Dr. Victoria Saporta
Chairperson
Mr. Jonathan Dixon
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International Association of Insurance Supervisors
Centralbahnplatz 2
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Re: IAIS public consultation on Draft Application Paper on Liquidity Risk Management

Dear Dr. Saporta and Mr. Dixon:

The Institute of International Finance (IIF) and its insurance members appreciate the opportunity to comment on the Draft Application Paper on Liquidity Risk Management (Draft Application Paper) published for public comment by the International Association of Insurance Supervisors (IAIS) on November 19, 2019. The IIF and its members appreciate the importance of robust liquidity risk management and its role in protecting policyholders and promoting financial stability, goals that are shared among industry and supervisors.

General Comments

The IAIS notes in the Introduction to the Draft Application Paper that, consistent with longstanding practice, the purpose of the Paper is to provide further guidance to supervisors in their application of the standards in the Insurance Core Principles (ICPs) and the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame), particularly ICP standards 16.8 and 16.9 and ComFrame 16.9.a – 16.9.d., by providing additional detail on that supervisory material and suggesting examples of good practice. We have noted in this comment letter a number of instances where the Draft Application Paper diverges from the IAIS' stated purpose and approach through its inclusion of unnecessarily prescriptive recommendations, which we believe could have negative macroprudential repercussions . While microprudential supervisory tools can be helpful in addressing macroprudential concerns, caution needs to be taken in the selection and use of those tools to avoid unintended consequences.

We believe that the avoidance of prescriptive recommendations in favor of a more flexible and proportionate approach would better recognize the varying nature of liquidity risk across companies and jurisdictions, differences in corporate structure and the degree of centralization of liquidity risk management. For example, Paragraph 52 would exclude from the liquidity portfolio instruments other than demand deposits issued by other financial institutions. We believe that the blanket exclusion of these instruments could contribute to system-wide liquidity pressures, incent insurers to assume larger single-name non-financial exposures (which may be riskier holdings particularly in an economic downturn), and possibly incent hoarding behaviors if there are supply-side pressures on alternative instruments. We would caution against the adoption of prescriptive or "hard-wired" liquidity metrics or restrictions on the types of assets that may be included in a liquidity portfolio, as these could have negative macroprudential ramifications (e.g. hoarding) and could give rise to inappropriate incentives for insurers (e.g. asset concentrations).

The Draft Application Paper should better acknowledge that the design of a company's liquidity risk management and governance framework is the responsibility of the insurer's senior management, with direction from the board of directors as to the company's risk appetite (as reflected in Paragraph 25). The design of liquidity stress tests, the composition of a company's liquid assets, and the range of options in a contingency funding plan are the responsibility of senior management, with oversight from the board of directors and consistent with the board-established risk appetite. The language of Paragraph 22 better reflects this division of responsibilities, as well as a proportional approach, than does the language of Paragraph 14. Accordingly, we would suggest the substitution of Paragraph 22 for Paragraph 14 and the deletion of Paragraph 14.

With respect to reporting, supervisors should consider whether and to what extent information on liquidity risk and liquidity risk management is available in existing data and reports before issuing new requirements. This point is appropriately acknowledged in Paragraph 81, which recognizes that elements of an insurer's liquidity risk management may be incorporated in a variety of materials based on senior management's judgment or the corporate structure. This emphasis on substance over form should be more consistently acknowledged throughout the Draft Application Paper.

More broadly, the Draft Application Paper should clarify how the guidance to supervisors contained therein forms is intended to support the Holistic Framework for Systemic Risk in the Insurance Sector (Holistic Framework), including the Global Monitoring Exercise, ICP 24 and relevant provisions of ComFrame. Paragraph 12 of the Holistic Framework discusses the key elements of the Framework, but it is not clear how each of those elements relates to the other elements and how the elements, individually and collectively, should be implemented by supervisors.

Specific Comments

Stress Testing. Paragraph 30 of the Draft Application Paper provides that, through stress testing, the insurer should assess the impact of its chosen scenarios on cash inflows and outflows, liquidity resources, profitability and solvency. We encourage the IAIS to elaborate on the need to analyze the impact of liquidity scenarios on profitability, which is beyond the scope of the liquidity risk management-related ICPs.

