



American Council of Life Insurers

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Justin C. Schrader, CFE
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Re: Comments on Liquidity Stress Testing Exposures

Dear Mr. Schrader:

The American Council of Life Insurers (ACLI) advocates on behalf of approximately 290 member companies dedicated to providing products and services that contribute to consumers' financial and retirement security. ACLI members represent 95 percent of industry assets, 93 percent of life insurance premiums, and 98 percent of annuity considerations in the United States. 75 million families depend on our members' life insurance, annuities, retirement plans, long-term care insurance, disability income insurance and reinsurance products. Taking into account additional products including dental, vision and other supplemental benefits, ACLI members provide financial protection to 90 million American families.

Thank you, as always, for the opportunity to comment on the important work of the NAIC Liquidity Assessment Subgroup. We are pleased that the Subgroup indicated during the June 25th conference call a willingness to carefully weigh the burden of any liquidity stress testing requirements against the likely insights to be gained as the Subgroup continues to implement various elements of the Macro-Prudential Initiative and to achieve its underlying policy objectives.

While we are encouraged by this consideration of costs and benefits, given the diversity of the industry, care should be taken to ensure that "simplistic" methods do not miss or misidentify risks, whether through a balance sheet or cash flow approach. Liquidity stress testing is a complicated topic that involves a range of considerations. It is significantly more complicated than the liquidity blanks expansion, and we believe the subject demands an expanded period of extensive dialogue between regulators and industry, accompanied by iterative field testing. Given the complexity and uncertainty around the ultimate use and scope, our comments take the form of Key Considerations, which we think will help to focus that dialogue. We are certain to have additional feedback as the Subgroup develops the specifications of the proposed stress testing regime, and we look forward to working constructively with the Subgroup on this project.

Scope Considerations for Liquidity Stress Test

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?

Key Consideration:

Knowing the ultimate purpose of the regulatory stress testing framework will inform the answer to this and many other questions. The NAIC Scope memo identifies several possible objectives, and, in our view, correctly notes that the construct of liquidity stress testing will depend on the agreed upon objective(s). These different objectives/purposes may lead to somewhat different conclusions about fundamental elements of any stress testing framework. For example, a purpose based on an “outward” look to potential risks that could be transmitted by the life insurance industry to the broader financial services sector may be limited to very large life companies. An “inward” looking approach would likely scope in a greater number of companies to be meaningful. An inward approach would also necessarily be more technically rigorous.

We question the feasibility of creating a truly “macro” measurement providing insights to the economy as a whole, as that may be practically unachievable. It should also be noted that the objectives may not be consistent and/or will require different measurements. We urge the Subgroup to carefully weigh the competing objectives and arrive at a clearly defined primary goal for liquidity stress testing prior to the development of specifications. In particular, if the purpose is, indeed, to better understand implications for the broader financial sector through liquidity stress testing, we would like this elaborated further.

2. Are there other criteria that should be considered besides size and activities?

Key Consideration:

As suggested in our response to the first question, this depends on the ultimate purpose of the NAIC’s liquidity stress testing regime. We also note that the timeframe and commitment expected of regulatory and industry resources for this project should be articulated early in the process, including the likelihood of one or more field testing exercises and the commitment of appropriate technical resources, such as consultations or referrals to appropriate NAIC committees, and input from expert external resources. This is consistent with the view of the IAIS, which has indicated that stress-based liquidity requirements “would take time to develop and may not be feasible in the short term.” [IAIS public consultation document on Activities-Based Approach to Systemic Risk, December 2017]

In addition, the legal basis and location (statute, manual, ORSA, other) should be identified and explained.

3. Would you recommend changes to the list of activities that could cause potential liquidity risk mentioned above?

Key Consideration:

Our initial view is that a specific list of identified activities should not be used given the evolving nature of the sector, varying impact of market conditions/fluctuations, and potential role of risk mitigation tools.

In addition, in evaluating the significance of activities from a liquidity risk perspective, it will be necessary to determine whether “significant gross exposure” is defined on an absolute basis or relative to the size of the firm. For “inward” purposes, the relative view is more meaningful (i.e., the liquidity risk to the firm depends on the size of the liquidity need relative to the firm’s resources). For “outward” or “macro” purposes, in some respects, the absolute size of the liquidity exposure may be meaningful. Yet the relation of the size of the exposure to available resources is also relevant, as this will affect company behavior and the potential for market impacts.

