



Prudential Standard FSI 6

Liquidity Risk Management

Objectives and Key Requirements of this Prudential Standard

This Standard outlines the fundamental principles and operational guidelines governing the effective management of liquidity risk for insurers. The development of these principles and practices stems from recognising the prudential significance that liquidity risk holds for insurers and the potential impact it can have on their operations.

The Standard mandates insurers to establish a robust liquidity risk governance framework encompassing the identification, assessment, management, reporting, and strategic planning for mitigating liquidity risk. It necessitates the implementation of a comprehensive set of processes to ensure effective risk management, such as identifying key risk drivers, conducting stress testing, formulating contingency funding plans, defining a liquidity risk appetite, and ensuring thorough and adequate reporting procedures.

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1. Application

1.1. This Prudential Standard applies to all insurers licensed under the Insurance Act, 2017 (the Act), other than microinsurers, Lloyd's, and branches of foreign reinsurers.

1.2. Unless otherwise indicated, all references to "insurer" in this Standard mean life insurers, non-life insurers, and reinsurers. Similarly, a reference to "insurance" obligations/policies in this Standard can be read as a reference to "reinsurance" obligations/policies unless otherwise specified.

- 1.3. This Standard does not apply to insurance obligations where the policyholder bears the liquidity risk.

2. Roles and Responsibilities

- 2.1. An insurer's board of directors is ultimately responsible for ensuring that the insurer complies with the principles and requirements of this Standard.
- 2.2. Prudent management of an insurer's liquidity risk vests with the insurer's board of directors, who must ensure that the insurer maintains sufficient liquid assets to meet its cash-flow obligations as and when they fall due during business as usual and stressed conditions.
- 2.3. The insurer's board of directors holds the responsibility to ensure that the insurer adheres to any guidelines set by the Prudential Authority regarding the management of liquidity risk.
- 2.4. The insurer's Head of Risk Management and Head of the Actuarial Function (HAF) are responsible for furnishing the board of directors with an opinion on the accuracy of the Insurance Liquidity Ratio (ILR) calculations and the appropriateness of the assumptions underpinning the ILR, as stipulated in paragraph 7 of this Standard.
- 2.5. An insurer's auditor, appointed pursuant to section 32 of the Act, must audit its financial soundness in accordance with its legal and regulatory obligations. This includes a thorough assessment of the insurer's exposure to liquidity risk, which could potentially impact its ability to meet its financial obligations. The auditor is required to communicate to the board of directors and the Prudential Authority any issues discovered during the execution of its duties, including potential liquidity risks, that could render the insurer financially unsound.

3. Liquidity Risk Governance Framework

- 3.1. The board of directors must ensure that the insurer has an adequate governance framework for liquidity risk that supports the identification, assessment, management, reporting, and planning of risk-mitigating decision-making. The governance and risk management framework must be proportionate to the insurer's nature, scale, and complexity.
- 3.2. An insurer must develop a board-approved risk appetite¹ and tolerance² for liquidity risk. The board is responsible for the effectiveness of the liquidity risk appetite and tolerance on an ongoing basis.

¹ Risk appetite refers to the overall level of risk the insurer is willing to accept in pursuit of its strategic objectives. It sets the general boundaries for risk-taking behaviour.

² Risk tolerance refers to the specific amount of variation from the established risk appetite that the insurer is prepared to handle for individual risks or situations. It defines the acceptable deviation from the desired risk level.

- 3.3. Senior management is responsible for ensuring that the insurer's liquidity risk appetite is aligned with its strategic objectives and is embedded in the insurer's day-to-day operations.
- 3.4. The board of directors is responsible for reviewing the insurer's liquidity risk practices and performance to ensure that the insurer is operating within its board-approved liquidity risk appetite and tolerance. The board may delegate this responsibility to a sub-committee, but it remains ultimately responsible for ensuring that the insurer effectively manages its liquidity risk.
- 3.5. The insurer's liquidity risk management framework should be reviewed for adequacy and effectiveness by the risk management function and the internal audit function to ensure that the insurer is operating within the liquidity risk appetite and tolerance and in line with the liquidity risk policy and procedures.

