

August 30, 2018

Justin C. Schrader, CFE
Chief Financial Examiner, Nebraska Department of Insurance
Chair, Liquidity Assessment (EX) Subgroup

Dear Mr. Schrader:

The undersigned companies appreciate the opportunity to comment on the document entitled “Scope of Insurers Subject to Liquidity Stress Test” exposed by the NAIC’s Liquidity Assessment (EX) Subgroup (the “Subgroup”) on July 31, 2018. We provide further thoughts on the questions posed in the discussion document regarding the revised scope criteria below.

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

The objectives of the Liquidity Stress Testing (LST) Framework, as defined in the exposure, are to “provide insights for macroprudential surveillance” and “provide useful insights regarding vulnerability of insurers to various economic factors.” We strongly support the objectives of the LST and consider it, as well as the other components of NAIC’s Macro Prudential Initiative (MPI), as further evolving and enhancing insurer and regulator enterprise risk management (ERM) practices within the life insurance industry.

In response to the 2008 financial crisis, the insurance sector strengthened ERM practices, particularly relating to liquidity risk. Today, LST serves as a critical element of insurance ERM with regulators and insurers having adopted more rigorous frameworks, requirements and practices, including internal processes, for identifying, assessing, and managing liquidity risks.

In 2012, the NAIC adopted the Risk Management and Own Risk and Solvency Assessment (ORSA) Model Act (Model)¹, an important ERM regulatory tool. Most states adopted the Model by the 2015 deadline, allowing for implementation in 2016. The Model serves two primary objectives: (1) to foster an effective level of ERM at all insurers, through which each insurer identifies, assesses, monitors, prioritizes, and reports on its material and relevant risks identified by the insurer, using techniques that are appropriate to the nature, scale, and complexity of the insurer’s risks, in a manner that is adequate to support risk and capital decisions; and (2) to provide a group-level perspective on risk and capital, as a supplement to the existing legal entity view.

We believe the NAIC’s establishment of a regulatory LST framework complements existing ERM best practices and regulatory requirements, including LST and ORSA. As such, we believe it is appropriate that the scope of application for this new regulatory tool should be consistent with the scope of insurers subject to the Model Act.

¹ [Risk Management and Own Risk Solvency Assessment Model Act #505, NAIC, 2012.](#)

Additionally, while the LST scope criteria proposed by the exposure may be effective at assessing and monitoring current areas of potential liquidity risk, we are concerned about the LST's ability to sufficiently achieve its regulatory objectives in the future. The scope criteria—six activities and related monetary thresholds—are likely to become static and stale over time. This could produce incorrect or inaccurate information, which in turn may result in misleading assumptions about liquidity risk in the market. Instead, the LST framework should be robust and flexible enough to adapt to the evolution in life insurance products, activities, and market conditions. Further, the LST framework should be structured in such a way that regulators can assess a large and meaningful segment of the life insurance industry and identify and address emerging systemic risks and broader market impacts over time. Otherwise, with an overly restrictive universe of companies, U.S. regulators may be unable to adequately identify and address liquidity and other systemic risks in the sector.

We believe that requiring all ORSA filers to participate in LST would be the most effective way to achieve these objectives and could also simplify the scoping exercise for the NAIC. The filers list is far more robust, easily verifiable, and includes a significant percentage of the market which ensures regulators will have more accurate information on potential liquidity risk exposures with which to make aggregate market assessments both now and in the future. The filers list is far more flexible than the exposure scope, as it is not limited to certain activities or monetary thresholds and is unlikely to require substantial changes to maintain relevancy. In addition, most filers engage in ERM best practices, including LST, and the ORSA already requires filers to participate in some LST activities. We discuss this recommendation in more detail below.