Design Elements: Considerations for Liquidity Stress Test

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

Key Consideration:

As noted earlier in the first question concerning scope, the answer to this question is dependent, in part, on the identification of the primary goal of stress testing. Life insurers often use a cash flow approach as the basis for internal liquidity stress testing; it may be preferable for that purpose because it better accounts for company-specific factors than a balance sheet-based approach. Yet cash flow testing is likely to be substantially more complex and company-specific than a balance sheet approach. As a result, the use of a cash flow approach for regulatory purposes would require adequate development time with technical resources made available for the progress and ongoing maintenance of the testing regime. Further, given the complexity, a cash flow approach would be more practical if the scope of application is relatively restricted. A balance sheet approach may be preferred if regulatory expediency is desired, technical resources are more limited, or if the scope of application is relatively broad. It is worth observing that existing rating agency tools, to the extent they include stressed liquidity concepts, are essentially balance sheet approaches. However, there are shortcomings that may make a balance sheet approach not reasonable, plausible or appropriate for a regulatory liquidity stress testing framework, including the lack of particular focus on macroprudential risks and the use of simplified assumptions that would not capture key liquidity risks or take into consideration all liquidity characteristics of a particular product.

More broadly, we noted some questions from regulators during the Subgroup’s call about using companies’ models as a starting point. If a modeled cash flow framework is ultimately adopted, we encourage regulators to start with existing, well-vetted and controlled models, while making appropriate adjustments to measure liquidity risk rather than requiring the creation of new models for liquidity stress testing purposes. Asset Adequacy Testing (AAT) models may be a starting place, but they would need to be adjusted to reflect the shorter time horizon typically used in liquidity testing. Several of the pros and cons of each approach include:

Balance Sheet

Pros

- Easy to calculate as of a point-in-time, although possibly offset by the fact it provides a view as of a specific day as opposed to a broader snapshot over a longer period.
- Relatively easy to construct and maintain.
- Easy for regulator to audit.
- Develops results that are comparable over time and across companies.

- Would not require company-defined assumptions, thus removing company discretion (all calculations could be prescribed).

Cons

- Would need to debate prescribed assumptions/factors. Common assumptions across the industry may be challenging/misleading as the appropriate factors may be company specific (example – security liquidity would vary based on the particular portfolio/size).
- Not aligned with the common basis used by life insurers for liquidity stress testing today (cash flow approach).
- May not provide sufficiently rigorous analysis (that is, appropriately capture different product features and the interactive nature of assets and liabilities); could create false picture of liquidity risk if company-specific considerations are not able to be incorporated.

Cash Flow

Pros

- More tailored, easily accommodates forward-looking assumptions.
- Better accounts for company-specific factors in comparison to a balance sheet-based approach.

Cons

- Requires complex sources and uses of liquidity projections (more useful than a balance sheet point-in-time view, but complex to do).
- Many company defined assumptions. Those more applicable to liquidity may differ from Asset Adequacy Testing. Could include assumptions based on systemic events or idiosyncratic events (persistence, policyholder behavior, future market movements such as interest rates, idiosyncratic triggers, future sales amounts/timeframe, sources of liquidity outside of asset sales, and others), which increases complexity
- Liquidity risk is more concentrated in the short-term, so meaningful time scale may be different than traditional Asset Adequacy Testing.
- Relatively more difficult to construct and maintain.
- More difficult for regulator to audit.
- May be difficult to compare across companies and over time.

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

Key Consideration:

The design elements appear reasonable based on what we know currently. We particularly urge the Subgroup, again, to leverage existing tools used by life insurers. If company-specific information and assumptions are desired, the most appropriate means to gather the required information, while maintaining confidentiality, should be investigated. In addition, the time horizons should be limited.

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

Key Consideration:

We believe, as a basic principle, that purposes, scenarios, and assumptions (and key characteristics of each) should be described in sufficient detail to provide context for firm-specific assumptions. While it may not be possible to prescribe every element of a common scenario, a comprehensive description of the purpose and scenarios should be provided as this will help firms bridge any gaps in the prescribed scenarios (e.g., unspecified economic variables) and develop firm-specific assumptions.

Further, a liquidity crisis is particularly responsive to management actions, such as directing investable cash premium inflows to pay excess claims or increasing secured borrowing in response to market stresses. For this reason, models that do not reflect management actions under a liquidity stress event, as contemplated in the Subgroup's Attachment 2, would miss critical information. If the NAIC adopts a cash flow approach, properly documented management actions should be reflected.

If a balance sheet approach is pursued, it would be appropriate to prescribe the relevant assets and liabilities and any haircuts to the reported values.

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

Key Consideration:

We urge the Subgroup to recommend a carefully calibrated approach and timeline as well as a dedication of sufficient technical resources, including appropriate referrals to other NAIC committees and input from expert external resources to this project that will allow for the collection of information and its thorough evaluation. At this stage, it is not possible to draw conclusions that the information provided will be sufficient to achieve the stated objectives.

Thank you again for the opportunity to comment, and please let me know if we can provide additional information.

Sincerely,



David Leifer

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