

8/1/17 Draft

NAIC Financial Stability (EX) Task Force

Macro Prudential Initiative (MPI): A Proposed Framework

Background:

Macro prudential monitoring furthers regulatory objectives

Macro-prudential monitoring involves analyzing how the insurance sector is impacted by, reacts to, and contributes to financial, economic and other common risk exposures. Understanding these relationships is critical to maintaining strong and competitive insurance markets. Doing so ensures the availability of sound insurance products that meet consumer needs, achieves core regulatory objectives, and contributes to financial stability to the benefit of all consumers. These goals are consistent with the mission of state insurance regulators. State insurance regulators, with support from the NAIC, have the data, knowledge and expertise on insurance and the authority to take corrective action on insurance companies and groups if needed, and thus are particularly well positioned to continue and improve macro-prudential monitoring.

Where are we now?

Post financial crisis the NAIC implemented a number of reforms as part of our Solvency Modernization Initiative (SMI) that continue to serve us well today in achieving our regulatory responsibilities. The ensuing years since the crisis have been characterized by a sustained low interest rate environment, changes in demographics, and rapid advancements in technology and communication. Insurers have responded by adjusting product offerings, as well as investment and reinsurance strategies. Others have made structural changes and expanded into new global markets. There are new market players, new distribution channels, and a sometimes complex web of interconnections between financial market players. What has not changed since the financial crisis is the intense scrutiny on the insurance sector in terms of understanding how insurers react to financial stress, and how that reaction can impact, via various risk transmission channels, policyholders, other insurers and financial market participants, and the broader public. The proposed new work on macro-prudential measures is reflective of the state insurance regulators' commitment to ensure that the companies they regulate remain financially strong for purposes of policyholder protection and a stabilizing force to contribute to financial stability, including in stressed financial markets. The NAIC's Macro Prudential Initiative (MPI) is a logical continuation of the SMI project and should bolster the confidence of insurance consumers and investors, and further enhance the credibility of the state system of insurance regulation.

Relationship of macro with micro prudential tools

MPI involves undertaking a review of the state regulators' toolbox and assessing what existing data, metrics and analysis is available to support macro-prudential monitoring and what enhancements or additions might be needed to serve this purpose. This initial step recognizes that many of the same tools used for micro-prudential surveillance at the legal entity level are also useful for macro-prudential analysis. It also recognizes that the NAIC has already developed tools and analytics that focus on the sector more broadly and are thus macro prudential in nature. These include various work-products of the Capital Markets Bureau, Financial Regulatory Services Department (FRS), Financial Analysis Working Group (FAWG) and the Center for Insurance Policy & Research (CIPR). These include for example analysis of financial data and solvency metrics on an aggregated basis which we have used for purposes of benchmarking individual insurer's results (more of a micro-perspective) as well as for evaluating the health of the industry as a whole (more of a macro-perspective).

The goal of MPI is to consider some new or improved tools that we can use to:

- Better monitor and respond to the impact of external financial and economic risks on the firms we supervise.
- Better monitor and respond to risks emanating from or amplified by the firms we supervise that might be transmitted externally, and which may result in significant market impacts or financial, reputational, litigation or regulatory risks for the firm.
- Increase public awareness of NAIC/state monitoring capabilities regarding macro-prudential trends within the US insurance sector and their implications.

MPI should provide greater insight to both aggregate risks across markets as well as to specific insurance firms where risks may be concentrated.

Work done to date

The FSTF has been monitoring federal and international activities in macro prudential surveillance and regulation for a few years now. Last year, NAIC staff provided a review of what other jurisdictions currently do in this space. Common themes noted in this review included a focus on stress testing; liquidity assessments; exposure concentrations; enhancing resolution planning and disclosures; and charts and discussions on various domestic economic/regional trends impacting the insurance sector.