Because the LST framework should apply liquidity stresses to a broad segment of the industry to adequately identify and assess activities that may pose systemic risk, we believe the testing scope and framework should:

- Not be limited to considering activities of the past that may have been, at one time, considered as a potential source of systemic risk. Instead the framework should be aligned to serve in identifying both existing and emerging liquidity risks that have the potential to create significant vulnerabilities today or in the future. An appropriately designed framework will identify activities that involve maturity or liquidity transformation that may create the potential for transmission of risks across the sector; and
- Not apply only at the legal-entity level. The document alludes to testing across the insurance group in several places, but Annex 1 dealing with scope does not include specific information on whether the threshold values were determined across the group or at the legal-entity level through the blue book. It is unclear from the exposure whether the NAIC plans to conduct the testing of the entire group, groups that are involved in life insurance operations (including other legal entity resources utilized for liquidity purposes), or legal entity for the life insurer only. We believe conducting LST

across the life insurance segment within the group, including consideration of liquidity support provided by other members of the group for the life insurance segment, would be an effective option for achieving the macroprudential goals stated in the exposure.

Lastly, we support the continued use of a cash flow approach as the basis for the regulatory LST analysis, as it allows insurers to identify cash demands that can be met with normal cash flows (e.g., premiums, investment income, maturing assets) in addition to asset sales/borrowing, providing meaningful insights on liquidity risks and mitigants to regulators.

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

To address the issues noted in our response to Question 1, we recommend the following:

1. Scope in companies that are subject to Own Risk Solvency Assessment (ORSA) requirements.

As discussed above, the LST framework should promote alignment with existing best practices and regulatory requirements for ERM. The proposed scope criteria in the exposure, over time, may not give regulators the proper information needed to assess the likelihood of the insurance industry or individual insurers contributing to a potential liquidity crisis. Therefore, the scope needs to be structured in such a way that it can accommodate changes to insurance markets, products, and activities, while reflecting a meaningful portion of the life insurance industry, to meet the LST's macroprudential surveillance goals and adapt to evolving ERM best practices. We believe the NAIC already has the proper surveillance scope for LST in place—companies that are subject to ORSA reporting requirements.

Per the Model, reporting applies to any U.S. insurer that annually writes more than \$500 million of direct written and assumed premium, and/or to any insurance group that annually writes more than \$1 billion of direct written and assumed premium, ensuring that all moderate and large U.S. life insurers receive enhanced regulatory oversight.² The ORSA filing companies' list automatically changes with the market and the filings themselves are flexible enough to meet regulators' evolving needs without requiring regular changes to the Model or other regulations or laws.

Further, it is important to include all ORSA filers in the LST scope because, regardless of their size or activities, they may still be at risk of an operational or reputational event that could lead to liquidity problems and result in a systemic concern. It would be imprudent to provide these companies with an exemption from liquidity risk monitoring as they could transmit potential liquidity risks to other insurers and financial services providers.

² "Section 6. Exemptions," page 2, *ibid.*

Expanding the LST scope to all ORSA filers would ensure a large and significant segment of the life insurance market is included in LST. More importantly, including all ORSA filers in the scope would yield a more comprehensive and accurate picture of how the insurance industry might react to various scenarios posed by the stress tests, help identify potential liquidity threats, and align the framework in a more effective way to achieve the NAIC's stated goals.

ORSA filers are already expected to meet many industry-wide ERM best practices and regulatory requirements, including conducting certain elements of LST as discussed in the first section. Including ORSA filers in the LST scope should not result in significant compliance burdens to these companies, as they often should have the infrastructure and knowledge established to conduct LST activities as part of their existing ORSA obligations and adoption of ERM best practices.

Aligning the LST with ORSA filings to the greatest extent possible will provide state regulators several important benefits, including:

- Expanding the ability to identify new or existing activities in the future that may pose liquidity risks beyond the list of select activities identified in the exposure (e.g., derivatives, securities lending) for further regulatory scrutiny;
- Promoting long-term stability and predictability on the scope of application. As individual exposures of activities evolve year after year, there is a likelihood that insurers will dip below or rise above activity thresholds proposed in the exposure, which could result in inaccurate or misleading conclusions when aggregating data. At a minimum, some alignment with ORSA, as a supplement to a scope of application to insurers engaged in certain activities, would strengthen the predictability for scope of application. We believe state regulators and insurers would ultimately benefit if continuity of framework application were achieved, especially as the framework and regulatory expectations associated with it are likely to evolve over time;
- Mitigating potential incentives for insurers to decrease or discontinue their exposure to certain activities to avoid the application of the LST framework requirements;
- Capturing activities and insurers engaged in those activities that, in isolation, may not be material but could be material in aggregation with other companies;
- Aligning with and complementing existing supervisory and risk assessment tools, such as ORSA and Supervisory Colleges, as well as recent enhancements to blanks reporting requirements on data related to liquidity risk; and

- Providing an avenue for other regulators to assess potential systemic activities for liquidity risk across the life insurance industry.

