell assets. In a stressed market, these sales could impact the insurer's creditworthiness, triggering more collateral demands and leading to a price spiral as the lender sells assets to meet collateral needs; and

4.2.3 Liquid liabilities backed by illiquid assets: Some products offered by insurers contain provisions whereby a policyholder can withdraw cash from the policy with little notice or penalty. Where insurers do not adequately match such liabilities with sufficiently liquid assets, this may lead to a liquidity shortage in certain circumstances and ultimately trigger fire sales[2].

4.3 The following liquidity risk drivers should be considered in assessing and designing the liquidity stresses:

4.3.1 Exposure to insurable events: consideration should be given to the nature, frequency, and severity of exposures to insurable events, including catastrophic events or material legal decisions that may occur within a short time horizon. The

[1] Systemic risk, as defined by the Bank for International Settlements (BIS), International Monetary Fund (IMF) and FSB (2009), refers to a risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and has the potential to have serious negative consequences for the real economy.

[2] Fire sale generally refers to a forced sale in which a large volume of securities is sold within a short amount of time at dislocated prices.”

insurer should consider its dependence on reinsurance and the possibility that a material portion is temporarily uncollectible or not funded timely, even if ultimately collectible. Where the insurer holds collateral for reinsurance, it should consider the value and liquidity of the collateral in light of the stress event.

4.3.2 Policyholder behaviour: this includes assessing possible withdrawals from different product types; some product features may create an immediate liquidity need, i.e., guarantees, surrender penalties, maturity dates, interest rate sensitivity, product purpose, borrowing costs for policy loans, and customer type. In determining potential stresses, assessments should include a potential reduction in regular premium receipts, non-renewals of contracts, and declines in new business and their impact on cash flows.

4.3.3 The insurer's reputation or the policyholder's confidence in its financial position may trigger higher policy lapses or withdrawals. The insurer should consider the impact of this on their liquidity position.

4.3.4 Contingent or off-balance sheet exposures: derivative cash flows and collateral requirements caused by deteriorating market conditions should be assessed. These include cash requirements from additional costs to rebalance the portfolios.

4.3.5 Collateral needs arising from reinsurance arrangements and any other potential material liquidity needs arising from off-balance sheet commitments, contracts, and facilities.

4.3.6 Impact of the insurer's credit rating deterioration: insurers should consider all types of outflows and collateral requirements resulting from its credit downgrades of varying magnitude. This should include considerations on the types, quantity, and timing of potential collateral and margin requirements. This analysis should encompass retail and institutional policyholders as well as capital markets and reinsurance counterparties.

4.3.7 Ability to transfer the liquidity across entities, jurisdictions, and portfolios: An insurer within a group should assess the transferability of excess liquidity within the group. Consideration should be given to legal, regulatory, and operational limitations to transfer liquidity and unencumbered assets between entities, business lines, and countries during normal stressed conditions. A prudent assumption may be that, under stress, a part or the whole of intragroup liquidity may become non-transferrable, so it is expected that the insurer will demonstrate that its approach to transferability is realistic.

4.3.8 As part of its stress testing, where material, the insurer should appropriately address legally or operationally ring-fenced assets; such assets could include legally insulated separate accounts, closed blocks[3], with-profits funds, or annuity blocks. Therefore, these blocks of assets should only be included as cash flow sources to back cash flow needs arising from these same accounts. The insurer should also detail how assets in these blocks may affect the insurer's balance sheet through guarantees, hedging programs, or other regulatory requirements to replace or maintain assets.

4.3.9 Foreign exchange convertibility and access to foreign exchange markets: An insurer should assess liquidity needs by individual currency to support an assessment of how shortfalls can be funded in a stressed market with impaired access to foreign exchange markets and loss of convertibility.

[3] Closed blocks refer to discrete pools of assets that are set aside to support the dividend expectations of participating policyholders from the periods before demutualisation, as well as anticipated policy benefits. Typically, changes in their values would be primarily offset by future changes in the dividend rates on these participating policies.

4.3.10 The reduction in secured and unsecured wholesale funding: An insurer should identify any wholesale funding[4] and assess how the funding would behave under stressed conditions. This should include the risk of shortening tenors, for example, if the funding provider has call options or refusal to roll over or extend the maturity of funding. A prudent assumption is that funding providers will be unable or unwilling to provide new unsecured borrowings or roll over or extend the maturity of existing funding for the length of the stress horizon. Wholesale funding that provides the counterparty with the optionality of acceleration, in particular, should be noted and elaborated on.

