May 13, 2019

Financial Stability Oversight Council
Attn: Mark Schlegel
1500 Pennsylvania Avenue NW, Room 2208B
Washington, DC 20220

RE: 12 CFR 1310, Appendix A to Part 1310—Financial Stability Oversight Council Guidance for Nonbank Financial Company Determinations (RIN 4030-ZA00)

On behalf of the Financial Regulatory Task Force (the Task Force) of the American Academy of Actuaries1 (the Academy), I am pleased to submit comments to the Financial Stability Oversight Council (the Council) on its proposed new interpretive guidance on nonbank financial company determinations.

The Academy assists public policymakers on all levels by providing objective expertise and actuarial advice on a wide array of risk and financial security issues that require the special set of skills and qualifications that actuaries offer. Many of today’s most pressing public policy financial issues require the application of sound actuarial principles.

The Task Force is pleased to offer our support to the Council wherever actuarial and insurance industry expertise might be helpful. In particular, we believe that this effort to update the interpretive guidance and move toward an activities-based approach to identify, assess, and address potential risks and threats to U.S. financial stability is a positive step that we are pleased to support.

Another overarching comment that we offer is that it is equally important to assess risk mitigants alongside sources of inherent risk in the financial system and broader economy. As the Council assesses activities that have the potential for amplifying risks, there should simultaneously be consideration of the impact of risk mitigants that reduce risk or reduce the potential for amplification. In that regard, insurance itself is, in general, a tool for risk mitigation, through risk pooling, risk diversification, and risk sharing. Our view is that insurance itself is not, inherently, a source of systemic risk.

1 The American Academy of Actuaries is a D.C.-based 19,500-member professional association whose mission is to serve the public and the U.S. actuarial profession. Academy members include consultants, corporate executives and staff, regulators, government officials, academics, and retired actuaries. Their areas of practice cover pensions, life insurance, casualty insurance, health insurance, financial reporting, risk management, and more.
We also offer the following in respect to specific questions posed in the Request for Comments:

Question 1. Does the Council’s proposal described above to prioritize its efforts to identify, assess, and address potential risks and threats to U.S. financial stability through a process that emphasizes an activities-based approach allow the Council to achieve its statutory purposes? Should the Council’s proposed approach to the activities-based approach be modified for other considerations?

As reflected in our general comments, we believe that an activities-based approach, appropriately crafted and executed, can allow the Council to achieve its statutory purposes effectively.

Activities occur within and are affected by the regulatory context, of course, and the Council might consider that interaction as well. For example, some regulatory actions could have entirely unintended, adverse impact on systemic risk potential; regulators could consider adding, as a regular component of their review of new regulatory requirements, an assessment of the systemic risk potential of the new requirements on the affected parties.

Question 5. The Proposed Guidance identifies certain characteristics that may amplify potential risks to U.S. financial stability arising from products, activities, or practices. Are the proposed characteristic examples (including asset valuation risk or credit risk, leverage, and liquidity risk or maturity mismatch) appropriate? Are there additional characteristics that the Council should consider, or are any of the identified criteria inappropriately specified?

The Council should consider the impact of risk mitigants, not just characteristics that could amplify potential risks. Potential mitigants include hedging, risk-sharing arrangements, and reinsurance and similar activities in an insurance context.

Question 6. Are the four framing questions described in the Proposed Guidance for evaluating potential risks appropriate?

The four framing questions are appropriate in evaluating potential risks, as demonstrated through risks exposed and experienced in the 2008 financial crisis. It might also be appropriate to consider whether the framing questions are general enough or are too anchored in the context of the last financial crisis and its specific history and dynamics. We recommend the Council remain alert to new dynamics that could underlie the next crisis. For example, the Council could consider scenarios where the precipitating risk events occur first in the larger economy and then propagate to and through the financial system.

Question 7. Should the Council make any changes to step two of the activities-based approach, as described in the Proposed Guidance?

Step two sets out a reasoned and methodical approach to address risks identified in step one, with extensive consultation and communication with and among impacted
companies and their primary regulators. The Council may also wish to consider and prepare processes for addressing risks that can propagate and amplify rapidly and therefore may need expedited corrective action by the Council and other regulators.

Question 8. The Proposed Guidance describes a uniform analytic framework for determinations that would be applied across industries; are there industry specific factors that should be addressed in the Proposed Guidance?

