

FINAL

Summary of Comments From the American Academy of Actuaries' Liquidity Work Group On the Life Liquidity Risk Working Group of the Life Insurance & Annuities (A) Committee's Draft Final Report October 31, 2001

Background

The American Academy of Actuaries' Life Liquidity Work Group reviewed a working draft of the report of the NAIC's Life Liquidity Risk Working Group of the Life Insurance & Annuities (A) Committee.

The comments below represent the thoughts of the American Academy of Actuaries' Life Liquidity Work Group as a whole, and do not necessarily represent any individual's opinion or the opinion of their employer.

The Academy's Life Liquidity Work Group recognizes that this is a draft, and subject to change. Therefore, some of the comments below may no longer be applicable.

Overview

The Academy work group recognizes that liquidity is an important facet to risk management, and therefore salutes the NAIC's Life Liquidity Risk Working Group for tackling this subject. The Academy's task force is in agreement with most of the NAIC's Working Group report. There are, however, a few areas that the Academy would like to comment on.

Prototype Spreadsheet

The major recommendation of the Academy work group is to consider eliminating the prototype spreadsheet.

The prototype spreadsheet is a disclosure on institutional business and does not, in the Academy work group's opinion, demonstrate a company's exposure to stress liquidity risk. Grouping of business by product "name" and type of policyholder contradicts the Academy work group's position that stress liquidity risk is a function of many factors, including but not limited to product design, policyholder sophistication, and supporting asset strategies. The spreadsheet includes liabilities with potentially little to no stress liquidity risk. It excludes both non-institutional liability liquidity risks and a supporting discussion of offsetting asset strategies. The Academy work group believes that these flaws will create misunderstanding and confusion rather than enhance the reader's understanding of stress liquidity risk exposure for an individual company.

The prototype spreadsheet deals predominantly with rollover/refinancing risk and secondarily with stress liquidity risk. Rollover risk is the risk that scheduled maturing outflows from large blocks of business all occur within a tight timeframe, potentially forcing the insurer to liquidate assets under adverse conditions. This risk focuses on predictable cash flows and the company's ability to fund

these flows. High rollover/refinancing risk can be determined by comparing the maturity structure of the liability portfolio with the cash inflows from the underlying assets. Stress liquidity risk focuses on unpredictable cash needs, when the timing of cash demands is in the hands of the customers. Moody's (and S&P) are interested in both types of risks. When the spreadsheet asks for a display of putable funding agreements, it addresses stress liquidity risk. When the spreadsheet asks for projected cash outflows, it addresses rollover risk. In essence, the spreadsheet asks for information on routine transactions that require liquidity. These same transactions do not necessarily impact stress liquidity.

The definitions of "Funding Agreements" and "GICs" are not clearly spelled out. Terminology used to name funding products is very inconsistent throughout the industry, and product diversity is very broad. Terms such as "putable" may not mean the same thing to every company. Interpretations range from paying book value on demand to a market-value-out feature. If a contract allows the insurer to delay payment for three months under certain conditions, it will be up to the issuing company to decide how to reflect this provision in the exhibit. Different companies would report very different products on the same line, since product features vary widely. (For example, Company A's "GIC" may be a ten-year guaranteed product with no possibility of early withdrawal. Company B's "GIC" may offer market value liquidation of the contract at the customer's discretion.) It is therefore possible that interpretations of the request will be inconsistent from company to company, and very likely result in an incorrect analysis when used by regulators, customers, or other analysts.

In conclusion, the Academy work group believes that the prototype spreadsheet is highly susceptible to misinterpretation and does not clearly address stress liquidity risk exposure. If the spreadsheet were to be modified sufficiently to present a comprehensive view of stress liquidity risk, it would rapidly become unwieldy. Therefore, the Academy work group prefers the approach of New York's Circular Letter 33 (2000), where a series of questions were asked of the company, with the potential of additional follow-ups as needed to clarify any unclear issues.

Timing of Reports

Things do move quickly. In Section 5, the NAIC work group may want to consider whether quarterly notifications to communicate any material changes should be considered.

Summary

We realize that the subject being covered in the NAIC Life Liquidity Risk Working Group, i.e., liquidity and risk management, is very important to the health of the insurance industry. We look forward to continuing to work with the regulators on this topic.

If you have any questions on this report, please contact the chair of the Academy's Liquidity Work Group, Donna Claire, at (631) 269-1501, or the vice chair, Laura Rosenthal, at (617) 572-8565.