4. Liquidity risk drivers

- 4.1. The insurer must identify and understand the drivers of its liquidity risk exposures and the implications of these liquidity risk drivers on its liquidity position, both under business as usual and stressed conditions. Liquidity risk drivers are specific to the insurer's business and should be identified relative to each insurer, structure, and class of business.
- 4.2. Insurers must remain cognisant of activities that may increase exposure to liquidity risk, where such activities may generate liquidity needs, potentially leading to an insurer's failure or generating systemic risk under certain circumstances.

5. Stress testing

- 5.1. Stress testing plays a critical role in liquidity risk management and should be an integral part of the insurer's risk management processes. Insurers must conduct stress tests that encompass a diverse set of severe yet plausible scenarios, encompassing short-term and protracted macroeconomic fluctuations, sector-wide disruptions, idiosyncratic events, and a combination of these factors. These stress tests should accurately reflect the unique characteristics of the insurer's business operations.
- 5.2. Stress scenarios must be chosen to reveal potential vulnerabilities in the insurer's liquidity profile and support management in identifying the insurer's liquidity risk. Scenarios and model parameterisation must not be limited to historical events, distributions, and correlations but must also be forward-looking.
- 5.3. Stress scenarios must be reviewed and approved by the board or a board subcommittee and approved by the board at regular intervals and in accordance with the insurer's liquidity risk appetite.

- 5.4. The insurer must assess the impact of its chosen stress scenarios on cash flows and liquidity resources both at the individual entity level and group level at the different time horizons (e.g., next day, 2-7 days, 8 days to 1 month, more than 1 month to 2 months, more than 2 months to 3 months, more than 3 months to 6 months, more than 6 months to 12 months).

6. High-quality liquid assets (HQLA)

- 6.1. An insurer must hold a portfolio of high-quality liquid assets that is sufficient to cover its liquidity needs at a given time horizon, both in business as usual and stressed conditions.
- 6.2. Assets included in the high-quality liquid asset portfolio must be highly liquid and readily convertible into cash, either through direct sale or repurchase agreements (repos), with minimal or no cost incurred. These assets must also be unencumbered³.
- 6.3. Assets held in the HQLA portfolio must be categorised as either Level 1, Level 2a, or Level 2b. Level 1 assets are typically regarded as being of the utmost quality and liquidity and are more likely to attract willing buyers even under strained circumstances.
- 6.4. The highly liquid characteristics of Level 1 assets must result in these assets comprising at least 60% of the HQLA portfolio. In contrast, Level 2a assets, whilst still of high quality, will generally incur higher haircuts and/or require more time to find a buyer than Level 1 assets. Level 2b assets will typically have fewer active markets and, therefore, require a longer time interval to find a willing buyer or will incur more substantial haircuts on sale during stressed market conditions.
- 6.5. The insurer must apply the appropriate haircut⁴ to the fair market value of the assets in the portfolio to account for increased credit and market risk during a stress event. Notwithstanding Table 1, instruments issued by the South African government shall be considered HQLA and similarly for jurisdictions where the insurer has a presence and is exposed to liquidity risk in that jurisdiction. Assets that must be included in the high-quality liquid assets portfolio include:

³ Unencumbered assets are free of any pledge, restriction or limitation (including any contractual obligation that must be fulfilled before a contractual right may be exercised) that limits access to or the use or disposal of an asset.

⁴ Haircuts are reductions in the value of an asset for the purpose of collateral or loan valuation. They are typically used to account for the risk of the asset depreciating in value before it can be sold. The larger the haircut, the smaller the value of the asset for collateral or loan purposes.