Industries are distinct in their characteristics. While banking emphasizes maturity transformation, insurance typically does not. Banks have large liabilities potentially payable on demand. Many insurance liabilities, in contrast, can be long term and are payable only in the event of an insured event. Even then, the obligation may be payable only after a settlement process that can, in some cases, be lengthy. Also, each industry has its distinct risk-mitigation techniques. For insurance, these can include hedging, matching of asset and liability, reinsurance, and other mechanisms. Applying the same criteria across industries might miss key factors that should be considered for a particular industry. The analysis should at a minimum consider the key factors and key risk mitigants for each industry under stress.

Question 12. The Council may consider various types of exposures that counterparties and other market participants have to a nonbank financial company, which the Proposed Guidance notes are highly dependent on the nature of the company’s business. Are there other unique types of exposures that such parties may have to a nonbank financial company, or factors that may mitigate the risks posed by these exposures? How should the Council take into account any such mitigating factors in its analysis?

Regarding other types of exposures, the Council might consider the roles and resilience of intermediaries that are critical to market functions.

Regarding risk mitigation, the techniques actually used should be taken into account in assessing the risk exposures that companies have. Insurers, for example, commonly mitigate risk through diversification of independent, or partially independent, risks; capacity limits; liquidity monitoring with attention to the time dimension of liquidity need and liquidity generation; asset and liability matching; monitoring of capital and reserve sensitivity to reinvestment scenarios; reinsurance (including quota share, catastrophe, and stop loss coverage); etc.

Question 13. The Council may consider a company’s liquidity risk, based on a set of proposed factors (short-term financial obligations, financial arrangements that can be terminated by counterparties and therefore become short-term, etc.) when evaluating the asset liquidation channel. Are there other factors the Council should consider, in addition to those proposed? Is there an appropriate time period during which the Council should evaluate a company’s liquidity risk, tailored for specific types of financial products?

Insurers commonly assess their own liquidity requirements and available liquidity over several distinct time horizons—for example, over 90 days, 180 days, and one
year—to assess the company’s resilience to stressed-liquidity draws over each horizon. The size of the entity can be a relevant factor in assessing amounts available by timeframe. The question, as stated, focuses on “company” liquidity risk, but market risks are important as well. From a marketwide or macroprudential perspective, the ability of the financial markets to absorb correlated stress liquidation demands from multiple market participants should be assessed.

Question 14. The Council may also evaluate a company’s leverage when evaluating this transmission channel, based on a set of proposed factors (including total assets and total debt measured relative to total equity, and derivatives liabilities and off-balance sheet obligations relative to total equity). Are there other factors the Council should consider, in addition to those proposed? How should the Council assess the effects of a company’s leverage in this channel?

The callability of liabilities is important, not just leverage. And callability likely will vary by activity or even by individual contract terms. Callable liabilities can also vary in how quickly they must be satisfied if called, thus carrying liquidity implications that may differ by time horizon. Attempts to compare leverage across industry sectors will need particular care because of these and other differences in the nature of the liabilities and the determination of their financial statement values.

Items like derivative liabilities should be viewed in the context of their use—whether they are speculative or used as a risk-mitigation technique. If used for hedging, one should assess the timeframe/liquidity needs arising from any systematic hedging program.

Again, the macroprudential view is important: The Council should consider the potential for correlated liquidity demands by multiple market participants.

Question 24. How should the Council address uncertainty (for example, using alternate baselines or sensitivity analyses)?

In the insurance industry, stress and scenario testing is commonly used to address uncertainty in the future environment, sometimes evaluating prescribed stresses and sometimes evaluating company-specific risks and stresses—for example, in an “own risk & solvency assessment” (ORSA). Modeling of future asset and liability cash flows under a range of deterministic financial market stress scenarios, or across a set of stochastically generated scenarios, is also an approach often used.

Question 28. What metrics or factors should the Council consider when attempting to quantify the likelihood of a company’s material financial distress? If such quantification is not possible with respect to a specific company, what additional factors should the Council consider? What are the appropriate methodologies or models (including appropriate time horizons and assumptions) to assess the likelihood of a nonbank financial company’s material financial distress?

For insurance activities, a qualified actuary could be engaged to model, scenario test, and provide an opinion on the risk of material adverse deviation. Similar to our
comment on Question 24, stress and scenario testing is commonly used in the insurance industry to address the likelihood of future financial distress. This could include estimates of the full range and implications of tail outcomes as contrasted with the traditional banking approach to truncate results above a predefined level.

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Thank you for this opportunity to provide comments to the Council. We hope these comments are helpful. If you have any questions or would like to discuss this letter in more detail, please contact Vaun Cleveland, the Academy’s policy analyst for risk management and financial reporting, at 202-785-7851 or cleveland@actuary.org.

Sincerely,

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