4.3.11 Correlation and concentration of funding sources: The insurer should consider the instrument type, market, currency, and counterparty, including groups of related counterparties. This assessment should analyse the effectiveness of the diversification across the insurer's chosen sources of funding.

5 Stress testing and forward-looking analysis

5.1 Through stress testing, the insurer develops a sound understanding of how its activities affect its liquidity risk profile both under normal and stressed conditions; stress testing should therefore be robust as it is a vital part of liquidity risk management.

5.2 An insurer's stress tests should include a range of severe but plausible scenarios, covering short-term and protracted macroeconomic, sector-wide and idiosyncratic events and a combination thereof that reflects appropriately its business's distinctive features. For material legal entities that are part of a group, this includes appropriate, locally developed stresses that reflect local business vulnerabilities and market conditions.

5.3 Depending on its business model, an insurer may be vulnerable to different liquidity stresses in comparison to other insurers. Certain activities may contribute to larger or less predictable liquidity needs. Stress scenarios should be chosen to reveal potential vulnerabilities in the insurer's liquidity profile. In this way, the chosen stresses should support management to identify material risks to the insurer. The scenarios and model parameterisation should not be limited to historical events, distributions, and correlations but should also be forward-looking.

5.4 The insurer should assess the impact of its chosen scenarios on cash flows, liquidity resources, profitability, and solvency both at the material individual entity level and group level at the different chosen time horizons (i.e., daily, 7 days, 30 days, 90 days, and one year). It may be more appropriate for an insurer to use the 1-day horizon in its stress testing, depending on the types of exposures it has.

5.5 The insurer should make conservative assumptions appropriately, both qualitative and quantitative, in determining its stress scenarios. Key assumptions should be described and justified in relation to the level of severity of the scenario and relevant risk factors taken into account. In determining stress scenarios, the insurer is expected to be prudent; this includes not assuming the availability of uncommitted off-balance-sheet funding lines. While these may provide sources of funding under normal conditions, they may not be available when needed in times of stress as a large number of institutions might try to seek funding from the same sources.

[4] Wholesale funding generally refers to any financing from institutions

5.6 Other potential cash inflows, such as future premiums, may still be assumed to be available under stressed conditions, though the insurer should adjust their assumed availability in line with the stress scenarios. The insurer's determined responses during stress should be so that it does not significantly damage the insurer's reputation.

5.7 In conducting stress tests, insurers should avoid relying on capital-led stress scenarios and create separate scenarios outside the Own Risk and Solvency Assessment scenarios. This is because events that significantly impact capital may not have a significant impact on liquidity.

6 Composition of highly liquid assets in the high-quality liquid assets portfolio

6.1 An insurer should hold a portfolio of high-quality liquid assets to cover any liquidity gap at a particular time horizon both in benign and stressed conditions. All assets within the portfolio should be documented at the appropriate level of granularity. Cash flow estimates from the business-as-usual projections and stress testing results may be a useful tool to determine the appropriate level of assets sufficient to make up for any liquidity gap in line with the approved liquidity risk appetite.

6.2 Assets included in the high-quality liquid assets portfolio should be highly liquid, that is, easily and immediately convertible into cash, either through outright sale or repo, at little to no cost. The nature of these assets is such that they have a low risk (e.g., credit, market, etc.), ease and certainty of valuation, and low correlation with risky assets. These assets typically also have a consistently active outright sale or repo market with evidence of the market breadth and depth with a diverse group of active buyers and sellers, i.e., they are "readily marketable". Finally, assets should have a proven record as a reliable source of liquidity during stressed market conditions.

6.3 Assets in this portfolio should be unencumbered. Unencumbered assets are free of legal, regulatory, contractual, or other restrictions on the ability of the insurer to liquidate, sell, transfer, or assign the asset.

6.4 There are natural differences in the liquidity of these assets that would limit the insurer's ability to monetise them during a stressed situation. As a result, the insurer should group assets according to their usability in stress with sufficient granularity to adequately manage risks in its liquidity profile. To ensure their realisability in stress and to minimise financial stability impacts from the monetisation of financial assets, insurers generally should not rely on lower-quality assets for shorter stress periods as they may be unable to monetise these assets quickly enough to meet liquidity needs. Moreover, large sales of lower-quality assets in a short time, particularly in stressed conditions, could impact market prices, thereby affecting similar assets held by other institutions.