At the April 2017 NAIC national meeting, the Executive Committee adopted a new charge for the FSTF that would allow it to take the next steps to explore possible enhancement to the NAIC's macro prudential toolbox. The charge reads:

“Analyze existing post-financial crisis regulatory reforms for their application in identifying

macro-prudential trends, including identifying possible areas of improvement or gaps, and propose to the Financial Condition E Committee or other relevant committee enhancements and/or additions to further improve the ability of state insurance regulators and industry to address macro-prudential impacts; consult with such committees on implementation as needed.”

There are several existing NAIC work-products that may be a beneficial starting place for macro analysis. These products are inventoried in Appendix I along with a brief description of each.

Potential way-forward:

For discussion purposes, staff has outlined a number of areas for consideration and potential development.

- 1) Improving the effectiveness and use of existing tools
 - As an initial step, combine some parts of the existing reports to provide a more holistic picture of the primary drivers of the financial risks identified and how they are impacting the insurance sector. For example, consideration could be given to enhancements to the Market Monitor to include more narrative or guidance to examiners when considering the graphical presentation. In addition, consideration could be given to developing an industry dash board or heat map. The heat map could be organized around the NAIC’s 9 branded risk categories, thus providing a familiar framework for assessing risks or the direction of risks but with a focus on the macro-prudential implications of those risks. Future enhancements could include deploying this work product in a more automated fashion, allowing for more summarized central pages with drill down capability, etc.
 - Consider options for increasing regulator and public awareness of the NAIC existing macro-prudential tools. One way this could be accomplished is by creating a regulator only portal as well as a public facing webpage on the NAIC website.

- 2) Four focused areas for potential enhancements
 - Liquidity: Take a deeper dive into the regulatory tools for assessing liquidity and particularly the liquidity characteristics of insurers’ liabilities. This work will involve identifying the most appropriate metrics for a regulatory assessment of liquidity, reviewing the NAIC toolbox to see if those metrics or elements thereof already exist, and considering if additional data elements should be collected, the universe of companies to which any recommendations may apply, and the most appropriate route to collect them. Perform a comprehensive review of our regulatory requirements around liquidity management, including liquidity stress testing, and identify areas that may benefit from strengthening, including the proposed universe of companies to which any changes will apply, (e.g. large life insurers). As there are many dimensions to assessments of liquidity, consideration could be given to establishing a new sub-group with representation from both FSTF and other relevant committees.
 - Recovery and resolution: Consider what aspects of, or type of information from, recovery

and resolution planning process could be most valuable to regulators and insurers, and see if enhancements are needed to the current information collected by regulators. One area where resolution related enhancements might be useful is in ORSA guidance, particularly as it relates to understanding the functioning of inter-affiliate agreements in a resolution. Another area to consider is providing further guidance to regulators for pre-receivership situations, potentially through enhancements to the troubled company handbook. A third area for focus could be preparation of a comprehensive guide on best practices for states to handle cross-border coordination in troubled-company and receivership processes. Any recommendations for resolution-related enhancements should be assessed in terms of their contribution to the orderly unwinding of firms and should be coordinated through appropriate NAIC committees.

- Capital stress testing: Assess the value of capital stress testing for macro-prudential surveillance. Since the ORSA already involves company specific capital stress testing, consider the potential value of establishing baseline stresses which the NAIC can perform, and/or whether there is value in having the companies perform regulatory specified stresses. The latter item would need to be coordinated with the Group Capital Calculation (E) Working Group, which has a charge for developing stress tests related to the group capital calculation.
- Exposure concentrations: Consider the tools available for assessing counterparty concentrations, including at the group level. This step will consider existing regulatory requirements and disclosures for counterparty credit limits and collateral. Consideration could be given to interconnections that arise from both on and off balance sheet items and could consider potential enhancement to disclosures.

Timelines for future work

While macro-prudential monitoring is an on-going activity and each activity will be maintained and enhanced in the normal NAIC process, the initial MPI enhancements are anticipated to be a two to three year project. Initial work will begin immediately. A draft of a proposed work plan is attached as Appendix II.

