Box 16

ASSESSING THE LIQUIDITY RISKS OF INSURERS

Liquidity risk has caused problems and even insolvencies in the financial services industry in the past and it remains a key risk for financial institutions to manage in the future. Liquidity risk can be defined as the risk that cash resources are insufficient to meet cash needs either under current conditions or in stress scenarios.¹ This box describes some of the key liquidity risks that can confront insurers and presents some liquid asset measures.²

Insurers can be confronted with both asset and liability liquidity risks. As regards liability-side liquidity risks, insurers, unlike banks, generally have liabilities with a longer maturity than their assets, which makes them less vulnerable to customer runs. In addition, insurers’ liabilities are in general less liquid than bank deposits, as the possibilities for savings withdrawals are restricted in most insurance contracts and are also more costly for customers (owing to tax and surrender penalties). That said, liability-side liquidity risks still exist for insurers. For example, life insurers, in particular, face the risk of simultaneous withdrawals or policy surrenders by policy-holders.

² The focus of this box is on liquidity risks for the account of an insurer. Liquidity risk can, however, also exist for the account of policy-holders, where the policy-holder bears the investment risk.
This risk could, for example, be triggered if policy-holders have reason to question the financial soundness of the insurer. Non-life insurers can experience liquidity shortages as a consequence of large natural or man-made catastrophes, leading to large claims that have to be paid over a short period of time.

Turning to asset-side liquidity risks, insurers face the risk of impaired liquidity in capital markets. When previously liquid asset classes become illiquid, raising cash can prove to be difficult and may force insurers to sell their most liquid assets even though they may have preferred to keep them. It is therefore important for insurers to have assets backing liabilities that are able to provide enough cash to cover all needs, under both normal and stress conditions.

Liquidity shortages can also occur if an insurance company’s credit rating is downgraded by a rating agency. Insurers have often agreed to retire parts of their financing, or to post new collateral against trading positions, in the event of a rating downgrade. A rating downgrade can therefore cause liquidity shortages. In such a scenario, the initial rating downgrade may be followed by additional rating changes as a result of the liquidity problems. A recent prominent example of this is to be found in the problems experienced by the American insurer AIG. AIG made losses on credit default swaps, in particular. These losses and the deteriorating outlook for the insurer led to rating downgrades in September 2008, which forced it to post collateral payments on derivatives trades. AIG was unable to raise enough capital to satisfy demands for collateral quickly enough, which resulted in the insurer receiving government support. Given the importance of credit ratings for insurers, rating actions and rating outlooks should be monitored to assess the possibility of liquidity risk arising from rating downgrades (see Section 5.3).

Insurers that offer banking services or insurers that are part of a financial conglomerate can face particular liquidity risks. An insurance entity might be called upon to provide intra-group transfers of liquidity to an ailing banking entity, as has happened during the current financial crisis.

For financial stability and supervision purposes, it is important to analyse the different types of liquidity risk confronting insurers, as well as insurers’ liquidity positions. Calculating liquidity positions, however, is difficult without access to internal data from insurance companies. Nonetheless, some rudimentary indicators can be constructed on the basis of disclosures made by insurers in their financial reports. For example, the ratio of liquid assets to liabilities and the composition of liquid assets provide a broad overview of the liquidity positions of insurers

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3 See, for example, Standard and Poor’s, “Evaluating Liquidity Triggers in Insurance Enterprises”, November 2008.
(see chart). For a sample of large euro area insurers, this liquid assets indicator decreased somewhat, on average, from 2007 to 2008 (see chart). Corporate and government bonds accounted for the largest share of liquid assets, and the shares increased in 2008 (see chart). Government bonds can generally be considered to be more liquid than corporate bonds. Insurers’ corporate bond investments, however, are predominantly in the investment grade-rated segment, which is usually more liquid.

The amount of cash held by insurers increased slightly, on average, from 2007 to 2008, but the average figure conceals the disparity between insurers. Some insurers increased their cash holdings significantly (by up to 78%), whereas others saw their cash buffers reduced notably (by up to 71%).

To sum up, for financial stability and supervision purposes, it is important to analyse insurers’ liquidity positions against liability structures and potential liquidity calls to assess how well-positioned insurers are to handle stress scenarios. At the same time, it is important for insurers to manage and monitor liquidity risks (stemming from both the asset and liability sides) adequately and to have sufficient liquidity buffers available.