6.5 Assets held in the high-quality liquid assets portfolio should be considered as Level 1, Level 2a, or Level 2b. Level 1 assets are generally those of the highest quality and liquidity and are more likely to have willing buyers in very short horizons, even during stressed conditions. Because of this, Level 1 assets should generally comprise a majority share of the portfolio. Level 2a assets are still of high quality but will generally incur larger haircuts[5] and/or take more time to find a buyer than

[5] According to the Bank of International Settlements (BIS) and International Organisation of Securities Commissions (IOSCO) 2012 principles for financial market infrastructures, haircut refers to a specific percentage that is used to reduce the market value of the underlying assets.

Level 1 assets. Level 2b assets will, in general, have less active markets, and therefore take even more time to find a willing buyer, or will incur more substantial haircuts on sale during stressed market conditions.

6.6 Different proportions of Level 1, Level 2a, and Level 2b assets may be appropriate depending on the horizon of the liquidity stress. For short-term stresses, for example, those of one month or less, insurers should rely more on Level 1 assets, though they may also consider limited quantities of Level 2a or level 2b assets. For medium-term stresses, for example, those between one month and three months, the insurer should rely on both Level 1 and Level 2a assets, but may also, in such circumstances, consider limited quantities of Level 2b assets to be appropriate. For longer-term stress periods, for example, those longer than three months, the insurer would likely be expected to sell assets more strategically to minimise losses. As such, Level 1, Level 2a and Level 2b assets could be allocated to the high-quality liquid assets portfolio in appropriate quantities.

6.7 Assets included in the high-quality liquid assets portfolio should not be concentrated into one asset class or correlated assets. This is to avoid a significant portion of the assets becoming illiquid just when it needs to be used. Therefore, the insurer should regularly assess the concentration of the assets by the counterparty (including group related) and instrument type. Instruments issued by other financial institutions have the potential for wrong-way risk (i.e., their liquidity is correlated with developments in the financial markets and/or broader economy) and may exacerbate stress at the insurer level. Moreover, such instruments could contribute to systemic risk by increasing the insurer's interconnections with the rest of the financial sector. As a result, it would not generally be expected that instruments issued by financial institutions, or their affiliated entities would be appropriate for inclusion in the high-quality liquid assets portfolio.

6.8 The insurers should apply the appropriate haircut to the fair market value of the assets in the portfolio to account for increased credit and market risk during a stressed event. The transferability of the assets within the high-quality liquid assets portfolio should also be assessed by the insurer as it may be at a location where there are restrictions. It is also prudent to assume that assets within underwriting entities are not transferable elsewhere within the group, to protect policyholders in times of stress. It is expected that intra-group transactions will be excluded from the analysis of an insurer's liquidity position on a group basis.

6.9 Assets should be classified as follows:

Asset type	**Quality determinant* based on local ratings scales**	**Classification**	**Haircut**	**Time horizon**
Cash and Demand deposits	Sufficiently diversified and highly rated financial institutions and available within time horizon.	Level 1	0%	Up to 1 month Up to 3 months Up to 12 months
Securities issued or guaranteed by sovereign, supranational, or other non-sovereign public sector entities backed by their full faith and credit	Rated AA- / Aa3 or better	Level 1	0%	Up to 1 month Up to 3 months Up to 12 months
	Rated A- / A3 or better, but less than AA- / Aa3	Level 2a	15% 0%	Up to 1 month Up to 3 months

DRAFT

Asset type	Quality determinant* based on local ratings scales	Classification	Haircut	Time horizon
			0%	Up to 12 months
Securities issued by a Government Sponsored Enterprise senior to preferred equity	Rated AA- / Aa3 or better	Level 1	0%	Up to 1 month Up to 3 months Up to 12 months
	Rated A- / A3 or better, but less than AA- / Aa3	Level 2a	15% 0% 0%	Up to 1 month Up to 3 months Up to 12 months
Vanilla corporate debt securities, including commercial paper	Rated AA- / Aa3 (A1 / P1 for commercial paper) or better; AND Not issued by a financial institution or its affiliates.	Level 2a	15% 0% 0%	Up to 1 month Up to 3 months Up to 12 months
	Rated BBB+ / Baa1 (A2 / P2 for commercial paper) or better, but less than AA- / Aa3 (A1 / P1 for commercial paper); - Not issued by a financial institution or its affiliates.	Level 2b	50% 25% 0%	Up to 1 month Up to 3 months Up to 12 months
Covered bonds	Rated AA- / Aa3 or better	Level 2a	15% 0% 0%	Up to 1 month Up to 3 months Up to 12 months
	Rated BBB- / Baa3 or better, but less than AA- / Aa3	Level 2b	50% 25% 0%	Up to 1 month Up to 3 months Up to 12 months
Common equity shares	Publicly traded on a major exchange; AND Not issued by a financial institution or its affiliates	Level 2b	50% 25% 0%	Up to 1 month Up to 3 months Up to 12 months
Other fixed income instruments issued by public sector entities	Rated BBB+ / Baa1 or better	Level 2b	50% 25% 0%	Up to 1 month Up to 3 months Up to 12 months
Foreign currency liquid assets	Liquid foreign currency are: USD: United States Dollar EUR: Euro GBP: British Pound		8% 0% 0%	Up to 1 month Up to 3 months Up to 12 months
Other assets	Demonstrated to have low credit risk, low volatility, and readily marketable and has a proven record as a reliable source of liquidity during stressed market conditions.	Level 2a	15% 0% 0%	Up to 1 month Up to 3 months Up to 12 months

