FINAL

Summary of Comments
From the American Academy of Actuaries' Liquidity Work Group
On the Life Liquidity Risk Working Group's
Revised Draft Prototype

January 31, 2002

Background

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

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

The Work Group recognizes that this is a draft and subject to change.

Overview

Liquidity is an important facet to risk management, and the Work Group appreciates the efforts undertaken by the LLRWG. In October 2001, the Work Group submitted comments that essentially recommended that the prototype spreadsheet be eliminated. Despite some significant revisions to the prototype spreadsheet, the Work Group's recommendation still stands. The reasoning behind this recommendation is explained in the following report.

Focus of the Disclosure

From the information shown in the spreadsheet, it is not clear to the Work Group as to what question the LLRWG is really trying to address. Based on past discussions and communications, it seems that the LLRWG wants to determine each company's exposure to stress liquidity risk. If this is the case, the proposed prototype cannot be used because it ignores the company's assets, and it is a point-in-time exhibit, which will be out of date when finally published.

If the LLRWG is trying to determine the size and nature of a company's institutional business, then the prototype needs to be carefully constructed to elicit the desired information. Terminology in this business is very inconsistent throughout the industry, and product diversity is very broad.

In any event, the Work Group suggests that a clear statement from the LLRWG regarding the purpose of the disclosure would help to focus the ongoing discussions.

Unclear Definitions

Regardless of the intent of the questions asked by the LLRWG, any disclosure template must include very clear definitions. The following issues represent a partial list of questions that the Work Group had in understanding the prototype spreadsheet as it appears now.

- Cash Demand: In banking, this term usually refers to demand deposits. These can be withdrawn at book value, and the timing for withdrawals is not predictable. If these characteristics define the term, then scheduled maturities and business with market value adjustments can be excluded.

- Short-Term Cash Demand: This term is in the title of the exhibit, but business with 180- and 360-day puts does not seem "short term."

- Putable: Usually a putable contract is one that can be put back at par. This would exclude any contracts where the putable amount is less than par (e.g., with market value adjustments).

- Commercial Paper: This can be construed as either an asset or liability. Although the Work Group assumes that the line refers to commercial paper issued by the company, a definition in the instructions would help.

- Other Non-Putable Funding Agreements: If these contracts do not have a feature that allows for accelerated payouts, it does not seem reasonable to include them in this exhibit.

- GIC: The Work Group assumed that GICs with a specified maturity structure were to be included, but that GICs with evergreen provisions or those which are experience rated would not be.

- GIC vs. Funding Agreement: These contract types can be very similar. How does the LLRWG define the difference? Does this difference merit showing them on separate lines?

- EMTNs/GMTNs: Companies that do not issue European or Global Medium Term Notes (EMTN/GMTN) do not know what this line refers to. Also, almost all EMTN/GMTN business is not putable (i.e., offers no options to contractholders to accelerate payments) and probably does not present much of a stress liquidity risk.

- Which companies must complete the exhibit? Do companies that issue commercial paper but have no institutional business still have to fill it in?

- What is intended by the last line on the exhibit? It seems that if the exercise of "cash demand" is contractually limited and therefore unlikely, most companies would not include these amounts in the upper part of the table. Perhaps this line is to represent Corporate Owned Life Insurance or Bank Owned Life Insurance (COLI/BOLI) forgiveness.

In summary, any exhibit in the Annual Statement regarding this business must have extensive instructions and very clear definitions. Without them, companies will interpret the terms inconsistently, even while trying to complete the form correctly.

Alternative Suggestions

If the intent of LLRWG is to enhance state regulators' understanding of how companies manage and measure their exposure to stress liquidity risk, the Work Group continues to recommend the approach used in New York's Circular Letter 33 (2000). Its in-depth questions cover both assets and liabilities, as well as ongoing strategies to manage potential liquidity crises. At a minimum, the Circular Letter offers a start to a meaningful discussion between the company and the regulators.

Alternatively, if liquidity management is to be included in the Annual Statement, the Work Group suggests including additional questions in the General Interrogatories section. Examples of possible questions are as follows:

- "Does the company have a liquidity process in place, including liquidity measures?"
- "Does the company have a formal liquidity plan?"
- "Has the company filed a description of its liquidity management process with the regulators in

If the focus of the LLRWG is to publicly disclose certain information about a company's institutional business, then the Work Group would be pleased to help develop a meaningful exhibit.

Summary

Liquidity risk is a very important issue to both insurers and regulators. However, it is a very complex risk to analyze. It is not clear to the Work Group whether the LLRWG wishes to focus completely on stress liquidity risk or whether it has shifted its focus to disclosure of various features in institutional products. The Work Group is concerned that if unbalanced, loosely defined and inconsistent data are presented in a public document such as the Annual Statement, uninformed readers are likely to draw erroneous conclusions. We look forward to continuing discussions 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.