

# Liquidity Risk: A brief history and where we go from here

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# Agenda



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What we'll cover

- 1 What is liquidity risk?
- 2 A brief history lesson
- 3 Liquidity risk management and liquidity metrics
- 4 A global perspective
- 5 Closing remarks and Q&A

For and on behalf of Hymans Robertson LLP.



# What is liquidity risk?

For insurance companies, one definition is...

## Liquidity Risk

The risk that a firm does not have available liquid assets, or assets of the right type, to meet its contractual obligations as they fall due, either in BAU or stressed scenarios.

### Examples of Sources of Liquidity Risk

#### Assets

- Settlement delays
- Forced sales
- Delays in finding willing buyer
- Encumbered assets
- Concentration risks

#### Liabilities

- Mass lapse
- Pandemic event
- Uncertainty of future premiums
- Cashflow timing differences
- Reinsurance collateral calls
- Concentration risks

#### Off-Balance Sheet

- Derivatives (collateral/margin requirements)
- Credit rating downgrade (collateral calls)
- Maintaining liquidity facilities to support securitisations

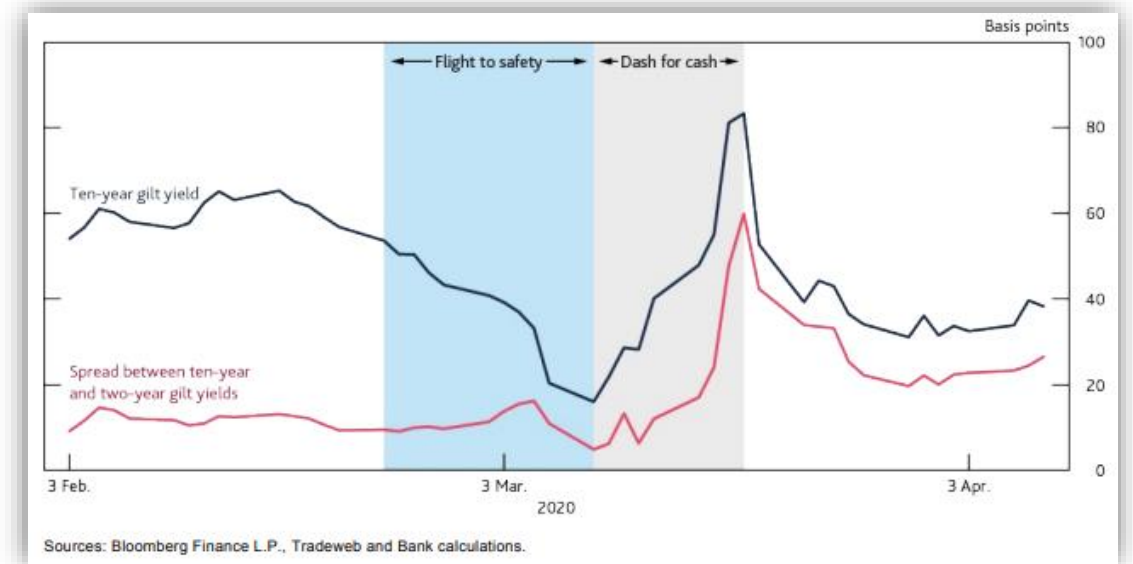
#### Funding

- Credit rating downgrade (early redemptions)
- Contingent terms and conditions
- Inability to roll agreements

# A brief history lesson...

## Real-world dynamics at play

- Covid 19 ("Flight to Safety" & "Dash for Cash")
- LDI Crisis (Sept 22 mini-budget)
- Recent gilt yield movements (2022 vs 2024)



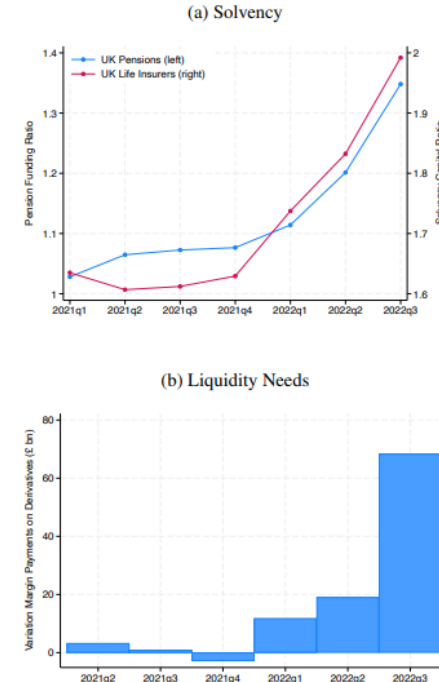
Failure to prepare is preparing to fail

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Figure A10: Solvency and Liquidity of UK Life Insurers



Notes: Panel (a) of this plot shows solvency ratios for the UK pension and life insurance sectors. Pension solvency is measured as asset-to-liabilities and insurance solvency is measured using the Solvency Capital Requirement (SCR) coverage ratio. Panel (b) shows total quarterly variation margin payments made by insurers on derivatives positions, as measured by the change in the mark-to-market value of derivative liabilities. Pension data is from the PPF 7800 index and insurance data is from the Bank of England's aggregate insurance quarterly report.