DRAFT

Asset type	Quality determinant* based on local ratings scales	Classification	Haircut	Time horizon
		Level 2b	50% 25% 0%	Up to 1 month Up to 3 months Up to 12 months

6.10 Insurers should take several additional considerations into account when including assets in the high-quality liquid assets portfolio. To avoid double-counting, assets generating future cash-flows used as cash inflows in the insurer's liquidity stress test projections, for example, through a coupon or interest payments or maturities, should not be allocated to the portfolio as the insurer may not be willing or able to sell them without impacting its existing business or risk management strategies (i.e., it could not realise these cash flows if the asset were sold). This does not mean that assets used to meet cash flow needs outside of the relevant time horizon could not be allocated to the buffer as the insurer would likely have time to rebalance its portfolio.

6.11 The insurer should assess its ability to convert its high-quality liquid assets portfolio into cash in a short time frame. This may involve periodically monetising a representative portion of the high-quality liquid assets portfolio, either through repo or outright sale. This may help the insurer test its access to the market, the effectiveness of its processes for monetisation, the availability of the assets, and minimises the risk of negative signalling during a period of actual stress.

6.12 Even where policyholders bear the investment performance of these assets fully, large-scale asset sales or purchases for these policies may still present operational challenges. As such, the insurer should consider its ability to monetise assets without compromising on either speed of disposal or price. As part of this assessment, the insurer should describe and justify all key assumptions about the amount of time needed to sell significant blocks of assets or the availability of willing counterparties for repo transactions. The insurer should also consider the impact of its actions on the wider market and financial stability.

7 Contingency funding planning

7.1 The insurers should conduct contingency funding planning to respond to liquidity stress events to assist the insurer in addressing stress situations where its liquid assets are insufficient or unexpectedly become illiquid. It should include the actions that the insurer could realistically take to ensure that liquidity sources are sufficient to maintain normal operations and continue to meet its financial obligations, including collateral needs, under stress. Such a plan should describe the insurer's strategies for addressing liquidity shortfalls in emergency situations timely and at a reasonable cost.

7.2 To ensure the operational robustness of the plan, the insurer should test its contingency funding plan annually. The contingency funding plan should be reviewed and updated based on the test results and where there are significant changes in the business to ensure that it remains adequate. The frequency of performing tests of the contingency funding plan should be based on the volatility in the liquidity position of the insurer. The insurer's contingency funding plan should address a range of plausible stresses and in different time horizons, including intraday where relevant.

DRAFT

7.3 The plan should include a diversified set of viable, readily available, and flexibly deployable methods that the insurer would use to access alternative funding sources. For example, these may include off-balance-sheet liquidity facilities to the extent that such facilities cannot be unilaterally revoked, are already available, and can be accessed without further action by liquidity providers, such as new approval to access a liquidity facility.

7.4 The plan should also describe when and how each of the actions could be activated and the time needed to access funds and the quantity of funds that would be expected to be available from each contingency source in the given stress. The plan should describe clear steps that allow the insurer to make timely and informed decisions, execute contingency measures efficiently, and communicate effectively. No one particular method, such as accessing a pre-funded liquidity facility, is expected to be included as part of this plan. The plan serves as a reference point to inform and guide the actions of the insurer in times of actual stress, though the insurer's ultimate action should be adapted to the conditions of the actual stress event.

