FINANCIAL STABILITY (EX) TASK FORCE

Financial Stability (EX) Task Force Aug. 5, 2019, Minutes
Liquidity Assessment (EX) Subgroup May 10, 2019, Minutes (Attachment One)
The Financial Stability (EX) Task Force met in New York, NY, Aug. 5, 2019. The following Task Force members participated: Marlene Caride, Chair (NJ); Eric A. Cioppa, Vice Chair (ME); Ricardo Lara represented by Susan Bernard (CA); Andrew N. Mais and Kathy Belfi (CT); David Altmaier and Ray Spudeck (FL); Doug Ommen (IA); Dean L. Cameron represented by Eric Fletcher (ID); Gary Anderson represented by James A. McCarthy (MA); Chloria Lindley-Myers represented by John Rehagen (MO); Bruce R. Ramge represented by Justin Schrader (NE); Jessica Altman represented by Melissa Greiner (PA); Raymond G. Farmer (SC); Carter Lawrence represented by Trey Hancock (TN); Kent Sullivan represented by Mike Boerner and James Kennedy (TX); and Scott A. White represented by Doug Stolte (VA).

1. **Heard Opening Remarks**

Commissioner Caride introduced Timothy Nauheimer (NAIC) who, going forward, will be the lead staff support for this Task Force and the coordinator of all things macro-prudential, both domestic and international.

2. **Adopted its Spring National Meeting Minutes**

Commissioner Altmaier made a motion, seconded by Superintendent Cioppa, to adopt the Task Force’s April 8 minutes (see NAIC Proceedings – Spring 2019, Financial Stability (EX) Task Force). The motion passed.

3. **Adopted Liquidity Assessment (EX) Subgroup’s May 10 Minutes**

Commissioner Altmaier made a motion, seconded by Superintendent Cioppa, to adopt the Liquidity Assessment (EX) Subgroup’s May 10 minutes (Attachment One). The motion passed.

4. **Heard an Update on FSOC Developments**

Superintendent Cioppa reported that since the Spring National Meeting, the Financial Stability Oversight Council (FSOC) met in closed session to hear a presentation on comments submitted in response to its proposed interpretative guidance on nonbank designations. He added that the FSOC continues to evaluate those comments as it works toward finalizing that guidance. He also reported that the FSOC received an update on U.S. nonfinancial corporate credit and leveraged lending, which is an important issue that the NAIC has also been monitoring.

5. **Received an Update from the Receivership and Insolvency (E) Task Force on its Work to Address the Financial Stability (EX) Task Force’s Referral Letter to Undertake Analysis Relevant to the MPI**

Mr. Kennedy reported that the Receivership and Insolvency (E) Task Force continues to work to address the Financial Stability (EX) Task Force’s referral letter to undertake analysis of resolution and recovery concerns important to financial stability as part of the Macropрудential Initiative (MPI). First, amendments to NAIC Guideline #1556, highlighting the fact that a federal rule does not recognize state-based temporary stays on terminating master netting agreements for qualified financial contracts in a state receivership proceedings, are being sent to the Financial Condition (E) Committee and Executive/Plenary for consideration by the Fall national meeting. Second, a new charge has been assigned to the Receivership Model Law Working Group to explore if bridge institutions could be implemented under the administrative supervision of an insurer, essentially, pre-receivership. Third, imposing recovery plan reporting requirements on insurers that are not in financial distress is outside the scope of the Receivership and Insolvency Task Force, and thus other working groups of financial regulators would be more appropriate to consult. However, as the IAIS is expected to work on an application paper for resolution planning in the near future, the Task Force will review and provide input in the development of that paper. Fourth, the Receivership Model Law Working Group will be charged with developing updated guidance to help receivers in the area of taxes in receivership and federal releases. Fifth, the Receivership Model Law Working Group will be asked to consult with the Group Solvency Issues (E) Working Group and further discuss possible remedies and/or guidance for addressing continuity of essential services of non-regulated entities. Finally, the Task Force adopted the recommendation to undertake the task of considering methods for encouraging states to adopt provisions in law that address key areas of receivership in order to enhance efficiencies and effectiveness of the receivership process, including potential Accreditation program change recommendations.
Draft Pending Adoption