Paragraph 32 states that, generally, stressed cash inflows should not assume borrowings from off-balance sheet sources such as lines of credit. We believe that the Draft Application Paper should refrain from promoting excessively prudent assumptions and instead include text that focuses on the importance of a careful review of the availability of off-balance sheet sources of cash in times of stress to ensure that assumptions are appropriate. More broadly, we note that it is important that due consideration be given to the role of other risk management tools and requirements – particularly those pertaining to the management of counterparty risk – to avoid redundant or conflicting guidance that could result in unintended consequences.

Stress testing horizons and assumptions should be governed by the liquidity risk profile and risk appetite of the company and not determined by the supervisor. If a supervisor considers that an insurer is not implementing a robust liquidity risk management program, it may ask for additional stress tests to be conducted but, in the ordinary course of supervision of a well-managed company, management should have the responsibility for the construction and implementation of stress tests.

Liquidity Risk Drivers. Paragraph 37 states that the supervisor should consider the insurer's dependence on reinsurance and the possibility that a material portion of reinsurance recoverables is uncollected or not funded in a timely manner. We do not believe that this statement reflects actual practice in the timely recovery of reinsurance payments, nor does it reflect the common practice of netting reinsurance recoverables. As noted above, we believe the Draft Application Paper should refrain from promoting excessively prudent assumptions and instead include text that focuses on the importance of a careful review of the appropriateness of assumptions, in this case as they pertain to reinsurance. This could be achieved through deletion of the second sentence of Paragraph 37.

Paragraph 38 discusses policyholder withdrawals and surrenders without considering common contractual provisions and non-contractual factors that disincent withdrawal or surrender. A more balanced discussion of withdrawals and surrenders is recommended. For example, the Paper could note that withdrawals or surrenders may be disincented by adverse tax consequences to policyholders.

Paragraph 40 is unnecessary in light of Paragraph 39 and we suggest its deletion or the addition of the phrase, "or deterioration in the insurer's credit rating" at the end of Paragraph 39.

Paragraph 41 presents another instance of overly prescriptive guidance on assumptions that supervisors should deem appropriate. Similar to our comments above, we do not believe that it is appropriate to recommend adherence to an assumption that liquidity becomes non-transferable. Rather, we believe the focus should be on calling for a careful review of assumptions that include reliance on intra-group assets to satisfy liquidity needs.

With respect to Paragraph 45, we agree that asset concentrations can be a driver of liquidity risk. Asset concentrations can be exacerbated by an overly restrictive definition of liquid assets that inhibits an insurer's ability to diversify its liquidity portfolio.

Liquidity Portfolio. Paragraphs 46 and the following Paragraphs define the liquidity portfolio in an overly conservative and restrictive manner that is inconsistent with ComFrame 16.9.b.2 and 16.9.b.3 and that may lead to an insurer holding assets that do not necessarily align with the liquidity profile of its liabilities and, as noted above, may lead to asset concentrations. Importantly, an overly conservative approach to an insurer's liquidity portfolio may give rise to unintended macroprudential consequences, including impacting the pricing and supply of assets and incenting hoarding behaviors.

Insurers match their assets to their liabilities as part of their asset/liability management strategies and practices. As such, the concept of the liquidity portfolio should not be construed as requiring a segregated account of liquid assets.

Paragraph 46 provides that "[a]ny assets that the insurer includes in the [liquidity] portfolio should be documented with an appropriate level of granularity." Paragraph 54 appears to provide some guidance as to the appropriate level of granularity by stating that, "the insurer should assess the diversity of its liquid assets by counterparty, including groups of related counterparties, counterparty jurisdiction, and instrument both with regard to its own asset portfolio, and also considering the broader market (i.e. the insurer does not hold a substantial share of the market for a particular counterparty or asset class) to ensure that the market will be able to bear the insurer's sales without adversely impacting its ability to monetize its liquid assets as planned." While we agree that the insurer should assess the diversity of its liquid assets, this level of granularity (i.e. down to the instrument level) should not be necessary if the insurer can, as expected, demonstrate a well-diversified portfolio.