7.5 The plan should include quantitative metrics that the insurer would use to identify a range of liquidity stress events, including its impact on the insurer's liquidity position, high-quality liquid assets portfolio, and sources of available funding. Such metrics should be informed by the insurer's stress tests and could include sharp increases in interest rates, catastrophic events, steep equity market declines, multiple rating downgrades, or other events that could affect the policyholder's or counterparties' perception of the insurer's reputation and liquidity or solvency condition. Based on these metrics, the plan should define a variety of circumstances in which it would be invoked. The insurer may wish to use different metrics to differentiate between systemic and idiosyncratic liquidity stress. For instance, with idiosyncratic liquidity stress, the insurer may have a broader range of possible actions that it could use to raise liquidity or make more time to execute planned actions, compared to systemic liquidity stress.

7.6 The plan should set out a process on what actions to take and their timing, who can initiate it, and clear escalation procedures. The plan should establish a clear allocation of roles and clear lines of management responsibility and define procedures for identifying early warning indicators for potential liquidity stress events that are based on the distinctive features of its business. The plan should also contain a governance process for escalation. It should establish the lines of communication to ensure that the Board and Senior Management receive the necessary management information timely. It is important that the relevant employees know the operational procedures to transfer liquidity and collateral across legal entities and accounts and the restrictions that govern such transfers.

7.7 The insurer's contingency funding plan should take into account the impact of stressed market conditions on its ability to monetise assets, including market-imposed haircuts or operational limitations, the impact of a freeze in typically available market funding options, the financial, reputational, or other consequences for the insurer of executing its contingency funding plan and its ability to transfer liquidity between entities. In addition, the plan should clearly articulate the communication plan for both internal and external stakeholders.

7.8 The insurer may integrate its contingency funding plan into its recovery planning.

8 Risk appetite and risk limits

8.1 A central component of liquidity risk management is a clear articulation of the acceptable level of liquidity risk that the insurer may assume to achieve its strategic objectives. This should be described in a risk appetite statement that defines the duration and type of stress or stresses that the insurer aims to survive. This statement should include both quantitative targets, such as excess liquidity or insurance liquidity ratios and qualitative objectives. The insurer's risk appetite statement should be articulated in a manner that management at all levels can clearly understand and apply it to all aspects of liquidity risk management throughout the organisation. Accordingly, all elements of the liquidity risk management report should be consistent with the risk appetite statement.

8.2 To the extent possible, the insurer's liquidity risk management report should include a description of the systems and metrics used to measure and monitor liquidity risk. Several techniques can be used for measuring liquidity risk, ranging from simple calculations to highly sophisticated modelling. The degree of sophistication in risk metrics should be reflective of the size, nature, and complexity of the insurer's activities.

8.3 To implement the insurer's stated risk appetite, based on these metrics, management should consider where limits should be set, in accordance with the nature, size, and complexity of the insurer's activities. Activities that may warrant limits to be set are (i) non-insurance liabilities maturing or redeemable within various time horizons; (ii) off-balance sheet or other exposures that could create liquidity needs during stressed market conditions; (iii) concentrations of liquid assets and funding sources by currency, single counterparty or group of related counterparties, counterparty type, instrument type, and instrument seniority; (iv) liquidity risk arising from insurance liabilities; (v) maturity gaps; and (vi) the value or proportion of encumbered assets. These limits should be documented in the insurer's liquidity risk management report, including how they interact with the insurer's stated risk appetite and the insurer's current liquidity position.

8.4 Senior management should disseminate the insurer's liquidity risk guidelines to involved employees and ensure that these employees work cooperatively to implement the insurer's liquidity risk management policies. Throughout its liquidity risk management report, the insurer should demonstrate how the liquidity risk appetite is applied, in particular, how it and the insurer's liquidity risk management report are integrated into the risk management framework and how they inform business decisions (i.e., a use test).

8.5 Regarding the use test, for example, liquidity risk should be integrated with investment risks and influence business decisions around purchases and sales, and asset allocation. Liquidity risk and liquidity risk appetite should also influence product design when considering large policy limits, guaranteed rates, surrender periods, and benefits.