Table 1: Liquid and Marketable Assets

Asset type	Quality determinant* based on the national scale mapping	Classification	Comments
Cash and Demand deposits	Sufficiently diversified and highly rated financial institutions and available within the time horizon.	Level 1	
Money market funds	Sufficiently diversified and highly rated financial institutions and available within the time horizon.	Level 1	
Securities issued by the sovereign and similar, backed by their full faith and credit.	Rated AA- / Aa3 or better	Level 1	
	Rated A- / A3 or better, but less than AA- / Aa3	Level 2a	
Securities issued by public sector entities, municipalities and similar or guaranteed by the sovereign, backed by their full faith and credit.	Rated AA- / Aa3 or better	Level 1	
	Rated A- / A3 or better, but less than AA- / Aa3	Level 2a	
Vanilla corporate debt securities, including commercial paper	Rated AA- / Aa3 (A1 / P1 for commercial paper) or better.	Level 2a	
	Rated BBB+ / Baa1 (A2 / P2 for commercial paper) or better, but less than AA- / Aa3 (A1 / P1 for commercial paper);	Level 2b	
Covered bonds	Rated AA- / Aa3 or better	Level 2a	
	Rated BBB- / Baa3 or better, but less than AA- / Aa3	Level 2b	
Common equity shares	Publicly traded on a major exchange;	Level 2b	
Other fixed-income instruments issued by public sector entities	Rated BBB+ / Baa1 or better	Level 2b	
Other assets	Demonstrated to have low credit risk, low volatility, and readily marketable and have a proven record as a reliable liquidity source during stressful market conditions.		Subject to review by the Prudential Authority.

7. Insurance Liquidity Ratio

7.1. The Insurance Liquidity Ratio (ILR) measures an insurer's ability to meet short-term cash flow obligations. It is calculated as the ratio of the insurer's total Adjusted High-Quality Liquid Asset to its net Cash Outflows Under

Stress. The Prudential Authority (PA) requires insurers to maintain an ILR of no less than 100% over a 30 calendar daytime horizon.

7.2. The details of this calculation are set out below.

7.2.1. The Insurance Liquidity Ratio (ILR) must be calculated as follows:

ILR = Total Adjusted High-Quality Liquid Asset / Net Cash Outflows Under Stress

Where:

Total Adjusted High-Quality Liquid Asset⁵ = The Market value of all high-quality liquid assets after applying haircuts for assets backing obligations where the policyholder does not bear the investment risk⁶.

Net Cash Flows Under Stress⁷ = Total net cash outflows. Defined as the total expected cash outflows minus total expected cash inflows in a specified stress scenario for the subsequent 30 calendar days⁸. Total cash inflows must be capped at 75% of total cash outflows.

8. Contingency Funding Planning

- 8.1. The insurer must develop and implement a board-approved contingency funding plan to respond to liquidity stress events. This plan should help the insurer address stress scenarios where its liquid assets are insufficient or become illiquid unexpectedly.
- 8.2. The contingency funding plan must include realistic actions that the insurer could take to ensure that sources of liquidity are sufficient to maintain normal operations and continue to meet the insurer's financial obligations, including collateral needs under stress scenarios. The contingency funding plan must

⁵ Adjusted High-Quality Liquid Asset. This term emphasises that the value is adjusted (due to haircuts), pertains to high-quality assets, and is readily available for liquidity needs. It also aligns with the insurance industry's focus on asset quality and risk management.

⁶ As per the liquidity risk return.

⁷ This term emphasises that these are the net cash outflows expected under a stress scenario, which is a key consideration for liquidity risk management in insurance companies. It also aligns with the insurance industry's focus on stress testing and risk management.

⁸ As per the liquidity risk return.

describe the insurer's strategies for addressing liquidity shortfalls in stress liquidity situations timeously and at a reasonable cost.

- 8.3. The insurer must test its contingency funding plan annually and in accordance with its liquidity risk appetite. The contingency funding plan must be reviewed and updated based on stress test results and where there are significant changes in the business to ensure that the contingency funding plan remains adequate for the insurer.
- 8.4. The contingency funding plan must include a diversified set of viable, readily available, and flexibly deployable management actions that the insurer would use to access alternative funding sources or reduce liquidity risk exposure.
- 8.5. The contingency funding plan must describe when and how each action could be activated, the time needed to access funds, and the amount of funding expected to be available from each contingency funding source in the given stress. It should also identify any unintended consequences to the execution of each action.
- 8.6. The contingency funding plan must describe clear steps that allow the insurer to make timely and informed decisions, execute contingency measures efficiently, and communicate effectively.
- 8.7. The contingency funding plan must include quantitative metrics or early warning indicators that the insurer would use to identify a range of liquidity stress events, including its impact on the insurer's liquidity position, HQLA portfolio, and available funding sources.
- 8.8. The contingency funding plan must specify the actions to be taken, their timing, the parties responsible for initiating them, and the escalation procedures.
- 8.9. The contingency funding plan must establish a clear allocation of roles and lines of management responsibility, including defining procedures for identifying early warning indicators for potential liquidity stress events based on its business model's distinctive features.
- 8.10. The contingency funding plan must also contain a governance process for escalation. It must establish lines of communication to ensure that the board or the board sub-committee and senior management receive the necessary management information timeously. The plan must clearly articulate the communication plan for internal and external stakeholders.

