February 4, 2021

Dr. Victoria Saporta
Chairperson
Mr. Jonathan Dixon
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International Association of Insurance Supervisors (IAIS)
Centralbahnplatz 2
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Re: IAIS Public Consultation Document: Development of Liquidity Metrics: Phase 1 – Exposure Approach

Dear Dr. Saporta and Mr. Dixon:

The Institute of International Finance (IIF) and its insurance members appreciate the opportunity to comment on the IAIS Public Consultation Document: Development of Liquidity Metrics: Phase 1 – Exposure Approach (Liquidity Metrics Consultation).

Overarching Comments

The Liquidity Metrics Consultation proposes an Insurance Liquidity Ratio (ILR) that is intended to serve as a macroprudential indicator of liquidity risk to aid in the assessment of systemic risk in the global insurance sector, which includes companies with a variety of business models, assets, liabilities and products. We understand and support the IAIS's interest in monitoring the global insurance industry's exposure to liquidity risk as part of its framework for the assessment and mitigation of systemic risk sector-wide (Holistic Framework) and its interest in developing a metric to be applied consistently across the sector. The ILR may have a role as a basic macroprudential monitoring ratio that supervisors can employ to analyze year-over-year liquidity trends across the sector. However, for reasons expressed in this letter, we have some reservations about the usefulness of this metric as a macroprudential monitoring tool. Moreover, we would emphasize the role of supervisory discussion and coordination through the IAIS Supervisory Forum in developing a robust macroprudential assessment of sector-wide liquidity risk. We caution against any simple aggregation of the ILR across firms as an indicator of the liquidity risk of the sector.

Microprudential liquidity risk, as distinguished from macroprudential liquidity risk, is a company- and scenario-specific risk that generally is not amenable to standardized monitoring measures. We encourage the IAIS to clarify that the ILR should not be used as a microprudential measure. Based on discussions with Chief Risk Officers and liquidity risk experts in our member firms, the ILR is too broad a metric to produce significant decision-useful information for firms. The ILR does not incorporate the thorough reflection of liquidity sources and needs that is required for a microprudential tool to accurately assess an insurer's liquidity risk profile, nor does it reflect the time horizon over which liquidity stresses could materialize in an individual insurer or group or how the reliability of assets as a source of liquidity can change over time. Individual IAIS members are best placed to assess microprudential liquidity risk using the guidance contained in the IAIS Application Paper on Liquidity Risk Management and tools that reflect the specific risk profiles of individual insurers and take into consideration any jurisdictional specificities.

Through our discussions, we have identified several shortcomings in the ILR as a macroprudential tool. Of particular note, the ILR is focused on group-level liquidity. As such, the ILR does not reflect that liquidity stresses are not shared equally within a group and that there are important sources of intragroup and holding company liquidity that can be used to address legal entity liquidity needs. Furthermore, the ILR does not recognize liquidity gaps within a group through the loss of information on mismatches between liquidity sources and needs. Consistent with best practices for liquidity risk management, both a bottom-up and a top-down approach to liquidity risk is needed at the microprudential level.

Importantly, a group-level ILR is incompatible with the way in which liquidity risk is managed, which is generally at the legal entity level, and the ILR is not always consistent with many liquidity risk management best practices that the IAIS itself has outlined in its Application Paper on Liquidity Risk Management, as well as in the Insurance Core Principles (ICPs) and ComFrame. These flaws could result in the ILR providing false signals as to the relative liquidity strength or weakness of individual insurers.

Furthermore, the ILR would exclude certain assets that are reliable sources of liquidity, such as instruments issued by other financial institutions, and does not recognize important local sources of liquidity. Differences in local liquidity conditions, as well as local sources of liquidity, make it difficult, if not infeasible, to develop global liquidity scenarios, parameters, or assumptions.

ICP 15.1.9 notes that prescriptive, rules-based requirements can inhibit innovation in investment strategies, may restrain insurers from holding the most appropriate assets in light of their financial objectives, and may discourage insurers from fully developing their own risk management. ICP 15.1.10 contrasts principles-based measures that provide flexibility for the insurer to follow an investment strategy that best matches its risk appetite and overall financial objectives. While a rules-based approach may be easier for supervisors to enforce, we do not believe that the ease of implementation should outweigh the importance of developing and implementing robust risk management frameworks for liquidity.

