■The LIAJ comments on the IAIS Draft Application Paper on Liquidity Risk Management

No.	Question	Comment
1	General Comment on Application Paper on Liquidity Risk Management	<General Comment> ・The Life Insurance Association of Japan (hereafter the LIAJ) appreciates the opportunity to comment on the Application Paper (hereafter the Paper) on Liquidity Risk Management. ・However, the LIAJ respectfully asks the IAIS and participating supervisors to take into account by reconsidering the points in the Paper in which we believe still do not properly reflect the reality of life insurers' businesses and may be overly prescriptive in light of the actual businesses conducted by life insurers. ・There are descriptions in the Paper that seem to have referred to banking regulation. However, there is a need to thoroughly consider the various features of an insurer's liquidity risk being different from a bank's business model, such as stable inflow of cash generated through level premium payment or long-term nature. Therefore, we would like to ask for revisions as indicated in the following individual comments. ・While assuming that the purpose of the Paper is to "provide examples of good practice," we would like to ask the IAIS to take a proportional approach since there are certain jurisdictions where the majority of a life insurer's business may be subject to the proposed liquidity risk regulation.
16	Comment on Paragraph 11 Liquidity risk can manifest when there is an imbalance between the insurer's liquidity sources and liquidity needs. Certain activities can increase insurers' exposure to liquidity risk by generating unexpected liquidity needs and, thus, may warrant more robust risk management, including the application of the policy measures described in ICP standard 16.9. Examples of such activities may include, but are not limited to : [...] · Backing liquid liabilities with illiquid assets: Some products offered by insurers contain provisions whereby a policyholder can withdraw cash from the policy with little notice or penalty. When 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.	<Liquidity Risk> ・In the third bullet point of paragraph 11, "Backing liquid liabilities with illiquid assets" is mentioned as an example of an activity having liquidity risk. ・While we do not have any objection in this example itself, there is a sentence that says "some products containing provisions where a policyholder can withdraw cash from the policy with little notice or penalty" have high liquidity, and hence should be subject to policy measures. We disagree with this statement, as we believe it does not capture reality. If such a way of thinking is applied, the scope of the substantial liquidity risk may be overly expanded to include such risks which in reality should not be included. ・EIOPA's document titled "Report on insurers' asset and liability management in relation to the illiquidity of their liabilities" (published December 16, 2019) reports that obviously, there is no strong connection between surrender rates and the existence of disincentives to surrender. ・Under paragraph 4.24 of the IAIS document titled "Systemic Risk from Insurance Product Features," it is implied that various potential mitigating and/or exacerbating factors should be taken into account when assessing substantial liquidity risk, such as the "purpose of the policy," "the existence of economic penalties" for example in policies with high assumed interest rate, different characteristics of individual and group insurance products, and the existence of "policyholder protection schemes and mechanisms." We believe such a holistic approach on liquidity risk should be maintained.
18	Comment on Section 1.4: Proportionality 13. This Application Paper should be read in the context of the proportionality principle, which acknowledges supervisors' flexibility to tailor their application of supervisory requirements and supervision to achieve the outcomes stipulated in the Principle Statements and Standards, as described in the Introduction to ICPs and ComFrame. 14. The supervisor may, as per ICP 16.9.4 and CF 16.9.b.2, increase or decrease the intensity of the requirements set out in ICP 16.9 for example by varying the frequency, scope and granularity of liquidity stress testing, the proportion and quantity of various types of highly liquid assets allowed in the portfolio of liquid assets or the form and level of detail in the contingency funding plan and liquidity risk management report. The supervisor may also decide on varying the form and level of detail in updates to the contingency funding plan and liquidity risk management report by taking into consideration subsequent material changes since the initial assessment.	・Paragraph 13 states that "this Application Paper should be read in the context of the proportionality principle." The LIAJ acknowledges and appreciates such stance on proportionality. ・However, on the other hand, paragraph 14 states that "the supervisor may, as per ICP 16.9.4 and CF 16.9.b.2, increase or decrease the intensity of the requirements set out in ICP 16.9 for example by varying the frequency, scope and granularity of liquidity stress testing, the proportion and quantity of various types of highly liquid assets allowed in the portfolio of liquid assets or the form and level of detail in the contingency funding plan and liquidity risk management report." This could be read as if the supervisor can solely decide on the design of the liquidity stress test and details such as frequency of stress testing, etc. However, we would like to confirm that basically, such decisions are made by insurers based on their respective risk preference, etc. ・This is also covered in the IAIS's "Main public consultation comments received and resolution to holistic framework supervisory material" published on November 14, 2019, which states that "ICP 16 is meant to provide minimum requirements for the ERM Framework, including the use of tools such as stress testing, while noting that ultimately it is the responsibility of the insurer itself to carry out the ERM."