The statement in Paragraph 47 that assets in the liquidity portfolio should be "easily and immediately convertible into cash, either through repo or outright sale, at little or no loss in value" does not recognize that insurers keep assets with a range of liquidity attributes. Indeed, some assets are immediately saleable while others could be liquidated, as needed, over time (this is recognized in Paragraph 50). Some assets may be sold at a loss as well and insurers' use of prudent haircuts can address this possibility, as is acknowledged in Paragraph 55. The sale or hypothecation of assets is a decision for management that is informed by a range of factors that reflect the unique circumstances of the firm at a particular point in time and the nature of the stress to which the firm is subject.

The statement in Paragraph 47 that assets included in the liquidity portfolio have low credit and market risk is inconsistent with the recognition in Paragraph 49 that the liquidity portfolio can include publicly traded equity securities. Rather, the Paper should provide that assets included in the liquidity profile should include an adequate volume of assets with relatively low levels of credit and market risk.

The grouping of assets into liquidity buckets indicates that the IAIS accepts the inclusion of less liquid assets in a liquidity portfolio. While liquidity bucketing may be a useful tool for some insurers but the decision to adopt a bucketing approach and the assignment of assets to specific buckets should be at management's discretion and not imposed by supervisors. A prescriptive bucketing approach may give rise to supervisors viewing the range of liquid assets too narrowly or not considering new types of assets that may be developed over time. It is also inconsistent with ComFrame 16.9.b, which provides that the head of the insurance group (rather than the supervisor) is responsible for determining what constitutes highly liquid assets. Supervisors should look to management to demonstrate the liquidity of the company's portfolio in light of the composition of its liabilities and the risk appetite set by the board.

We do not agree with the statement in Paragraph 52 that instruments issued by other financial institutions generally are not appropriate for inclusion in the insurer's liquidity portfolio, with the exception of demand deposits. Insurers do consider counterparty exposures and the marketability of individual assets and they accordingly adopt counterparty limits and haircuts. They also consider whether an instrument issued by a financial institution can be sold and under what conditions, taking into account market conditions and the nature of any market-wide stress.

It is estimated that instruments issued by financial institutions can constitute a significant portion of investment-grade corporate bond indices. An outright prohibition of these instruments would be excessive and could lead to liquidity pressures and incent insurers to assume larger and riskier single-name credit exposure in their non-financial corporate portfolios. A blanket restriction on the inclusion of instruments issued by other financial institutions may be more appropriate for the banking industry where wrong-way risk is considerably higher. (With respect to risk arising from the insurance sector, we note that a pure insurance-driven liquidity event, such as a natural catastrophe, has limited potential to transmit stress to other financial sector markets.)

These considerations also apply to Paragraph 57, which provides that assets held at regulated entities should be included in the portfolio only up to the amount of their net cash outflows plus any additional amounts that would be available for transfer to all other entities within the group without statutory, regulatory, contractual or supervisory restrictions. Insurers do consider restrictions on transferability in assessing the liquidity of their portfolios and, provided that these liquidity analyses are robust and limits and haircuts are appropriate, there is no need to unduly restrict the inclusion of certain types of assets in the liquidity portfolio. We would suggest the revision of the fourth and fifth sentences of Paragraph 57, as follows:

> Assets held at regulated entities should be assessed in terms of the ability of the insurer to transfer those assets in times of stress and in light of any applicable statutory, regulatory, contractual or supervisory restrictions on transfer. Funds held in regulated legal entities that would not be transferable within the group should not be considered fungible assets for purposes of assessing group liquidity and they should be included in the liquidity portfolio with appropriate haircuts and limits.

We find the second sentence of Paragraph 53 confusing and do not understand why assets generating cash flows should not be allocated to the liquidity portfolio. If, as we assume, this is an admonition against double counting, it should be presented as such. Requiring the exclusion of the principal amount of cash-generating assets is inappropriately restrictive. We would replace the language of Paragraph 53 with the following:

> When assessing the liquidity of assets in the liquidity portfolio, the insurer should consider its ability and willingness to sell assets generating cash flows.