9. Reporting to the Prudential Authority

Table 2: Frequency of reporting

Reporting Item	Frequency
Liquidity Returns	Monthly
Liquidity Risk Management Report	Annually
Own Risk and Solvency Assessment (ORSA)	Annually

9.1. The insurer must prepare and submit to the Prudential Authority a liquidity risk management report annually, together with the ORSA, which must include the following:

- 9.1.1. A liquidity risk appetite statement;
- 9.1.2. Established liquidity risk limits;
- 9.1.3. A discussion of the current liquidity position of the insurer relative to its liquidity risk appetite and limits;
- 9.1.4. A summary of strategies, policies, and processes that the insurer has in place to manage liquidity risk;
- 9.1.5. A discussion of potential vulnerabilities in the insurer's liabilities as well as the means of enhancing the liquidity position;
- 9.1.6. A discussion of the extent entities or sub-groups of group companies are self-sufficient or dependent on liquidity support from other parts of the Group, including an opinion of whether such arrangements are both prudent and expected to respond in a stress scenario; and
- 9.1.7. The insurer's approach to, and results of, liquidity stress testing.

9.2. The liquidity risk management report must be updated at least annually and when there are material changes to the nature, scale, and complexity of the insurer's activities, HQLA portfolio, and funding profile. The liquidity risk management report must be approved by the board of directors.

10. Own Risk Solvency Assessment (ORSA)

- 10.1. The Insurance Liquidity Ratio does not impact any Pillar 1 capital requirement nor form part of the valuation of technical provisions.
- 10.2. Insurers must assess their liquidity risk as part of their ORSA under Pillar 2.
- 10.3. In the event that the Prudential Authority assesses an insurer's liquidity risk to be significant or not adequately addressed by its ORSA, the Prudential Authority may require additional actions to be taken by the insurer to reduce liquidity risk.

11. Short title and commencement

11.1. This Standard is called *Prudential Standard FSI 6 Liquidity Risk Management*.

11.2. This Prudential Standard comes into operation on [insert date].

Table 3: Version control

Version number	Commencement date
1	1 July 2018
2	

12. Amendment of other regulatory instruments

This Prudential Standard repeals and replaces *Prudential Standard FSI 6: Liquidity Risk Assessment* and amends the regulatory instruments referred to in the Attachment below to the extent provided for in that Attachment.

Attachment 1: Amendments to other regulatory instruments

Standard	Name	Extent of repeal or amendment
Prudential Standard FSI 1	Financial Soundness Standards for Insurers - Framework for Financial Soundness of Insurers	<ol style="list-style-type: none"> 1. By deleting the words “FSI 6 (Liquidity Risk Assessment)” in section 6.6 and inserting the words “FSI 6 (Liquidity Risk Management)” 2. By deleting the words “FSI 6 (Liquidity Risk Assessment)” in section 9.1 and inserting the words “FSI 6 (Liquidity Risk Management)”
Prudential Standard FSI 4	Financial Soundness Standards for Insurers - Calculation of the SCR Using the Standardised Formula	By deleting the words “FSI 6 (Liquidity Risk Assessment)” in section 4.12 and inserting the phrase “FSI 6 (Liquidity Risk Management)”
Prudential Standard GOI 3.1	Governance and Operational Standard for Insurer’s - Own Risk and Solvency Assessment (ORSA) for Insurers	By deleting the words “(where relevant)” in section 6.2.