July 13, 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 documents entitled "Scope Considerations for Liquidity Stress Test" and "Design Elements: Considerations for Liquidity Stress Test" exposed by the NAIC's Liquidity Assessment (EX) Subgroup (the "Subgroup") on June 25, 2018. We look forward to continuing to engage with the Subgroup in its further development of a liquidity stress testing framework, and in this letter we provide our thoughts on the questions posed in the discussion documents regarding scope and design elements.

Scope Questions:

1. Should scoping for large life insurers that are subject to liquidity stress testing be based on both size and activities or on activities alone?
2. Are there other criteria that should be considered besides size and activities?
3. Would you recommend changes to the list of activities that could cause potential liquidity risk mentioned above?

Determining the scope of liquidity assessment is a crucial first-order decision point and it is imperative to ensure that a sufficiently large segment of the life insurance industry is covered so that any subsequent liquidity stress test can provide useful insights regarding industry-wide resilience (inward risks) as well as broader market impacts emanating from the insurance industry (outward risks). We believe that an effective macro-prudential framework should focus on liquidity risk-bearing activities across the insurance sector, rather than solely relying on a size or volume-based threshold to scope in companies. As demonstrated during the financial crisis, it is the nature of certain types of activities, particularly those involving maturity or liquidity transformation, which create the potential for transmission of risks across the sector. While size is an imperfect measure of the scale of liquidity risk-bearing activities, it could serve as an easily-implementable first step in the scoping methodology to ensure sufficient industry coverage in the liquidity stress test. The NAIC and the Subgroup may want to consider a two-step approach in their scoping methodology to ensure sufficient coverage of the life insurance industry's liquidity risk bearing activities.

Step 1 – Scope in companies that are subject to ORSA Requirements

This Step will ensure good coverage of the life insurance industry for the liquidity stress test and is easily verifiable. ORSAs provide pertinent information on companies' top risks (including liquidity) thus it will be important to include these companies in the scope to help regulators stay abreast of changing and emerging risks which could potentially extend beyond liquidity to other areas of the Macro Prudential Initiative.

Step 2 – If a company is not subject to ORSA Requirements, it should still be in scope if it has material exposure to liquidity risk-bearing activities.

Some smaller firms may be too small to be subject to ORSA Requirements, but they could still have material exposure to liquidity risk-bearing activities. Consequently, it will be important to secondly consider the size of liquidity-intensive activities relative to the firm's total balance sheet, with the size of liquidity-intensive activities being the notional sum of a firm's:

1. Securities lending and repurchase activities, plus
2. Derivatives book, plus
3. Liquidity-intensive products

NAIC could then still require firms to do liquidity stress testing if the size of liquidity-intensive activities as defined above exceeds a certain threshold (e.g., 10%) of a firm's total balance sheet.

An initial list of liquidity-intensive products could include:

- Fixed and indexed annuities with limited surrender charges
- Short-term borrowing (commercial paper, bonds with remaining maturities under 1 year)
- Short-term funding agreements and GICs
- Puttable borrowings

This initial list should be reviewed every 1-2 years and adjusted as appropriate.

We believe that an effective approach for identifying liquidity risk-bearing activities would be for the NAIC to engage in ongoing consultation, including with fellow regulators and policymakers, industry, and third-party experts, to assess the scope of activities (and companies) that should be scoped into each annual exercise. The perspectives of industry risk and finance officers, including the top internal risks captured in companies' ORSA filings, could also help to inform the scope of activities to be assessed. Additionally, we believe the NAIC will gain greater insight on liquidity risk drivers (and mitigants) through each iterative run of its liquidity stress testing exercise.

Design Element Questions:

1. Is the proposed cash-flow approach preferable over a balance sheet-based approach?

We believe that a cash-flow approach is generally preferable to a balance sheet (or factor-based) approach. The scenario-based assessment of cash flows provides more meaningful insights on liquidity risks (and mitigants). A cash flow approach enables insurers to identify cash demands that can be met with normal cash flows (e.g., premiums, investment income, maturing assets), versus demands that must be met with asset sales and/or other contingent sources – a differentiation that is important to identifying potential cross-sectoral impacts.

2. Have we identified the most salient design elements for initial decision-making?

Yes, and we look forward to working with the Subgroup in their development of a more fully-specified liquidity stress testing framework that is anchored in these design elements. We view the following as important principles to underlie the development of liquidity stress testing:

- Assess Industry-Wide Resilience (How risks emanate from specific activities in a common stress environment)
- Understand Broader Market Impacts (How risks could amplify market impacts through synchronized reactions to stress)
- Balance Prescription with Principles-Based Methods (Results should be aggregable without sacrificing meaningfulness)
- Maintain Confidentiality (All results should be protected by strong confidentiality provisions)

While we view the Subgroup's initiative on liquidity stress testing as worthwhile, we also think it is important that the NAIC consider the role of stress testing as one element within a more coherent, broader, well-governed liquidity risk program. Foundational elements of such a broader program include processes for: risk identification; scenario design and application (reflective of the risks most material to each company); quantification (encompassing stress tests as well as other activity-specific evaluations); reporting and analysis; and an over-arching governance framework, which includes relevant limits and guidelines.

We are not advocating for the NAIC to prescribe specific criteria and parameters for the design of a company's broader liquidity risk program. We do, however, believe that supervisory monitoring of a company's internal liquidity risk management practices would (i) reduce the sole reliance on stress testing as a liquidity tool; (ii) better ensure that companies have a fundamentally sound and comprehensive approach to addressing liquidity risk; and (iii) focus on the role of management actions, rather than a reductive "pass / fail" or ratio-driven approach, in mitigating potential vulnerabilities across the sector. We believe that the NAIC's initial efforts several months ago to learn more about the internal liquidity assessment practices of several

Life Insurers is the appropriate basis for developing supervisory expectations and the role that stress testing plays as one component within a broader liquidity management program.

3. Which design elements should be prescribed by state insurance regulators?

While we understand the need for some degree of commonality in design elements, an overly prescriptive approach creates a risk of over-emphasizing scenarios and assumptions that are minimally relevant to a given company's key exposures. In other words, excessive commonality would decrease the informational value of the exercise. At this formative stage of the Subgroup's policy process, it is difficult to describe with precision where the balance should lie between flexibility and prescription; however, we believe, as a basic principle, that scenarios and assumptions should be described in sufficient detail to provide context for firm-specific application. As it may not be possible to prescribe every element of a common scenario, a comprehensive description of the scenario should be provided as this will help firms bridge any gaps in the prescribed scenario (e.g. unspecified economic variables) and develop firm-specific assumptions.

4. Will the inputs to and outputs from the exercise as described above provide information sufficient to achieve the stated objectives?

In principle and at this stage: yes, although we would need further elucidation of the specifics of scenario design and assumption. This question – of how effectively the design elements achieve the NAIC's over-arching public policy objectives – is critical to pose. Indeed, we encourage the NAIC to continually consider this question as it makes further progress on the technical aspects of the MPI.

Thank you for considering these comments.

Sincerely,

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