

LEGAL UPDATE

Draft Prudential Standard and Proposed Guidance Note on Liquidity Risk Management for Insurers

2 July 2024 4 min read

By Slade van Rooyen, Candidate Attorney, reviewed by Natalie Scott, Director and Head of Sustainability

On 28 May 2024, the Prudential Authority ("PA") published a notice inviting submissions on the Draft Prudential Standard on Liquidity Risk Management for Insurers ("**Draft Standard**") and Proposed Guidance Note on Liquidity Risk Management for Insurers ("**Proposed Guidance Note**"). The Draft Standard and Proposed Guidance Note aim to address concerns that the current liquidity risk framework does not take into account certain non-traditional insurance business activities that could potentially result in liquidity strain.^[1]

The Draft Standard "enhances and augments" certain key aspects of liquidity risk management.^[2] The salient features of the revised framework include requirements that the insurer^[3] must –

- develop and implement an "adequate governance framework for liquidity risk", which includes a statement of the insurer's liquidity risk appetite and tolerance;
- identify and understand the drivers of its liquidity risk exposures and the implications thereof on its liquidity position under both business-as-usual and stressed conditions;
- conduct stress tests that "encompass a diverse set of severe yet plausible scenarios" and "reveal potential vulnerabilities in the insurer's liquidity profile", taking into account specific liquidity (and not only solvency) stress scenarios. Annexure 1 to the Proposed Guidance Note sets out a list of scenarios that may be employed to analyse the impact of a liquidity shock, including operational risk events, such as cyberattacks, and payment system disruptions;
- hold a portfolio of high-quality liquid assets ("**HQLAs**") that is "sufficient to cover its liquidity needs at a given time horizon", so as to meet any liquidity shortfalls that may arise. The Draft Standard prescribes assets to be included in the HQLA portfolio, and the appropriate categorisation of HQLAs based on the likelihood of the assets attracting buyers under distressed circumstances;
- maintain an Insurance Liquidity Ratio ("**ILR**")^[4] of no less than 100% over a 30 calendar day time horizon;
- develop and implement a contingency funding plan, approved by the board of directors of the insurer, to respond to liquidity stress events; and
- prepare and submit an annual liquidity risk management, as separate from its Own Risk and Solvency Assessment, to the PA.

This will ensure that insurers "sufficiently assess their liquidity risk positions and report [thereon] in accordance with the nature, scale and complexity of their business".

The abovementioned requirements will ensure that an insurer properly assesses its liquidity risk position; reports thereon in accordance with the scale, nature and complexity of its business; and takes sufficient account of liquidity risk arising from, *inter alia*, margin and collateral calls, as well as securities lending transactions.

The board of directors of the insurer bears the responsibility for ensuring compliance with the Draft Standard when promulgated in final form. The review of the insurer's liquidity risk practices and performance may be delegated to a subcommittee, subject to the board retaining ultimate responsibility for managing the insurer's liquidity risk prudently.

Comments on the Draft Standard and Proposed Guidance Note must be submitted to the PA on or before 31 July 2024.

[1] See paragraph 1.5 of the draft "Statement of the need for, expected impact, and intended operation of the proposed framework for liquidity risk management for insurers" published on 28 May 2024.

[2] Paragraph 3.3.

[3] The Draft Standard applies to all insurers licensed under the Insurance Act 18 of 2017, with the exception of microinsurers, Lloyd's and branches of foreign reinsurers (see paragraph 1.1 of the Draft Standard).

[4] The calculation of the ILR, being the ratio of the insurer's Total Adjusted HQLA to its Net Cash Outflows Under Stress (as defined in the Draft Standard), is set out in paragraph 7.2.1 of the Draft Standard.