Source: BoE Staff Working Paper No. 1089 July 2024

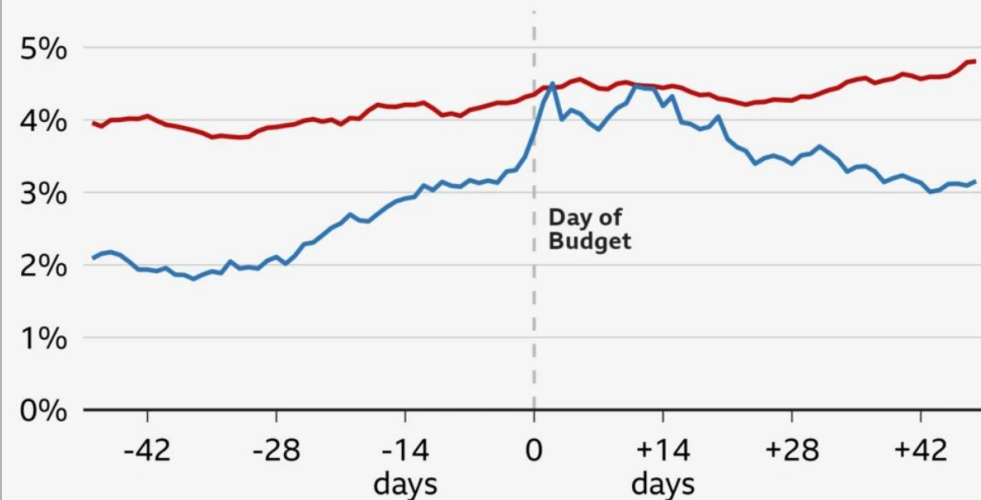
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**Change in UK government borrowing costs**  
Yields on 10-year bonds before and after **Truss's mini-Budget (Sep 2022)** and **Reeves's Budget (Oct 2024)**



Note: Markets are open 8:00-17:00 Monday to Friday

Source: Bloomberg

BBC

**Failure to prepare is preparing to fail**

# Liquidity risk management

A robust liquidity risk management framework is critical for managing liquidity risk well



## Risk Policy

- Overarching document (or documentation suite) that outlines how liquidity risk should be managed across the business
- Comprehensive range of topics, including governance requirements, methodology and assumptions for liquidity metrics and stress testing, plausible management actions, and composition of liquidity buffer to cover liquidity requirements.
- Alignment/consistency with wider system of risk management, e.g. ORSA



## Governance & Reporting

- Clear set of roles and responsibilities for each element of the liquidity risk management framework, including risk escalation process
- Regular reporting of stress testing and liquidity metrics into senior management/Board
- Operational capabilities for regular reporting, daily-reporting in some cases
- Enhanced regulatory reporting requirements



## Risk Appetite

- Clearly articulated liquidity risk appetite statement that considers the duration, type and severity of liquidity stresses the firm aims to survive
- Consideration of liquidity risk limits for sources of liquidity risks

## Liquidity Risk Management Framework



## Contingency Planning

- Identification of actions that are plausible and realistic to implement under stress
- Trigger framework with clear roles & responsibilities and assumed timeframe for implementation
- Robust testing plans that are reviewed and implemented regularly



## Liquidity Metrics

- Quantifiable measure(s) developed internally, used to monitor compliance against risk appetite and risk limits
- Measurement over various time periods (short, medium, long), in base and stress scenarios
- Common metrics: Liquidity Coverage Ratios (“LCRs”), Excess Liquidity
- Early Warning Indicators (“EWIs”)