		・Therefore, paragraph 14 should be revised according to the statement in paragraph 22, so that supervisors may impose supervisory measures only when it deems that an insurer' s liquidity risk management is not conducted appropriately. ・However, as the actual implementation of policy measures are largely dependent on the discretion of the supervisors, we would like to ask the IAIS to continue to encourage proportional application of policy measures among its member supervisors.
49	Comment on Paragraph 38 (2) Policyholder behaviour This includes an assessment of the possible withdrawals from different product types, taking into account features such as guarantees, surrender penalties, maturity dates, interest rate sensitivity and customer type, and should also include liquidity needs arising from both life and non-life products. Stresses should also assess potential reductions in regular premium payments, non-renewals, and declines in new business and their impact on net cash flows.	・In paragraph 38, as an example of a driver triggering liquidity risk, "policyholder behavior" is mentioned, and that it includes "an assessment of the possible withdrawals from different product types, taking into account features such as guarantees, surrender penalties, maturity dates, interest rate sensitivity and customer type." ・The LIAJ welcomes this statement as it is in line with the LIAJ' s position, as well as the statement in paragraph 4.24 of the IAIS' s "Systemic Risk from Insurance Product Features" that mentions various potential mitigating and/or exacerbating factors to be taken into account when assessing substantial liquidity risk, such as the "purpose of the policy," "the existence of economic penalties" for example in policies with high assumed interest rate, different characteristics of individual and group insurance products, and the existence of "policyholder protection schemes and mechanisms." ・We would like to reconfirm that "an insurance product that has a provision where a policyholder can withdraw cash from the policy with little notice or penalty" does not translate immediately to having high liquidity risk. Rather, we would like to confirm that the spirit of paragraph 38 stating that a holistic approach should be taken when assessing insurance product liquidity is an overarching principle that covers the entire Paper. ・In addition, as a factor that discourages policyholders from surrendering their policies, we ask that the issue of tax disincentive and lack of alternative protection (specifically, the difficulty of repurchasing the same coverage due to health conditions or age) to be added for consideration.
57	Comment on Section 4: Liquidity portfolio	<On Liquidity Portfolio> ・In order to have a realistic understanding of an insurer' s actual liquidity risk, liquidity assessment needs to be based on both asset side and liability side. Hence, with regard to the Global Monitoring Exercise, we expect that the Liquidity Risk Metrics that is currently being developed by the IAIS as risk monitoring measure will include both the asset and liability sides for consideration, so that it will better reflect the reality of an insurer' s actual liquidity risk.
61	Comment on Paragraph 47 Assets included in the portfolio should be easily and immediately convertible into cash, either through repo or outright sale, at little or no loss in value. Such assets generally have low credit risk and low market risk; have easy, transparent and accurate valuations and have low correlation with risky assets, ie they are "liquid". These assets typically also have active outright sale or repo markets at all times with evidence of market breadth and depth with a diverse group of active buyers and sellers, ie they are "readily marketable". Finally, assets should have a proven record as a reliable source of liquidity during stressed market conditions.	・In paragraph 47, it states that "assets included in the portfolio should be easily and immediately convertible into cash, either through repo or outright sale, at little or no loss in value." However, this is inappropriate as it does not reflect the fact that insurers own diverse liquid assets. For example, in paragraphs 50 and 55, it is indicated that there are various types of liquid assets ("Primary," "Secondary" and "Tertiary" Liquidity Buckets) that may be monetized over a certain period of time, as well as accommodation for "appropriate haircut to the fair market value of assets" in an event of loss incurred. ・Moreover, while paragraph 47 states that "such assets generally have low credit risk and low market risk," paragraph 49 states that "common equity shares" can be included in liquidity portfolio, which seems to be contradictory. ・The Paper should have a provision that explicitly allows an appropriate amount of assets with relatively low credit and market risks in the liquidity portfolio.
66	Comment on Paragraph 52 Instruments issued by other financial institutions are generally not appropriate for inclusion in the insurer' s liquidity portfolio, except for demand deposits. This is due to the potential for wrong-way risk (i.e. that 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.	・In paragraph 52, it is stated that it is "generally not appropriate" to include financial instruments issued by other financial institutions in an insurer' s liquidity portfolio, "except for demand deposits." However, this sentence should be deleted since prohibiting such products is excessive and may negatively impact the maintenance of appropriate liquidity. Insurers consider exposure to counterparties and marketability of each individual asset when setting risk limit according to each counterparty.
71	Comment on Paragraph 56 The insurer should assess its ability to convert its liquidity portfolio into cash in a short time frame. This may involve periodically monetising a representative portion of the liquidity 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	・In paragraph 56, it is stated that insurers should "periodically monetize a representative portion of their liquidity portfolio" to assess their ability to convert liquidity portfolio into cash in a short time frame. However, this is overly prescriptive and may destabilize liquidity risk management, which could lead to a negative impact. Therefore, it is not appropriate and should be deleted. An insurer' s ability to monetize liquidity could be assessed through the routine sales of assets as part of its normal asset management. In

	signalling during a period of actual stress. Even where policyholders fully bear the investment performance of these assets, 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 on financial stability.	addition, the ability to monetize liquidity can be assessed without actually selling assets by conducting a simulation of when and at what price they can monetize such assets.
75	Comment on Paragraph 59 As indicated in ICP 16.9.2, contingency funding planning to respond to liquidity stress events may 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 would 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 all existing strategies, policies and procedures for addressing liquidity shortfalls in emergency situations in a timely manner and at a reasonable cost. It should include a diversified set of viable, readily available and flexibly deployable methods that the insurer would use to access alternative sources of funding. The plan should also describe when and how each of the actions can and should be activated and the time needed to access funds and quantity of funds that would be expected to be available from each contingency source. The plan should describe the 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.	・In paragraph 59, it is stated that the contingency funding plan should include "the actions that the insurer **would** take" to ensure that liquidity sources are sufficient to maintain normal operations. However, when a stress event occurs, it is important to have a certain degree of flexibility when the insurer executes its solution. Therefore, the second sentence in paragraph 59 should be revised to "the actions that the insurer **could** take". ・In addition, the third sentence in this paragraph states that "(contingency funding) plan should describe all existing strategies, policies and procedures for addressing liquidity shortfalls in emergency situations in a timely manner and at a reasonable cost." Instead, this sentence should be revised to reference "**a wide range of** strategies, policies and procedures" for the same reason.
104	Comment on Paragraph 83 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.8	・In paragraph 83, it is stated 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." In the case of collecting such additional information, the cost and benefits should be assessed thoroughly and the scope and volume of information subject to collection should be strictly limited to the purpose of collection. The LIAJ would like to confirm that such additional data collection will not be imposed as a burden for insurers to collect disproportionately excessive amounts of information.