9 Analysis of the insurer's liquidity profile

9.1 The insurer should consider potential vulnerabilities in its liability profile, both insurance-related and non-insurance-related. The insurer's liquidity risk management report should discuss its outstanding products in sufficient detail so that a reader can understand their features. The insurer should pay particular

attention to product features that may encourage withdrawals or otherwise create significant liquidity demands under certain circumstances, for example, the following:

9.1.1 To the extent the insurer provides group employee benefits schemes, it should describe the exposures and assess the potential liquidity needs that could arise from these products;

9.1.2 The insurer should describe any investment-type contracts[6] or similar products. Where a trust or special purpose vehicle (SPV) or other structure is used to transform the maturity of the issued instrument, for example, in a funding agreement-backed securities programme, these structures may exacerbate liquidity risk and the insurer should describe such structures in the report;

9.1.3 Any material outstanding legal decisions that could create unexpected liquidity needs;

9.1.4 The insurer's report should describe any non-insurance liabilities that could contribute to liquidity stress. Detail should be provided of yield-enhancing activities, such as SFTs that the insurer engages in, including reinvestment practices and its internal policies regarding such activities; and;

9.1.5 The insurer should also describe its hedging strategy and the ways through which it manages the associated liquidity risk, for instance, through margin calls.

9.2 The insurer should maintain adequate ability to measure, monitor, and report to the Prudential Authority all insurance contracts that could present funding draws due to policyholder decisions. This is because the Prudential Authority may request this information from insurers. This should be done at such a level to identify blocks of business that may behave similarly. Insurers should be able to monitor these amounts net of surrender penalties and market-value adjustments to assess maximum cash flow needs and to identify changes in the aggregate profile of a block's surrender charges.

9.3 In the normal course of business, the insurer should periodically produce cash flow projections, commensurate with the relevant time horizon, that incorporate (i) anticipated claim and annuity payments; (ii) policyholder options including surrenders, withdrawals, and policy loans; (iii) collateral requirements; (iv) expenses; (v) intercompany transactions; (vi) maturities and renewals of funding instruments, including through the exercise of provisions that could accelerate their maturity; (vii) premiums from new and recurring business; (viii) investment income; and (ix) any other potential cash flows that are relevant to the unique nature of the insurer's business and activities. Cash flows should be reported with sufficient detail on the underlying activity and at sufficient granularity concerning the time interval for the insurer to assess areas for potential vulnerabilities. Cash flows from asset disposals should be accounted for separately. In its liquidity plan, the insurer is expected to document and justify all key assumptions used in generating the cash flow projections. In the plan, the insurer should also identify and analyse any potential, discrete, and cumulative cash flow mismatches over various time horizons, as applicable to its activities and business.

[6] Investment-type insurance liabilities are those products that do not incorporate significant insurance risk. Examples of products that should be reported include Guaranteed Investment Contracts (GICs), Funding Agreements, Capital Redemption Policies, Annuities Certain, and Funding Agreement-backed or Fixed Annuity-backed securities.

10 Liquidity risk management report

10.1 The insurer should prepare a liquidity risk management report as part of the ORSA record which should include at least the following:

10.1.1 A liquidity risk appetite statement;
10.1.2 Established liquidity risk limits;
10.1.3 A discussion of the current liquidity position of the insurer concerning its liquidity risk appetite and limits;
10.1.4 A summary of strategies, policies, and processes that the insurer has in place to manage liquidity risk;
10.1.5 A discussion of potential vulnerabilities in the insurer's liabilities as well as the means of enhancing the liquidity position; and
10.1.6 For group companies, should consider if and to what extent entities or sub-groups are self-sufficient or dependent on liquidity support from other parts of the group and whether such arrangements are both prudent and expected to be honoured in a stress scenario.
10.1.7 The insurer's approach to, and results of, liquidity stress testing.

10.2 A liquidity risk management report's key purpose is to document and demonstrate overall liquidity adequacy, both under current and stressed market conditions. The report sets out an insurer's approach to liquidity and funding. It should be clear and self-explanatory so that any outside person familiar with the subject matter can easily understand it. The liquidity risk management report should also be tailored to the risks to which an insurer is exposed.

10.3 The liquidity risk management report should be regularly updated, particularly when there are material changes to the nature, size, and complexity of the insurer's activities, high-quality liquid assets portfolio, and funding profile. The liquidity risk management report should be approved by the Board of Directors or Board Committee.

11 Reporting to the Prudential Authority

11.1 The insurer should ensure consistency between its liquidity risk management report and all other supervisory required documents, such as recovery plans or ORSAs.

11.2 As part of its liquidity risk management, it is recommended that the insurer should have tools in place to report the ratio of the high-quality liquid assets portfolio to net stressed cash outflows (inflows minus outflows), the Insurance Liquidity Ratio (ILR), under each time horizon, as produced by the stress test(s).

11.3 The PA may collect additional information on the set of risks that may be relevant for a particular insurer as part of its monitoring of potential vulnerabilities arising from liquidity risk in the insurance sector.

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