Prudential Practice Guide

GPG 250 — Balance Sheet and Market Risk

February 2006

About this guide

Prudential Standard GPS 220 Risk Management (GPS 220) sets out APRA's requirements of general insurers (insurers) in relation to risk management. This prudential practice guide aims to assist insurers in complying with those requirements in relation to balance sheet and market risk and, more generally, to outline prudent practices in relation to balance sheet and market risk management.

Subject to the requirements of GPS 220, insurers have the flexibility to configure their balance sheet and market risk management framework in the way most suited to achieving their business objectives.

Not all the practices outlined in this prudential practice guide will be relevant for every insurer and some aspects may vary depending upon the size, complexity and risk profile of the insurer.

Balance sheet and market risk

1. Balance sheet and market risk includes, but is not limited to, investment and asset-liability management risk and the risks associated with liquidity management and the use of derivatives. Due to the nature of an insurer's business, there is a close relationship between investment risk and asset-liability management risk.

Investment risk and asset-liability mismatch risk

2. Investment risk refers to the possibility of an adverse movement in the value of an insurer's assets, including off-balance-sheet exposures. Investment risk derives from a number of sources, including market risk (e.g. equity, interest rate and foreign exchange risk), credit risk and investment concentration risk. Related to this is asset-liability management risk.
3. Asset-liability management risk is the risk of adverse movements in the relative value of assets and liabilities due to changes in general market factors, such as interest rates, inflation and, where relevant, foreign exchange rates. Assets and liabilities are considered to be well matched if their changes in value in response to market movements are highly correlated. If assets and liabilities are not well matched, the possibility of a reduction in asset value that is not offset by a reduction in liability value, or an increase in liability value that is not offset by an increase in asset value, becomes significant.
4. The expected payment profile of an insurer's liability portfolios is a crucial element of asset-liability management risk, as it determines the exposure of the portfolios' value to interest rates. Property business, such as household and comprehensive motor vehicle insurance, is typically short-term. Liability business, such as workers' or compulsory third party compensation and public liability, is typically long-term. The interest rate sensitivity of assets and liabilities is broadly determined by the timing of cash flows, although that will not always be the case (e.g. in the case of floating-rate notes or options). Timing of cash flows also affects the level of liquidity risk.
5. The systemic part of market risk is included under asset-liability management risk. Market risk also includes non-systemic or specific risk, which principally arises in the process of implementing the investment strategy.
6. In relation to investment risk, the risk management framework would typically include the following elements:
   (a) the investment objective;
   (b) formulation of an investment strategy, including allowable asset classes, strategic asset allocation, asset allocation ranges, benchmarks, risk limits and target currency exposures and ranges. The investment strategy would typically be formulated taking account of the investment objective, the insurer's capital position, the term and currency profile of its expected liabilities, liquidity requirements and the expected returns, volatilities and correlations of asset classes;
   (c) a process for how individual asset classes will be managed, including which of these tasks are done internally and which are outsourced to investment managers;
   (d) responsibilities of individuals and committees (e.g. investment committee, asset-liability committee) for deciding and implementing the investment strategy, and for monitoring and controlling investment risk, including reporting lines, decision-making powers and delegations;
   (e) a process for selection of investment managers, direct investments (including direct lending) and pooled investment vehicles;
   (f) limits and other restrictions on the actions of investment managers, whether internal or outsourced, and the means by which compliance with those limits is monitored;

(g) modelling and stress-testing of the impact of the current and alternative investment strategies on financial outcomes and asset-liability mismatch;

(h) processes for:

(i) ensuring the continuing appropriateness of the investment strategy, including timing and nature of strategy reviews;

(ii) ensuring the continuing appropriateness of the investment implementation process, including timing and nature of reviews of investment managers and manager configuration; and

(iii) monitoring compliance with the investment strategy;

(i) segregation of duties (which may also be covered by the operational risk management framework); and

(j) performance monitoring and its role in the oversight and control of the investment process.

Liquidity

7. APRA expects an insurer to have sufficient liquidity to meet all cash outflow commitments to policyholders (and other creditors) as and when they fall due. The nature of insurance activities means that the timing and amount of cash outflows are uncertain. This uncertainty may affect the ability of an insurer to meet its obligations to policyholders or may require insurers to incur additional costs through, for example, raising additional funds at a premium on the market or through the sale of assets.

8 Typically, in relation to liquidity, the risk management framework would include:

(a) consideration of the level of mismatch between expected asset and liability cash flows under normal and stressed operating conditions;

(b) the liquidity and realisability of assets;

(c) commitments to meet insurance and other liabilities;

(d) the uncertainty of incidence, timing and magnitude of insurance liabilities;

(e) the level of liquid assets needed to be held by the insurer; and

(f) other sources of funding including reinsurance, borrowing capacity, lines of credit and the availability of intra-group funding.

Derivatives

9. Derivative transactions are financial contracts in instruments such as forwards, futures, swaps, options and other similar transactions.

10. An insurer's risk management framework for derivatives would typically incorporate the following elements:

(a) the insurer's objectives in using derivatives;

(b) the risk tolerances of the insurer and a limit framework consistent with those risk tolerances;

(c) appropriate lines of authority and responsibility for transacting derivatives, including trading limits; and

(d) consideration of worst case scenarios and sensitivity analysis and reporting of that analysis.

Telephone
1300 13 10 60

Email
contactapra@apra.gov.au

Web site
www.apra.gov.au

Mail
GPO Box 9836
in all capital cities
(except Hobart and Darwin)