The work conducted by group supervisors and the IAIS during the current COVID crisis has demonstrated their ability to monitor the liquidity positions of IAIGs through insurer reporting, even during a stress event or period of market turmoil. The results of these analyses provided significant insights into sector-wide liquidity risks and trends, and confirmed that companies have maintained robust liquidity positions sufficient to continue to meet their obligations to policyholders and other counterparties. We encourage the IAIS to build upon the work of jurisdictional supervisors in continuing its work on macroprudential assessments of liquidity risk.

As we note below in response to the specific questions raised in the Liquidity Metrics Consultation, we believe that the empirical basis for the proposed calibration of the ILR is unclear, and that the calculation of the ILR would produce overly conservative results that would not be indicative of the true liquidity position of the sector. Of particular note, and consistent with our comments with respect to the IAIS consultation on the Draft Application Paper on Liquidity Risk Management[1], we believe that the exclusion of instruments issued by financial institutions, in addition to being overly conservative, would give rise to negative impacts on the financial sector and real economy by disincenting insurers' investments in the debt of other financial institutions. The exclusion of financial institution assets could also incent insurers to hold larger single-name non-financial exposures, which may result in riskier holdings in a market downturn. We also believe that the treatment of surrenders and withdrawals does not reflect the different levels of risk across insurance products, the range of characteristics impacting liquidity risk across different products, or the variety of factors that influence policyholder behavior. Moreover, the proposed treatment of surrenders and withdrawals disregards attributes that reduce the risk of surrenders and withdrawals. These shortcomings would produce a measure that would give rise to a false sense of security and confidence in the ILR.

Responses to Specific Questions in the Liquidity Metrics Consultation

Our overarching comments respond to IAIS Questions 1 through 3. Our additional specific responses follow.

As noted above, we understand the IAIS's interest in monitoring liquidity trends at a macroprudential level. However, for reasons noted in our answers below, we have serious misgivings about the current proposed design of the ILR. The empirical bases for the assumptions underlying the ILR are unclear, producing an overly conservative calibration that does not recognize the critical role of the industry as a provider of liquidity. The current design of the ILR appears to have been based on a measure that is more suitable for the banking industry, where liquidity pressures can give rise to systemic risks over a short-term time horizon.

We encourage the IAIS to consider the inherent limitations of any global liquidity ratio for the insurance sector, with its considerably more diverse and heterogeneous business models than the banking sector, and to more fully develop a use case for a ratio similar to the ILR.

IAIS Question 4: Do you agree with the exclusion of separate accounts from the ILR? If not, how should separate accounts be incorporated?

In general, the exclusion of separate accounts from a liquidity metric seems appropriate. There may be liquidity issues in separate accounts that are caused by operational events, such as a mismatch between financial instrument settlement periods and the disposal of the underlying assets. These issues are best addressed through a focus on the separate account(s) and through supervisory discussion with the firm, taking into account all relevant circumstances surrounding the operational event.

IAIS Question 5: Do you agree with the proposed factors for liquidity sources? If not, please explain.

As discussed in our comments with respect to the IAIS consultation on the Draft Application Paper on Liquidity Risk Management, we caution against restricting the types of assets that may be included in a

[1] https://www.iif.com/Portals/0/Files/content/Regulatory/01_22_2020_lrm_ap_response.pdf

liquidity portfolio, as they could have negative macroprudential ramifications, including impacts on the pricing and supply of certain types of assets, asset concentrations, and hoarding. During a stress environment, companies should not be constrained from using all available sources of liquidity, including financial institution sources, precisely when they need it most. The blanket exclusion of financial institution sources of liquidity is not risk-based and could lead to negative unintended consequences, as outlined in our response to Question 8.

The ILR asset factors are arbitrary and do not reflect how the availability of liquidity sources can change significantly over time, particularly in times of stress. The reliability of specific assets as a source of liquidity is scenario-dependent as well. As we saw in 2020, even sovereign debt exposures can be volatile, with other asset classes experiencing less volatility and serving as superior sources of liquidity. Moreover, the ILR asset factors do not reflect local sources of liquidity that may be very valuable to companies in those jurisdictions.

The composition of a company's liquid assets is the responsibility of senior management, with oversight from the board of directors and consistent with the board-established risk appetite. The establishment of prescriptive rules around what qualifies as a liquid asset and what haircuts should be applied shifts the responsibility from the board and senior management to supervisors that do not share the advantage of day-to-day insight into the company's liquidity risk management.