6. Received the Report of the Liquidity Assessment (EX) Subgroup

Mr. Schrader reported that the Liquidity Assessment (EX) Subgroup met May 10 to discuss the timelines, identify sources and uses of cash flows, types of assets to be monitored for asset sales, types of scenarios, and assumptions underlying a 2008 financial crisis scenario. He noted that the Subgroup met July 30 and June 14 in regulator-to-regulator session, pursuant to paragraph 3 (specific companies, entities or individuals) of the NAIC Policy Statement on Open Meetings, to discuss liquidity stress test structure and stress scenarios. Mr. Schrader noted that a study group, which is not an official NAIC group, has been meeting to inform the Subgroup. In particular, the study group identified an initial list of liquidity sources and uses that underlie the cash flow approach that is the basis for the stress test framework. He also noted that the study group identified an initial set of asset classes or categories for the purposes of grouping asset sales under stress. He said the study group is discussing the approach to calculate the expected asset sales under stress, which would be a ratio of total expected asset sales to total available assets, that would be modified to incorporate more insurer specific strategies, including the portfolio managers’ views on asset sales. He said the study group has also been discussing what stresses to apply, and it is considering a proposal to borrow from the Federal Reserve’s Supervisory Scenarios for Annual Stress Testing Required under the Dodd-Frank Act Stress Testing Rules. He added that the study group is considering using the economic and market assumptions underlying the Federal Reserve’s severely adverse stress scenario as the starting point for the assumptions grid and building out from there to more granular assumptions needed for insurers to run the stresses through their internal models. He emphasized that the Subgroup will need to make further determinations about market capacity for certain asset classes and other liability related assumptions that may be more unique to the insurance business model.

7. Heard an Update on Leveraged Loans

Eric Kolchinsky (NAIC) reported that leveraged loans are loans made to below investment grade companies, and those loans are often re-packaged into structured pools known as collateralized loan obligations (CLOs). Leveraged loans are a $1.7 trillion market serving below investment grade borrowers, and CLOs are a $615 billion structured security market. Mr. Kolchinsky added that insurance companies have more exposure to CLOs than leveraged loans directly. He noted that leveraged loans are frequently used by private equity firms to finance buyouts, dividends, and mergers and acquisitions. He added that the main difference in historical performance between high-yield bonds and leveraged loans has been the recovery rate, which was about 71% for first lien loans compared to 46% for senior unsecured bonds. He estimates that insurance companies hold approximately $42 billion of leveraged loans as of year-end 2018, with life insurers being the largest holders. He stressed that current concerns with leveraged loans, include being covenant-lite, lack of sufficient subordination, and pro-forma underwriting; i.e. lower standards. He concluded that the combined effect of those changes is that Moody’s estimates that recoveries will drop to 61% for first lien loans from 71% during the next downturn.

Mr. Kolchinsky reported that CLOs are structured finance instruments, which use the proceeds of the sale of notes with various repayment priorities or tranches to buy a pool of leveraged loans with approximately single B ratings. He explained that a manager purchases a portfolio of single B leveraged loans, which then issues several tranches. He added that some notable features of CLOs include that the portfolio is actively managed, and over-collateralization diverts interest and principal from junior notes to pay down senior notes. In terms of impairment, also known as default for bonds, CLOs have historically performed well compared to the impairment rate of other structured finance products and the corporate default rate. He noted that insurance companies had $122 billion in CLO exposure, of which $97 billion was rated NAIC 1. He announced that NAIC staff is running stress scenarios on CLOs and will provide results on a regulator-only basis by early Fall.

Superintendent Cioppa asked about the level of concern that state insurance regulators should have about CLOs. Mr. Kolchinsky responded that he will be able to provide an answer soon, but he did not expect there to be an industrywide issue, but more likely impact a few insurers that are concentrated in this product. Mr. Schrader asked if NAIC staff would be looking closely at the manager of CLOs. Mr. Kolchinsky responded that the NAIC is in the first phase of a stress test, which does not include a review of managers, but if a manager is affiliated with either an insurer or an underwriter, that could impact the pricing of the product.

8. Heard an Update on Macroprudential Surveillance

Mr. Nauheimer reported that the IAIS will be adopting a framework for a holistic approach to assessing systemic risk by November of this year. He added that the approach combines the current individual entity-based methodology for global systemically important insurers (GSIIs) with an activities-based approach. He said the IAIS Systemic Risk Assessment Drafting Group (SRADG) has updated numerous insurance core principles (ICPs) and the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame) to reflect the holistic approach. He said the IAIS has issued a public consultation with comments due on Aug. 15. He added that the SRADG is considering updating liquidity metrics used in the GSII assessment exercise and developing the liquidity risk application paper, which also coincides with liquidity enhancements.
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being developed by the NAIC. He noted that the consultation document is redlined with changes to ICPs 9, 10, 16, 20 and 24 which was sent to members of the Task Force seeking input on initial comments drafted by NAIC staff. He added that any input received from the Task Force will be circulated for consideration by the International Insurance Relations (G) Committee to review and approve submission of NAIC comments.

