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August 31, 2018

Justin Schrader
Chair, Liquidity Assessment (EX) Subgroup
National Association of Insurance Commissioners

Re: Scope of Insurers Subject to Liquidity Stress Test

Mr. Schrader,

The American Academy of Actuaries¹ Life Practice Council's Macroprudential Task Force (MPTF) offers the following comments, including answers to the questions posed to interested parties, to the July 31st exposure of the National Association of Insurance Commissioners (NAIC) Liquidity Assessment (EX) Subgroup entitled "Scope of Insurers subject to Liquidity Stress Test." These comments are provided in addition to those in our [July 16th letter](#). We thank the subgroup for the improvements and clarifications in the most recent scope memo and look forward to contributing to the further development of this tool.

Objectives

The MPTF appreciates the Subgroup's work to provide increased clarity regarding the objectives of the stress testing workstream. In order to ensure that the framework is fit for purpose, it is important to identify clear objectives, then to consider scope and design issues in the context of these objectives.

After reviewing the exposure, we understand the subgroup's objectives to be both sector-wide and individual ("microprudential"). The primary, sector-wide objective, according to the exposure, is to provide "insights as to potential asset sales (to meet liquidity needs)" that might arise in a stressed economic environment. A secondary objective is to provide "insights regarding [the] vulnerability of [individual] insurers to various economic factors." We would welcome confirmation of our understanding.

¹ The American Academy of Actuaries is a 19,500-member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

We have the following observations about these objectives, as we understand them:

- Typically, liquidity risk assessment involves a microprudential application. Within a group that comprises multiple legal entities, sound risk management entails that each legal entity maintain adequate liquidity, taking into account potential support from the group under an extended stress environment. Consequently, thought needs to be given as to the meaning and utility of stress testing that aggregates cash demands not only across insurance legal entities, but also across groups.
- As stated, the primary sector-wide objective involves an assessment of asset sales. Liquidity risk, however, manifests not merely as a result of asset sales, but also as the result of such attempted sales in markets in which buyers are limited or nonexistent. In other words, asset sales alone are not sufficient for liquidity risk to manifest. At times, liquidity risk arises because liquid markets become temporarily illiquid. Moreover, a liquidity event can be triggered by factors that are noneconomic, such as a loss of confidence related to a ratings downgrade. Consequently, clarity should be provided as to whether the application is intended to evaluate asset sales in a stressed environment, attempted asset sales into temporarily illiquid markets in a stressed environment, or liquidity risk in a broader sense, which may not involve a stressed environment.
- Prior to designing a stress testing regime, clarity should be provided regarding the metrics the subgroup desires to compare between the life insurance sector and the broader financial markets, as it will be important for it to be designed in such a way as to provide the necessary outputs.
- In terms of the secondary microprudential objective, we assume that, based on the subgroup's charges, the stress test would be limited to an assessment of liquidity risk and is not intended to assess exposure to market risk in general. Accordingly, we suggest clarifying that the secondary objective, assessing the vulnerability of individual insurers, is related to liquidity shortfalls and is not intended to identify vulnerabilities or solvency concerns that are not related to liquidity.

We encourage continued refinement of the objectives of the framework in order to inform the testing methodology and the usefulness of results.

Exposed Questions

Do the scope criteria achieve the objectives of the Liquidity Stress Testing Framework?

Annex 1 of the exposure indicates that application of the proposed scope criteria will result in 21 life insurance groups being subject to liquidity stress testing. Although not stated in this manner, the intent appears to be to capture a significant proportion of the perceived aggregate liquidity risk within the industry.

From a sector-wide standpoint, the scope criteria appear to be broadly congruent with the objectives of the framework as we understand them. As noted above, however, liquidity risk is

inherently an entity-specific concern, which makes it difficult to conclude whether the subgroup's apparent intent is met. Moreover, liquidity concerns are not necessarily related to the six noted activities. Consequently, the Subgroup may wish to explore how the selected 21 life insurance groups compare to the broader industry in terms of assets, risk capital, or other holistic size metrics.

It is somewhat less clear that the scope criteria are congruent with the microprudential objectives of the framework. It may be useful to review historical significant liquidity-related events (above a certain size) to determine whether the scope criteria would have captured these entities within the exercise. For example, neither cash-outs of life insurance policies nor contractual downgrade provisions are included within the proposed scope criteria.

In what way, if any, should the scope criteria be modified? Please explain the rationale for your recommendation.

Because the MPTF lacks access to the underlying data set, it is not possible for us to determine whether a practical benefit exists from modifying the scope criteria. We would, however, like to offer some considerations for the benefit of the subgroup. These considerations should be assessed in light of the objectives of the work plan, as they continue to be clarified and refined.

- Consideration should be given to the impact of potential year-to-year variations in the listing of groups subject to the stress test. Some variation will inevitably arise due to the evolution of the industry's profile. The use of fixed minimum thresholds, particularly for volatile indicators such as those based on fair-value measurements, could result in groups toggling in and out of scope. These variations may be problematic if the stress testing is intended to identify industry trends. If this is the case, we encourage an evaluation of historical data to determine whether the outcomes would be compromised by the proposed scope criteria.
- Consideration should be given to the discretion afforded to individual domestic regulators to include an entity which would not otherwise be within scope because of potential liquidity risk drivers outside of the scope criteria (e.g., downgrade triggers).
- A process for scope-criteria review and revision should also be contemplated as experience or new developments emerge.
- Depending on the assumptions and approach used to define the liquidity stress testing cash flow approach, the subgroup may need to consider adding a scope criterion based on illiquid assets. Statutory investment guidelines vary somewhat from state-to-state and are established independent of the liability holdings of a specific entity. An illiquid asset scope criterion may be beneficial if the design of the liquidity stress testing would not capture potential asset/liability liquidity mismatches.

The Macroprudential Task Force looks forward to discussing these comments further with you if you so choose, and working with the Liquidity Assessment Subgroup on the development of a liquidity stress test. If you have any questions, please contact Ian Trepanier, life policy analyst at the American Academy of Actuaries. (Trepanier@actuary.org)

Sincerely,

Jeff Johnson, MAAA, FSA
Chairperson, Macroprudential Task Force
American Academy of Actuaries