A prescriptive view of liquidity sources determined by the IAIS is inconsistent with ComFrame 16.9.b.2 and 16.9.b.3. ComFrame 16.9.b.2 and 16.9.b.3 call for the group supervisor to consider the results of the IAIG's stress testing or scenario analysis when assessing the quality and quantity of the assets that the IAIG considers to be highly liquid. The IAIG is responsible for demonstrating to its group supervisor the liquidity of those assets.

A restrictive and prescriptive list of permissible liquidity sources could lead to an insurer holding assets that are not well aligned with the liquidity profile of its liabilities, impeding sound asset/liability management

IAIS Question 6: Do you agree with the treatment of investment funds? If not, please explain and suggest an alternative treatment.

We encourage the IAIS to include investment funds as a source of liquidity, consistent with the liquidity of the underlying assets. Many investment funds are relatively liquid, especially those with robust cash holdings, funds that frequently revalue, and funds that limit outflows through redemption fees, swing pricing, or limited dealing days.

IAIS Question 7: Do you agree with the treatment of premiums? If not, please explain how premiums and excluded expenses should be treated in the ILR.

Paragraph 38 of the Application Paper states that future premiums and other potential cash inflows may be assumed to be available under stressed conditions, though the insurer should adjust their assumed availability in line with stress scenarios. The exclusion of expected future premiums from liquidity sources in the ILR is not consistent with their treatment in the Application Paper and we would recommend a partial inclusion of future premiums on a conservative basis.

IAIS Question 8: How should instruments issued by financial institutions be treated within the ILR?

As noted above, there are many sound reasons for allowing the inclusion of instruments issued by financial institutions in the liquidity portfolio of insurers, and unintended consequences that could be avoided by a more risk-based approach to these assets. The exclusion of instruments issued by financial institutions is not only overly conservative but also would give rise to negative impacts on the financial sector and real economy by disincenting insurers' investments in the debt of other financial institutions. The exclusion of financial institution assets could also incent insurers to hold larger single-name non-financial exposures, which may be riskier holdings in a market downturn.

The post-financial crisis reforms to the regulation of the banking industry were designed to help ensure that banks can meet their financial obligations under stress. Insurers should not be constrained in their ability to access bank sources of liquidity, consistent with strong risk management practices, including the avoidance of concentration risk.

IAIS Question 9: Do you agree with the inclusion of certain encumbered assets as liquidity sources within the ILR or should the IAIS alternatively exclude these encumbered assets and measure the related liquidity needs on a net basis?

We would measure an insurer's liquidity needs on a net basis.

IAIS Question 10: Do you agree with the treatment of liquidity risk from surrenders and withdrawals from insurance products in the ILR? If not, please explain how this could be improved.

We do not agree with the treatment of liquidity risk from surrenders and withdrawals from insurance products in the ILR. Although the IAIS recognizes that mass surrenders are a rare event and that there are various interacting factors that determine the liquidity risk of an insurance product due to surrenders and withdrawals, the IAIS proposes a treatment that is extremely conservative and insufficiently granular. An approach that focuses only on economic penalties and time restraints is overly simplistic and does not reflect the fact that policyholder behavior is based on the complex interaction of many factors. Moreover, the proposed treatment of surrenders and withdrawals disregards attributes that reduce the risk of surrenders and withdrawals, allowing for a methodology that would give a false prominence and sensitivity to these factors in the ILR.

We recommend that the IAIS review its calibration and reset the treatment of surrenders and withdrawals in a manner and to a level supported by evidence at the desired confidence level. We would broaden the discussion of economic penalties and time restraints to reflect practical limitations on and disincentives to surrender or withdrawal (e.g. tax penalties and the availability of other alternatives, such as policy loans). The IAIS should also provide for a more granular categorization of insurance products in order to capture the significant variation in surrender and lapse across product types.

IAIS Question 11: How should the IAIS capture liquidity needs from policy loans? Should these be incorporated into the ILR or be an alternative metric?

Liquidity needs from policy loans are embedded in the treatment of surrenders and withdrawals, which is discussed above in response to Question 10.

IAIS Question 12: Do you agree with the factors applied to retail insurance products being half of the factors applied to institutional products? How should the factors applied to retail and institutional policies differ?

While the application of different factors to retail and institutional products is reasonable, no specific quantitative justification for the calibration of these factors has been provided. Moreover, the factors do not reflect that economic penalties and time restraints will have different effects and produce different incentives across policyholders.

IAIS Question 13: Do you agree with the treatment of unearned premiums in the ILR? If not, how can it be improved?

Consistent with Paragraph 38 of the Application Paper, the conservative recognition of a portion of insurers' unearned premiums in the ILR would be appropriate.

