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Memo

To:	Marlene Caride, Financial Stability (EX) Task Force Chair, Justin Schrader, Liquidity Assessment (EX) Subgroup Chair
CC:	Elise Liebers (eliebers@naic.org), Mark Sagat (MSagat@naic.org), Todd Sells (tsells@naic.org), and Tim Nauheimer (tnauheimer@naic.org)
From:	LeeAnne Creevy, Partner Ben Leiser, Manager Tricia Matson, PartnerEd Toy, Senior Manager
Date:	February 6, 2020
Subject:	RRC comments on the Liquidity Stress Test Framework

Dear Commissioner Caride and Mr. Schrader:

Risk & Regulatory Consulting, LLC ("RRC" or "we") supports the efforts of the Financial Stability (EX) Task Force and the Liquidity Assessment (EX) Subgroup ("Subgroup") to provide additional tools to enable an assessment of macroprudential impacts on the broader financial markets of a liquidity stress impacting a number of insurers simultaneously.

We have reviewed the draft document "2019 NAIC Liquidity Stress Test Framework for Life Insurers Meeting the Scope Criteria" dated as of December 2019 and offer the following comments for your consideration. We would be glad to answer any questions, and we welcome the opportunity to offer our comments.

1. We appreciate the efforts of the Subgroup to thoughtfully consider the issue and to develop a Liquidity Stress Test ("LST") framework for large life insurers that would "aim to capture the impact on the broader financial markets of aggregate asset sales under a liquidity stress." However, we would suggest the Subgroup not limit the objective to capturing the impact of asset sales only, but consider other impacts as well, such as consumer confidence issues, run-on-the-bank outcomes, debt market capacity, etc. and their impacts on the broader economy. This might serve to inform the actual development of the framework itself and provide even more benefit.
2. We understand that the NAIC has not pre-judged the outcomes of this exercise and "believes there is value to the exercise whether it points to vulnerabilities of certain asset classes or markets or, alternatively, suggests that even a severe liquidity stress impacting the insurance sector is unlikely to have material impacts on financial markets." We also recognize that "the LST framework is intended to supplement, not replace, a firm-specific liquidity risk management framework." However, we would suggest that the NAIC actually consider, and discuss in advance, steps that might be taken to address any identified vulnerabilities. This could include collateral requirements, changes in regulatory guidance regarding admitted assets, intercompany agreements, pre-defined triggers requiring liquidity action plans, etc. This discussion on the tools that life insurers and other regulators have to deal with changing cash flow demands and potential liquidity issues could help inform the appropriateness of the framework itself and provide support for additional improvements or enhancements. This process could also benefit from collaboration with other financial regulators as discussed in the draft.
3. The scope criteria is intended to be risk-focused and not solely based on size, and specifies six activities to determine in-scope companies. We have the following thoughts and considerations with regard to these specifics:
    a. Consider a size floor to ensure that large companies, with possible idiosyncratic risk that might be impacted by the particular scenario even without the specific identified activity thresholds, are included.

b. Consider including regulator judgment, due to their specific knowledge of certain companies that might not meet the activity thresholds, in determining which companies to include.

c. Consider ranges around the activity thresholds (and allow for regulator judgment) due to the impact of companies entering / exiting the group on the consistency of trends in the results.

d. Consider other criteria besides these specific (and more easily measurable) activities, such as the impact of downgrades on highly rated (or other) companies, the size of illiquid asset portfolios, significant blocks of variable annuities, stable value products, and other ALM / mismatch criteria, etc.

4. Overall, we support the stress test approach outlined and believe that it strikes a good balance between principle-based and prescription. We have the following comments for your consideration:

   a. While we agree with the comment that the baseline scenario should show positive cash flows over a period of time, we believe that there may be instances in which companies have substantially negative cash flows in a baseline projection within a narrow window that may require sales of assets. We suggest that this be contemplated since it is material to liquidity risk.

   b. In addition to the potential for asset sales, we encourage the Subgroup to also carefully consider other issues that may arise that would impact, or be impacted by, liquidity needs. This includes requirements for posting collateral.

   c. To the extent that the stress scenarios include a focus on market volatility, an additional consideration may also be the potential impact on asset repayments and prepayments that would diminish expected cash inflows from assets.

   d. We would recommend that in considering stress scenarios that impact cash flow needs through increases in demands from the liability side of the equation and the ability to satisfy those needs by relying on asset liquidity, the Subgroup should not rely solely on historical experience. The Subgroup should also consider how asset markets have changed and how insurer products have evolved, and take into account what that might mean in assessing appropriate stress scenarios. For example, commercial mortgage loans have become more standardized which should improve their liquidity. The experience of recent market downturns on the other hand have shown the potential for loss of liquidity in structured securities in a stressed environment. Life insurers' annuity products have also evolved to allow for increased liquidity for policyholders and reduced surrender charges.

   e. In conjunction with the existing commentary for the "What If" variation of the 2008 Financial Crisis scenario regarding limited use of other funding sources, we would suggest you should explicitly require disclosure of the extent to which insurers have assumed a delay in payment of policyholder benefits (which is currently allowed in some insurance contracts) or new sales.

   f. For both regulator-prescribed scenarios, we suggest including guidance regarding reinsurer default risk. Since both scenarios involve a higher credit default environment, the risk of reinsurer default will increase and should be taken into account in the analysis.

   g. Related to the issue above, we recommend also considering the potential impact of a life insurer not being able to renew reinsurance contracts with both traditional reinsurance and capital markets instruments (i.e., insurance linked securities).

   h. Since the assumptions regarding policyholder behavior are critical to the analysis, some additional guidance may be useful to increase the consistency of the responses. We agree with the approach of using company-specific assumptions, but including requirements that the assumptions be "moderately adverse" or specifically requiring that companies apply dynamic behavior assumptions for products expected to exhibit such behavior may help to enhance consistency.

We would be happy to discuss these comments with the Subgroup at your convenience.