Inventory of NAIC Macro-Prudential Tools

- Capital Markets Special Reports
 - Distribution list includes non-regulators though target audience is regulators
 - Range of topics; some focus on market information and analysis of potential impact on insurer investments; others including more detailed exposure and risk analysis
 - Usually 1 to 2 a month
- Capital Markets Hot Spots
 - Appear as needed
 - Posted on Capital Markets webpage, notice is in the day's Capital Markets Daily Newsletter
 - Reflecting current issues with more detailed analysis than typical Daily Newsletter piece
 - Items for regulators to monitor even though impact on insurance is not considered substantial, updating of data
 - Also, more substantial work on significant events (e.g. Brexit) that cause major market moves
- Capital Markets Daily Newsletter
 - Regulators only
 - Sent out at the end of each business day with the three to five headlines (and a short paragraph) that are relevant to insurer investments
 - Includes tables with the day's closing levels for different things (e.g. specific insurer bonds)
- Capital Markets Market Monitor
 - Updated monthly and posted on Investment Resources page
 - Reflects more significant market indices that regulators should be monitoring as significant volatility could have a negative impact on insurer portfolios or investment strategies
 - Includes brief commentary on recent trends
 - Additional data (from Special Reports) on insurer exposures to different markets
- Industry Analysis Reports
 - Completed annually, but a mid-year update is also constructed.
 - Publicly available
 - Separate reports for life and fraternal; health; p/c and title.
 - Presents industry-wide statistics on key financial data and ratios from statutory financial statements.
 - Highlights changes from prior year and multi-year trends.
 - Used to understand the state of the US insurance markets and also to see how a particular insurer's statistics compare to its industry statistics.
- Solvency Monitoring Risk Alerts
 - Provided semi-annually
 - Regulator Only. For use in monitoring (analysis and exams) current and prospective solvency of insurers
 - Highlights areas of emerging or increasing solvency risk insurers may be facing in light of current market conditions and industry exposures.

Inventory of NAIC Macro-Prudential Tools

- Constructed from studies of reported financial results, monitoring of insurance and capital markets, monitoring of news stories and current events, etc.
- The process to identify and select risks for inclusion in the alert is overseen by the Financial Analysis (E) Working Group of the NAIC.

Macro Prudential Initiative (MPI) Work Plan

- Key Objectives: 1) Better monitor and respond to the impact of external financial and economic risks on the firms we supervise. 2) Better monitor and respond to risks emanating from or amplified by the firms we supervise that might be transmitted externally, and which may result in significant market impacts or financial, reputational, litigation or regulatory risks for the firm. 3) Increase public awareness of NAIC/state monitoring capabilities regarding macro- prudential trends within the US insurance sector and their implications.

Proposed deliverables and timelines for key areas of focus in the MPI Framework:

1. Further develop MPI Framework based on input from regulators and interested parties. Initiate work in 2017.
2. Liquidity: See the separate attachment “FSTF Proposal for Liquidity Assessment Subgroup.” Initiate work in 2017.
3. Capital Stress Testing: FSTF will consider the regulator need for stress testing in the context of macro-prudential surveillance including scope. Conclusions to be outlined in a letter to Group Capital Calculation (E) WG by the Winter of 2017.
4. Recovery and Resolution: Identify those elements of resolution planning exercises that provide insights for facilitating a smooth resolution. Produce discussion paper for consideration by the FSTF including assessment of the need for potential guidance on pre-receivership planning, identifying if there are recommended areas to be covered in ORSAs, and developing further explanations on cross border coordination and receivership processes. Make a recommendation/referral to the appropriate Committees/Task Forces potentially including Receivership and Insolvency (E) Task Force, Group Solvency Issues (E) Working Group, and Troubled Company Handbook (E) Working Group. Initiate work in 2018.
5. Counterparty exposure/concentration: NAIC staff to review best practices regarding counterparty concentration and disclosures and return with recommendations, if any. Initiate work in the Spring of 2018.