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Guideline

Subject: **Standards of Sound Business and Financial Practices -- Liquidity Management**

No: **F-10** **Date:** **February 1998**

A. PURPOSE

This guideline sets out the minimum policies and procedures that each company needs to have in place and to apply within its liquidity management program, and the minimum criteria it should use to manage and to control its liquidity prudently.

The guideline addresses a company's responsibility to have sound liquidity management practices which cover both operational and strategic considerations. Operating liquidity, or cash management, covers the day-to-day cash requirements under normally expected or likely business conditions. Strategic liquidity considers liquidity needs on a longer-term basis and recognizes the possibility of various unexpected and potentially adverse business conditions. Strategic liquidity is a key consideration of asset/liability management because of its potential effect on the ultimate viability of the company.

The guideline presents the management of liquidity undifferentiated as to currency denomination. However, each company that conducts business in foreign currencies should make distinctions between the management of liquidity in Canadian dollars and in other currencies.

B. DEFINITION

Liquidity is the availability of funds, or assurance that funds will be available, to honour all cash outflow commitments (both on- and off-balance sheet) as they fall due. These commitments are generally met through cash inflows, supplemented by assets readily convertible to cash or through the company's capacity to borrow. The risk of illiquidity increases if principal and interest cash flows related to assets, liabilities and off-balance sheet items are mismatched.

C. LIQUIDITY MANAGEMENT PROGRAM

Managing liquidity is a fundamental component in the safe and sound management of companies. Sound liquidity management involves prudently managing assets and liabilities (on- and off-balance sheet) to ensure that cash inflows have an appropriate relationship to the approaching size of cash outflows. This needs to be supported by a process of liquidity planning which assesses potential future liquidity needs, taking into account various possible changes in economic, market, political, regulatory, and other external or internal conditions. Such planning involves identifying known, expected and potential cash outflows and weighing alternative business management strategies to ensure that adequate cash inflows will be available to the company to meet these needs.

The objectives of liquidity management are:

- honouring all cash outflow commitments (both on- and off-balance sheet) on a daily and ongoing basis;

- avoiding excess funding costs realized through, for example, raising funds at market premiums or through the forced sale of assets; and

- satisfying statutory liquidity requirements, if any.

Although the particulars of liquidity management will differ among companies depending upon the nature and complexity of their operations and risk profile, a comprehensive liquidity management program requires:

- establishing and implementing sound and prudent liquidity policies; and

- developing and implementing effective techniques and procedures to monitor, measure and control the institution's liquidity requirements and position.

Liquidity Policies

Sound and prudent liquidity policies set out the sources and amount of liquidity required to ensure that liquidity is adequate to ensure the continuation of operations and to meet all applicable regulatory requirements. These policies should address both (i) operating liquidity and (ii) strategic liquidity and must be supported by effective procedures to measure, achieve and maintain liquidity.

(i) Operating Liquidity

Operating liquidity is that required to meet a company's day-to-day cash outflow obligations. The policy should consider a time horizon of about one month. It should take into account the factors which influence liquidity needs as well as the various sources of liquidity.

Factors influencing operating liquidity needs are:

- level of mismatch between current asset and liability cash flows;
- unrealizable cash flows resulting from mortgage renewals or maturity defaults;
- other liability requirements, such as death claim settlements and withdrawals prior to contract maturity; and
- other commitments, such as reinsurance settlements, capital purchases, or mortgage funding.

To meet such needs, the policy should set out the mix and priority in employing funding sources. These will take into account both the direct and indirect cost of such funds. Such funding sources include:

- liquid assets (i.e., cash, money market instruments, and other marketable instruments);
- bank lines of credit;
- premium income; and
- other borrowing.

The potential for creating an interest rate risk should be considered.

Holding assets in liquid form will often involve some loss of earnings relative to other investment opportunities. Nevertheless, the primary objective with respect to managing the liquid asset portfolio is to ensure its quality and convertibility to cash.

Essentially, operating liquidity is adequate if the company's approaching cash inflows, supplemented by assets readily convertible to cash and by the company's ability to borrow, are sufficient to meet the approaching cash outflow obligations.

(ii) Strategic Liquidity

Due to the long term nature of insurance contracts, strategic liquidity management must consider the long term obligations. The policy should address the future liquidity needs, taking into account current and potential future external and internal environments.

For example, the liquidity requirement should take into account:

- the economic and market conditions;
- the regulatory and political environment;
- consumer confidence in the industry and the company;
- strength of the company and its ability to borrow when needed;
- asset/liability management strategies;
- product design and administrative procedures; and
- concentration of risk.

The liquidity policy should address the corporate objective in terms of its ability to withstand cash demand. This could be expressed in terms of the amount of liquid assets deemed sufficient to support potential cash demands under adverse conditions. It should also ensure that a plan could be put in motion in the event of a liquidity crisis.

The policy should include a borrowing policy which may be used to manage any cash flow shortfall while recognizing that borrowing may not be available when needed.

The liquid assets will not only include the assets defined in the Operating Liquidity section but would also include any other assets where the cash may be realizable, over a certain period of time, even if at an economic loss.

The liabilities should also be examined as to their liquid nature from the policyholders' point of view. Some products will not include any cashout privileges, others will include various adjustments or no adjustments. Also, various settlement periods may be used. These product features should be reflected in the need for liquid assets.

The liquidity position under various conditions should be monitored regularly and reported to the board of directors at least annually.

Liquidity Management and Control Procedures

Each company needs to develop and implement effective and comprehensive procedures and information systems to manage and control liquidity in accordance with its liquidity policies. These procedures must be appropriate to the size and complexity of the company's activities.

Internal audits should be used to:

- ensure liquidity policies and procedures are being adhered to;
- ensure effective controls apply to managing liquidity; and
- verify the adequacy and accuracy of management information reports.

Assessments of the liquidity management operation should be presented to the company's board of directors on a timely basis for review.

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