IAIS Question 14: Should the IAIS apply standardized factors to insurers' projected ultimate catastrophe losses or rely on company projections for the speed of catastrophe payments and reinsurance recoveries?

The IAIS should rely on company projections for the speed of catastrophe payments and reinsurance recoveries. Because the speed of payments and recoveries can vary widely across companies, an approach that relies on company projections better reflects an insurer's own liquidity risk than a less granular factor-based approach.

IAIS Question 15: Do you agree with the proposed treatment of catastrophe insurance claims? If not, how can it be improved?

We question the need for standardized haircuts on liquidity resources to reflect stress. Rather, the approach should reflect the risk of whether a particular counterparty would be unable to cover the claim in a stressed environment. The treatment of catastrophe insurance claims may be best addressed at the microprudential level, as the reliability of catastrophic claims payments can vary significantly across firms.

IAIS Question 16: Should the proposed treatment of deposit liabilities include more or less granularity? If so, what additional dimensions (e.g. the presence of an effective deposit insurance scheme) should be captured or left out?

We agree that bank deposits generally are not a significant source of insurers' funding. However, the factors proposed do not reflect the acknowledged ready liquidity of bank deposits. Furthermore, the few insurers with significant banking operations are already subject to the rigorous and granular oversight of bank supervisors. As such, a less granular approach than that applied by the Basel Committee is warranted. However, this does not support the application of a more conservative approach than is applied by the Basel Committee.

IAIS Question 19: Do you agree with the treatment of derivatives? If not, please explain and suggest an alternative treatment.

The adoption of a measure similar to the Basel Committee's net stable funding ratio should be further examined with due consideration given to the differences between the bank and insurance business models. Standardized factors do not take into account the complexity of derivatives, the degree of reliance on derivatives by a particular insurer, and do not reflect jurisdictional differences in the treatment of derivatives. For these reasons, we believe that derivatives exposures should be treated at the microprudential level.

IAIS Question 20: How should the ILR treat debt with financial covenants that may be triggered under stress?

Firm-specific scenario analysis is the best method to treat debt with financial covenants that may be triggered under stress. A firm-specific analysis can take into consideration the severity of the stress that would be required to breach the covenant, which in most cases would require an extreme stress. The bespoke nature of individual debt instruments and related financial covenants renders a standardized treatment inappropriate.

IAIS Question 21: How should the ILR assess potential liquidity needs from a downgrade?

Potential liquidity needs from a downgrade are best analyzed at a firm-specific level using liquidity scenario analysis as part of the insurer's liquidity risk management framework.

IAIS Question 22: Do you agree with the discussed limitations and mitigations of the ILR? What other limitations should the IAIS consider and how can these be mitigated when the IAIS monitors liquidity risk?

As noted in our Overarching Comments, we understand and support the IAIS's interest in creating a consistent metric that would help monitor the global insurance industry's exposure to liquidity risk as part of macroprudential supervision. We appreciate the IAIS's acknowledgement of the limitations of the ILR and our comments reflect our view that the measure may have limited utility and comparability as a global measure of insurance liquidity risk.

We strongly encourage the IAIS to avoid any implication that the ILR should be used as a microprudential supervisory measures due to a number of design features that make the ILR ill-suited for microprudential use. As we note above, the ILR is focused on group-level liquidity but does not reflect that liquidity stresses are not shared equally within a group, and that there are important sources of intragroup and holding company liquidity that can be used to address legal entity liquidity needs. Additionally, the ILR does not recognize liquidity gaps within a group. The ILR also excludes certain assets that are reliable sources of liquidity, such as instruments issued by other financial institutions and local sources of liquidity. Importantly, a group-level ILR can be inconsistent with the way liquidity risk is managed, as some insurers address liquidity risk at a legal entity level. These flaws could cause the ILR to provide false signals as to the liquidity strength or weakness of individual insurers.

An alternative approach that focuses on supervisory review of the robustness of an insurer's liquidity risk management would be a superior method of identifying potential supervisory issues. A supervisory approach would be company-specific and holistic, and would reflect the manner in which liquidity risk is managed by the company.

We appreciate the opportunity to comment on the IAIS's approach to liquidity risk and the proposed ILR. We would be pleased to expand upon this response, and we encourage the IAIS to convene a stakeholder meeting on the important issues raised by this consultation, as well as on broader aspects of macroprudential supervision and systemic risk.

Respectfully submitted,

MF Monroe

Mary Frances Monroe