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February 6, 2020

Commissioner Marlene Caride
Chair, Financial Stability (EX) Task Force
National Association of Insurance Commissioners (NAIC)

Justin Schrader
Chair, Liquidity Assessment (EX) Subgroup
National Association of Insurance Commissioners

Via email to: tnauheimer@naic.org

Dear Commissioner Caride and Mr. Schrader:

On behalf of the Macroprudential Task Force (MPTF) of the American Academy of Actuaries,[1] I appreciate the opportunity to offer comments on the exposed draft NAIC Liquidity Stress Testing (LST) Framework.

The MPTF welcomes the release of the draft framework. We agree that regulators should move to capture the impact on broader financial markets of aggregate asset sales under a liquidity stress and that liquidity stress testing can provide helpful insights. In our letter, we suggest three areas where additional consideration and refinement of the draft framework seem warranted.

1. A realistic implementation timeline should be followed.

The exposure characterizes the LST exercise as a component of the NAIC's work on macroprudential surveillance. For such surveillance initiatives, we expect that the NAIC will provide findings to other supervisors or even issue a public communication that characterizes the "outward" liquidity risk that the insurers pose to capital markets in times of stress.

While we acknowledge that the exposure describes the early years of the exercise as "iterative," it nevertheless positions 2020 as the first year of "implementation." A stress testing application that is implemented with undue haste could result in communications that substantially overstate or understate the liquidity-related systemic risk that the industry poses to the financial sector and the economy as a whole. As a consequence, we believe that the LST framework must be developed with deliberation and care.

[1] The American Academy of Actuaries is a 19,500-member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

Within the draft framework, meanwhile, a number of issues appear to be unresolved or unclear, including fundamental issues involving the scope of entities involved, granularity, and assumptions. For example, the exposure lacks clear guidance on whether, or under what circumstances, entities outside of the United States should be included in the exercise. It is also unclear whether there is an intended difference between the granularity of *testing* and the granularity of *reporting*. In the absence of additional development of the framework, varying interpretations and implementations appear to be likely. This could compromise the relevance of the aggregated data and the conclusions drawn from the exercise.

We are also cognizant of the importance of having reliable results. Given that this is a new initiative, some insurers might need to create the necessary modeling infrastructure and reporting controls to meet NAIC requirements. Liquidity modeling is complex, and, as the exposure notes, companies have tended to develop customized approaches that they deem suitable for their unique needs and risk profiles. The NAIC's proposed approach, while providing for a degree of flexibility, could be challenging for some companies to implement in a manner that ensures reliable results in time for a 2020 implementation.

In light of the above, it seems premature to characterize the draft LST framework as implementation-ready. This accelerated timeline contrasts with the approach taken for other projects such as the own risk and solvency assessment (ORSA), which was subject to three years of voluntary—and yet helpful— work during a pilot project period prior to formal implementation. We encourage reconsideration of the proposed timeline and potential 2020 implementation. At a minimum, we recommend that the sharing of any findings and conclusions from the 2020 application be limited to U.S. insurance regulators.

2. The proposed liquidity scenarios should be further developed.

The two proposed LST scenarios embed markedly different levels of regulatory prescription. The first, "2008 Financial Crisis," uses Federal Reserve assumptions extensively, while the second, "Interest Rate Spike/Industry Outlook and Downgrade Scenario," has much less prescription. Although this obvious inconsistency between the two scenarios appears to be intended, it is not explained.

While we do not necessarily believe prescribed assumptions are generally appropriate, additional consistency would be created among company results if the NAIC scenarios were to describe more fully the actual liquidity impacts that are being assessed. For example, it is not clear whether insurers should assume a "mass lapse" shock in the spike scenario. A consistent understanding of the intended liquidity impacts would encourage companies to adjust their models in a manner that achieves more consistent outcomes.

3. An intended level of stress severity should be described, and scenarios should be developed in a manner consistent with the intended level.

The MPTF recognizes that an element of expert judgment is inevitably required when developing appropriate stress scenarios. A stress that is insufficiently severe may not yield meaningful insights, while a stress that is excessively severe may lead to unwarranted conclusions and concerns.

Recognizing the inevitability of judgment, we nevertheless believe it would be helpful for the NAIC to characterize, qualitatively, the intended level of stress. Specifically, it is our sense that the “what-if” variation to the 2008 financial crisis-like scenario embeds an excessively severe level of stress. The 2008 financial crisis-like scenario is already modeled on the more severe of the two stress tests set by the Federal Reserve Board under the Dodd-Frank Act, and the “what-if” variation makes it more severe by placing restrictions on an insurance group’s ability to respond to a market crisis using typical management tools. In the absence of a descriptive goalpost, however, it is difficult for us to conclude whether the “what-if” scenario is either inconsistent or consistent with the regulators’ own objectives for the exercise.

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The MPTF stands ready to answer questions and assist with the continued development of the LST framework. Should you have any questions or comments regarding this letter, please contact Ian Trepanier, life policy analyst at the Academy (trepanier@actuary.org).

Sincerely,

Jeffrey Johnson, MAAA, FSA
Chairperson, Macroprudential Task Force
American Academy of Actuaries