FINAL

Summary of Comments
From the American Academy of Actuaries' Liquidity Work Group
On the Life Liquidity Risk Working Group's
"Fund Demand Disclosure for Institutional Business"

May 30, 2002

Background

The American Academy of Actuaries' Life Liquidity Work Group (Work Group) reviewed a working draft (dated April 19, 2002) of the "Fund Demand Disclosure for Institutional Business" proposed by the NAIC's Life Liquidity Risk Working Group (LLRWG) of the Life Insurance & Annuities (A) Committee. There were some modifications to this draft as a result of the LLRWG conference call of May 3, 2002, and those modifications were reflected in the Work Group's discussions.

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.

Overview

While liquidity is an important facet to risk management, the Work Group retains its earlier recommendation that the proposed disclosure not be included in the Annual Statement Blank. The Work Group asserts that any liquidity exhibit must also include appropriate asset information and that because of the complex nature of the risk, no simple exhibit can be developed that will clearly display potential weaknesses in corporate liquidity management. New York's Circular Letter approach continues to be the tool most supported by this group.

Despite this recommendation, the Work Group appreciates the efforts undertaken by the LLRWG and wants to assist in development of any disclosure that the LLRWG deems necessary. The current format of proposed disclosure is definitely an improvement from the initial proposal. The comments that follow are intended to help with some of the definitional and format issues that were raised during the LLRWG conference call of May 3, 2002.

Wording of the Instructions

The key definition is "institutional business". This definition determines exactly which products and associated amounts are to be included in the disclosure. The following changes to the current instructions are recommended:

1. Set the minimum dollar amount to $10,000,000 rather than $100,000. The Work Group is concerned that the smaller amount will lead to excessive "false positives" by including many retail policies that represent minimum risk. These comparatively small amounts usually don't represent the sophisticated customers that "institutional" seems to imply.

If the LLWRG is concerned that smaller companies may then be exposed to stress liquidity risk that will not show up on the exhibit, an alternative definition is suggested: The lesser of $10,000,000 or 10 percent of company surplus (where the size of surplus is that shown in the prior year's Annual Statement). This is similar to the definitions in New York's Circular Letter.

It was mentioned that the LLRWG was concerned about potential "game playing" if the $10,000,000 figure was used. The Work Group's response was that carriers who do this type of business would not risk alienating sophisticated customers by suggesting contracts of $9,999,999, which would start a potential uncomfortable line of questioning. Large carriers don't think that showing contracts of this size in the Annual Statement is worth risking customer satisfaction.

2. Aggregating business among various lines of business poses a concern to multi-line carriers. The Work Group agrees that the common control minimum should include all cash demand products issued by the carrier. However, some products carry very little liquidity risk (e.g., long-term care products), which technically must be aggregated. And administratively, it can be very difficult to search for one owner across all product lines.

3. Separate accounts should only be included in the exhibit if their guarantees could potentially affect the General Account. The Work Group suggests including only the contractual cash demands in the Separate Account that can exceed the available amounts already in the Separate Accounts.

4. Regarding how much of a contract should be reported, the current instructions require that the total amount of the contract should be included, even if only a portion is maturing. This is likely to overstate a company's demand position. For example, a GIC may mature in installments over a five-year period. If only one fifth of the contract will mature within one month, showing the entire contract as maturing in one month is confusing and, the Work Group believes, was not intended.

5. The last sentence in the current instructions says that a "put" gives the contractholder the unilateral right to accelerate payment for "any reasons specified in the contract". As currently stated this would include employee benefit withdrawals under GICs and GICs that can only get a return of cash when the plan terminates or faces other major trauma. The Work Group doesn't think this was the intention of the LLRWG. Rather, the phrase was intended to include possible downgrade puts, which are a potential liquidity risk.

Here is a re-write of the instructions, based on the Work Group's comments:

Instructions:

- Institutional Business is defined as business in the company for which a single person or entity controls an aggregate (across products or markets) of $10,000,000 or more of cash demand.

- The cash demand is limited to the General Account plus any guaranteed contractual demand in the Separate Accounts that can exceed available cash in those accounts.

- A "Put" is a contractual provision where the contractholder has the unilateral right to accelerate amounts due under the contract for any reason OR if the amounts may be withdrawn due to the financial deterioration of the issuer.

- "Non-Exercised Puts" are the only amounts shown where the timing of the cash payment is unknown. Time periods in this section represent the earliest dates that cash must contractually be paid out, assuming that all puts on in-force business become exercised on the Statement Date. Also assume that the company exercises any of its contractual rights to defer, limit, restrict or make payments in installments. Amounts shown as maturities or exercised puts cannot be paid out earlier.

- Only the amounts that can be withdrawn or will mature within the stated timeframe should be shown in the exhibit.

- Amounts due at book value include amounts subject to a surrender charge, unless that charge is market-based and is a reasonable proxy for a full market value adjustment.

Format of the Exhibit

The proposed disclosure is very similar to that offered by the group of interested parties dated January 31, 2002. However, the intent of the interested parties was to focus on unknown cash flows rather than those that can be planned for. The Work Group recommends that Section 1 of the current disclosure form (Non-Exercised Puts Only) be kept and that the other sections be eliminated. If the LLRWG wants some history of put experience, Section 3 (Exercised Puts Only) could be kept. The Work Group believes that Section 2 (Maturities) is not really "Fund Demand" in that these cash outflows are known and can be planned for. If the LLRWG wishes to retain this section showing maturities, the line for "Amounts Due at Market Value" should be eliminated because book and market values are equal for maturing business.

General Interrogatories

In the Work Group's comments of January 31, 2002, some possible questions were suggested for the General Interrogatories section of the Annual Statement. The LLRWG asked that these be reworked for clarity. The revised questions are as follows:

- Does the company have a liquidity management process in place where results are reported periodically to the Board?
- If not, why not?

Conclusion

Liquidity risk is a very important issue to both insurers and regulators. However, it is a very complex risk to analyze. The Work Group recommends that disclosure of liquidity risk in the Annual Statement be confined to any questions posed in the General Interrogatories section. If the LLRWG wishes to add an exhibit on the stress liquidity risk in Institutional Business, it is recommended that the disclosure be limited to Section 1 of the current proposal (Non-Exercised Puts). The Work Group is also concerned that including too much business under the heading "Institutional" will lead to a distortion of the results and more work for regulators to unravel the true underlying risk. We believe that the changes to date in the proposed disclosures are in the right direction and 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.