If regulators determine broadening the scope of the LST framework application to all ORSA filers is not a feasible near-term goal, we recommend regulators pursue enhancements to the NAIC ORSA guidance to establish minimum standards in liquidity stress testing in line with those required by industry ERM best practices. This could be achieved through proportionality, where the requirements for the smallest insurers subject to ORSA filing would not be as comprehensive or onerous as those for larger insurers. From a macroprudential surveillance perspective, it is important that regulators have the most comprehensive view possible of the life insurance sector by assessing the largest range of activities across the broadest spectrum for liquidity risk. As mentioned above, many of the ORSA filing companies should already have the infrastructure and knowledge in place from their own participation in industry ERM best practices to conduct some LST activities.

We also believe it would be appropriate to consider requiring certain non-ORSA filers that have material exposure to liquidity risk-bearing activities to participate in the LST framework, as they still could be subject to liquidity risk individually or they could collectively amplify market impacts in reaction to a stress scenario. The NAIC's exposure provides a reasonable framework for broadening the scope beyond ORSA filers as it focuses on liquidity-risk bearing activities that could also adversely impact a non-ORSA filer. Scoping in both ORSA filers and non-ORSA filers with material liquidity risk-bearing activities would allow the LST Framework to more effectively meet its objectives.

2. Revise criteria for any derivatives considerations.

First, we would like to clarify a generalization included in the derivatives activities criteria and, if necessary, ask regulators to reassess the criteria and thresholds of utilizing derivatives to determine the LST scope. The exposure on page 2 notes for derivatives that "the key liquidity risk is the requirement of daily posting of cash collateral if the fair value of the derivative changes or under other circumstances such as a credit rating downgrade." However, that is not the case for all life insurer derivatives. Many large life insurance companies do not need cash collateral when an instrument moves, since they are permitted to post corporate bonds as an alternative under the SEC and CFTC Title VII Dodd-Frank Act regulations. Cash collateral is only required for the exchange-traded and cleared swap margins. Securities (including corporates, if permitted in the credit support annex) can be posted in non-cleared over-the-counter derivatives. The use of corporate bonds for collateral purposes reduces liquidity risk in the product and stress in the markets.

Second, "fair value" may not be the appropriate measure for assessing the liquidity risk associated with derivatives. For example, "fair value" reflects a point in time measure of value for derivatives and the value could be significantly different over time and under different economic conditions, making it difficult to determine future exposures. This could lead to situations where an insurance group could be considered "in scope" in one year and

“out of scope” in another year due to changes in economic conditions. While it would make the most sense to utilize values with risk sensitivities (e.g., IR01 for interest rates), we recognize that this information may not be readily available to state insurance regulators through the blue book or current annual disclosure statements. In the absence of such information, we have identified the following two “notional” value options disclosed in NAIC Financial Statement Schedule DB that could be used to determine the value of derivatives as part of the scope of NAIC’s LST framework³:

1. Part A, Section 1, Column 9 “Notional Amount” (e.g., the amount upon which the next cash payment is based); or
2. Part B, Section 1, Column 3 “Notional Amount” for futures positions.

We thank the NAIC for continuing to engage stakeholders in the LST Framework development process and for the consideration of our comments. We look forward to providing additional comments on future scope and design proposals as regulators work to complete the LST Framework and other MPI initiatives.

Sincerely,



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³ These options are suggested for determining the potential scope of NAIC’s MPI LST framework only. The notional value calculations are not being suggested for other Federal or state regulatory policy considerations at this time.



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