Mr. Nauheimer reported that the IAIS Macro-Prudential Surveillance Working Group (MPSWG) is responsible for global and sector wide monitoring to detect the possible build-up of systemic risk. He added that the initiative underway by the MPSWG includes the process of collecting data from key jurisdictions for which the NAIC will provide existing regulatory data on a best effort basis by the Aug. 15 deadline. He stressed that the IAIS will aggregate the data with the primary objective of identifying and monitoring systemic risk in the insurance industry worldwide. He said that the IAIS recently completed the quantitative phase of its seventh annual assessment of GSIIIs with the data comprising the same elements as last year and some additional data to support the development of an activities-based approach. He added that later this year, the Financial Stability Board (FSB) will assess the IAIS recommendation to suspend GSII identification; in 2022, the FSB will consider whether to discontinue or re-establish an annual identification of GSIIIs. He concluded that the continued participation of firms in the GSII data collection will facilitate the evolution toward a more holistic framework for assessing systemic risk.

9. Discussed Other Matters

Todd Sells (NAIC) provided an update on Commissioner Caride’s June 10 letter to the Valuation Analysis (E) Working Group. He said the Working Group will address a potential macro-prudential concern related to ESGs developed by the American Academy of Actuaries (Academy), which the NAIC currently prescribes or encourages companies to use in the following situations:

1) Risk-based capital (RBC) for variable annuities and certain annuities or single premium life insurance products.
2) Statutory Reserves for Variable Annuities.
3) Statutory Reserves for Life & Variable Life Insurance.

Mr. Sells reported that in 2017, the Academy notified the Life Actuarial (A) Task Force that it did not have the resources to maintain their ESGs. He added that ESG parameters and calibration criteria will no longer be updated, although the Academy intends to maintain the ESGs in their current form until a suitable replacement can be found. He noted that the Life Actuarial (A) Task Force is working on selecting a third-party vendor to provide those services. He said the Life Actuarial (A) Task Force will consider the impact of low or negative interest rates on the ESGs, which may be a macro-prudential concern for variable annuity reserves in the interim period between now and when the NAIC has found a replacement for the current ESG. He concluded that the Valuation Analysis (E) Working Group will assess this interim concern and address any issues as needed in response to Commissioner Caride’s June 10 referral letter.

Mr. Sells also reported that with respect to the Task Force’s data call related to life annuities, the NAIC received over 500 data call submissions for 2018 year-ends results by the June 28 deadline, which are for state insurance regulator use only. He added that NAIC staff are working to address issues with those files that did not load and investigate other concerns, such as large negative total premiums and discrepancies from amounts reported in the 2018 life blank.

Having no further business, the Financial Stability (EX) Task Force adjourned.

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Liquidity Assessment (EX) Subgroup Conference Call
May 10, 2019

The Liquidity Assessment (EX) Subgroup of the Financial Stability (EX) Task Force met via conference call May 10, 2019. The following Task Force members participated: Justin Schrader, Chair (NE); Kathy Belfi (CT); Philip Barlow (DC); Carrie Mears (IA); Bruce Sartain (IL); Fred Andersen (MN); Bill Carmello (NY); Ray Spudeck (FL); and Mike Boerner (TX).

1. Discussed its Progress

Mr. Schrader stated that a small, unofficial study group comprised of state insurance regulators, industry participants and NAIC staff was formed to consider the specific data needs and technical aspects of the liquidity stress test project for large U.S. insurers that are within the scope. The study group met in person on March 22 and three times via conference call (May 9, April 25 and April 11) to discuss the project, including a timeline for deliverables.

Mr. Schrader added that by the end of May, the study group would like to figure out what the stress output will address and initial thoughts on cash flow inputs and outputs. He said the study group would identify an initial list of liquidity sources and uses to be included in the cash flows, the types of assets to be monitored for asset sales data, and a comparison to market trading volumes. He noted that by the end of June, the study group would: 1) identify a common set of assumptions underlying the 2008 financial crisis scenario; 2) suggest a few additional baseline stress scenarios; 3) identify what legal entities within the group should be included in the stress test; and 4) identify activities, in addition to the six activities used for the scoping exercise, that should be assessed for materiality when determining if a legal entity within the group should be part of the liquidity stress test. He said the proposed timelines are aggressive and may need to be adjusted at a later date.

Mr. Schrader noted that in terms of time horizon for the liquidity stress test, the study group needs to provide support for not prioritizing short-term cash flows for the seven day to two-week time horizons. In addition, the study group needs to provide support for de-prioritizing certain stresses such as cyber, pandemic and sector-wide downgrades.

Mr. Schrader requested that study group members review the Excel template (Attachment 1).

Andrew T. Vedder (Northwestern Mutual) asked for a clarification between available and expected assets. Mr. Schrader responded that the study group defined the difference as follows: available asset sales are assets that could be sold (i.e. the entire portfolio) and expected asset sales are assets that would be sold in certain scenarios.

Mr. Boerner asked if the amount of assets counted is post-haircut. Mr. Schrader responded that the assets would receive a haircut based on certain scenarios.

Having no further business, the Liquidity Assessment (EX) Subgroup adjourned.

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