We disagree with the suggestion in Paragraph 56 that an insurer should periodically monetize a portion of its portfolio. Insurers have the capability to assess portfolio liquidity without recourse to practices that may negatively impact or destabilize its liquidity risk management. Moreover, insurers can rely on sales in the ordinary course of business or conduct simulated sales to assess portfolio liquidity based on readily available market data, providing insights into market access and the effectiveness of its operational processes without actually liquidating assets.

Paragraph 57 provides another example of overly prescriptive guidance on assumptions that supervisors should deem appropriate. As noted in our comments on Paragraph 41, which also deals with fungibility, we believe that the text should be elevated to focus on calling for a careful review of assumptions that include reliance on intra-group assets to satisfy liquidity needs. We offer the following proposed rewrite of this Paragraph for your consideration:

> The insurer should consider fungibility in determining the magnitude of the required liquidity portfolio and the location of the portfolio. To facilitate policyholder protection, insurers may be restricted from transferring liquidity out of insurance underwriting entities. As such, insurers should adequately assess the availability of intercompany assets to cover potential liquidity shortfalls elsewhere in the group. Assets held at regulated entities that the insurer determines would not be available for transfer to other entities within the group should not be included in the liquidity portfolio.

Liquidity Contingency Funding Plans. The second and third sentences of Paragraph 59 contemplate a more or less automated process for contingency planning when, in fact, it is very scenario-dependent, as is recognized by the fourth sentence of that Paragraph. The execution of a contingency plan needs to provide for flexibility and iteration as the stress event unfolds and ultimately is resolved. Therefore, the reference in the second sentence to "the actions that the insurer **would** take" should be revised to read, "the actions that the insurer **could** take" and the reference in the third sentence to "all existing strategies, policies and procedures" should be revised to read, "**a range of** strategies, **consistent with the insurer's** policies and procedures." After providing some needed flexibility in the fourth sentence of this Paragraph, the fifth and sixth sentences revert to a more inflexible process – the words "can and should" in the fifth sentence should be revised to read "could" and the reference in the sixth sentence to "the clear steps" should be revised to refer to a range of potential steps.

Similarly, Paragraph 62 reflects a rigid approach to contingency planning that is at odds with the need for flexibility during a stress event. While we agree with the need for clear processes and well-articulated roles and responsibilities, the expectation that the plan would "clearly set out a process on what actions to take at what time, who can take them, and what needs to be escalated and prioritized" does not reflect the fluid nature of a stress event and the need for management to be nimble and flexible in its response. The first sentence of this Paragraph could be deleted, retaining the key messages.

The location of any liquidity contingency plan within the overall liquidity risk management framework of the insurer should be a matter for senior management discretion, reflecting the company's liquidity risk governance.

Liquidity Risk Management Report. The liquidity risk management report discussed in Paragraphs 65 through 67 may be required by supervisors but is not a mandatory element of liquidity risk management, per ComFrame 16.9. (Indeed, for many insurers, the ORSA can serve as a liquidity risk management report.) We would recommend that Paragraphs 65 through 67 reflect this for greater alignment with ComFrame. The report should be presented by senior management to the board of directors or an appropriate committee (as reflected in Paragraphs 26 and 27) but the board or committee should not be required to approve the report. Senior management with responsibility for liquidity planning has the appropriate in-depth expertise to design and implement a liquidity risk management plan and report to the board or its risk (or other appropriate) committee; specific liquidity risk expertise generally is not shared widely among the members of the board. Accordingly, it is not appropriate to ask board or committee members to be responsible for the report.

Supervisory Reporting. Paragraph 83 states that the supervisor should 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. We encourage the IAIS to add additional language calling for an assessment of the costs and benefits of these additional information requests, in order to avoid burdensome data requests that could strain resources and systems for little added value.

Beyond consistency, Paragraph 81 should encourage supervisors to leverage the ORSA in order to reduce duplication and avoid inconsistencies in other supervisory reporting. To facilitate consistency and integration with supervisory reports such as the ORSA, we encourage a broader reference to "risk exposures" rather than "liquidity exposures" in Paragraph 18.a.

We appreciate the opportunity to provide our feedback on the Draft Application Paper and welcome the opportunity to discuss these comments in greater detail.

Respectfully submitted

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