## Stress Testing

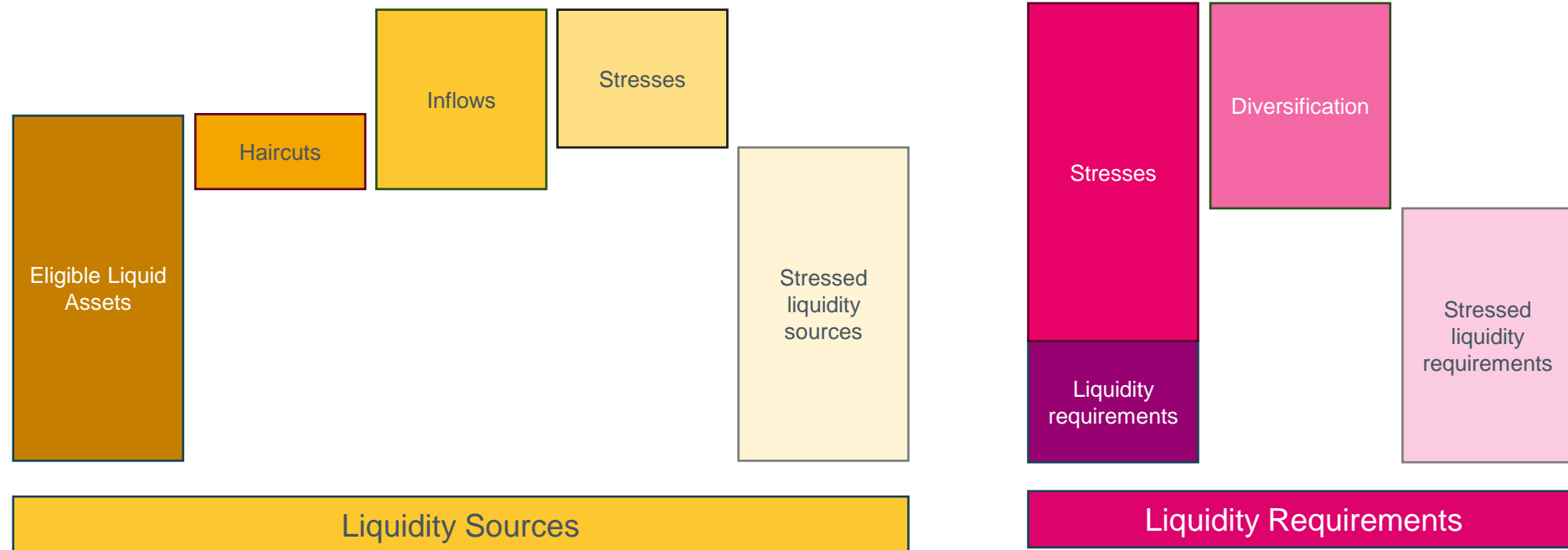
- Calibration of severe but plausible scenarios used to quantify liquidity metrics and exposure to liquidity risk over various time horizons
- Key methodology decisions: data window for calibrations, targeted percentile for loss functions (or identification of biting scenario), reliance on economic or regulatory capital risk calibrations, adjusting calibrations to shorter-term time horizons, consistency in stresses between liquidity sources and liquidity requirements
- Robust modelling tools that are fit for purpose and subject to firm-wide model governance standards

Group-level considerations and fungibility constraints are important components to embed across the liquidity risk framework

# Liquidity Metrics

Choice of liquidity metrics is firm-specific and depends on the nature, term and complexity of the business

- 1 **Liquidity Coverage Ratio** = Stressed liquidity sources divided by stressed liquidity requirements
- 2 **Excess Liquidity** = Stressed liquidity sources in excess of stressed liquidity requirements



*For illustration purposes only*



# A global perspective

## PRA

2019

- ❖ SS5/19 (Liquidity risk management for insurers)

2024

- ❖ Liquidity Subject Expert Group (“L-SEG”)
- ❖ CP19/24 (Closing liquidity reporting gaps)
- ❖ Contingent NBF1 Repo Facility (“CNRF”)

## BMA

2023

- ❖ Liquidity stress scenario introduced into BSCR submission template
- ❖ Introduced SBA-Lapse-Liquidity-Return template

2024

- ❖ Amendment to rules, including requirements for liquidity risk management

**International and local regulators and trade bodies typically have similar overarching aims and expectations for liquidity risk management**

## IAIS

2019

- ❖ Introduced holistic framework for systemic risk in insurance sector

2020

- ❖ Application Paper on Liquidity Risk Management

2022

- ❖ Finalised Level 2 text for liquidity metrics

## EIOPA

2021

- ❖ Methodology for insurance stress testing (liquidity risk)

2023

- ❖ Update to reporting framework, new QRTs issued for liquidity risk

2024

- ❖ Consultation Paper on Liquidity Risk Management Plans

**Market-wide assessments, with a focus on liquidity risk are now performed annually by all these organisations**

# Key take-aways

- 1** **Liquidity risk is an important risk** for insurers to monitor and manage well, especially those who have material exposures to derivatives and lapse risk.
- 2** Recent stress events, including the COVID “dash for cash” and the 2022 LDI Crisis, have **sparked the attention of insurers and regulators alike**, which has helped the industry see positive progress with regards to liquidity risk management. However, a **variety of market practice** continues to be adopted across the industry so there is still room for improvement.
- 3** **Regulators, on a global scale, are cracking down on liquidity risk** – with greater and more regular reporting requirements and higher expectations from insurers. Thematic reviews are now also commonplace, and we can expect to see further guidance from regulators in 2025.

Questions?



# Thank you



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