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Life Liquidity Risk

by Jon E. Niehus

At the recent NAIC spring meeting in Nashville, the Life Liquidity Risk Working Group met. This working group, chaired by Mike Boerner of the Texas Department of Insurance, reports to the NAIC's Life Insurance and Annuities (A) Committee. This working group is continuing to review issues in connection with the liquidity of insurance companies and may complete its work by the end of the year. The major focus of its efforts is to investigate sources of liquidity risk and risk management practices, which may help to alleviate that risk.

The Life Liquidity Risk Working Group is closely related to the Life Risk-Based Capital Working Group. In a December 2000 report, the working group indicated that it would (1) discuss with the Life Risk-Based Capital Working Group the appropriateness and reasonability of adding a charge for liquidity risk to the formula in order to discourage excessive amounts of liquidity risk from being taken; and (2) research whether and how liquidity risk impacts risk-based capital requirements for other financial intermediaries.

Concerns about modeling liquidity risk date back at least ten years. The Society of Actuaries published a *Dynamic Financial Condition Analysis Handbook* in May 1996. However, the recommendations contained in this document have not been widely adopted. Although the RBC has been used for several years now, it is a static formula that could be improved. Regulators believe that the recent modification to the C-3 (Interest Rate Risk) component is a step in the right direction. For several years some rating services (*Best's and Moody's*) have been requesting supplemental information from companies writing certain product lines to assist in evaluating liquidity risk.

The Life Liquidity Risk Working Group arose from an interest in liquidity matters in 1999 by the Life and Health Actuarial Task Force relative to guaranteed investment contracts with bail-out provisions with increased interest subsequent to the General American insolvency. The working group was formed to consider and make recommendations related to products issued by life insurers that have significant liquidity risk (e.g., GIC's with bailout provisions). Areas to be considered include, but are not limited to, appropriate limits on the level of activity by insurers, required and/or prohibited contractual language, reserving methods, reporting requirements and risk management systems for insurers engaged in this activity. The working group is studying whether changing the RBC formula can adequately reflect liquidity risk or whether actuarial modeling needs to be incorporated.

The working group is reviewing work done by banking regulators and by insurance regulators in Canada. The working group has been studying a handbook released in February 2001 by the Office of the Comptroller of the Currency to provide guidance to help examiners and banks understand and manage liquidity risk. The press release announcing the handbook states, "The handbook recommends that bankers use their contingency funding plan (CFP) to integrate liquidity analysis into the day-to-day liquidity management process. The CFP can assist in identifying an appropriate amount of liquid assets, measuring and projecting funding requirements during various scenarios, and managing access to existing and alternative funding sources. The

handbook also advises bankers to evaluate liquidity risk from a number of perspectives, using tools such as a rollover report to identify significant maturity gaps and a funding concentration report to identify changes in significant funds providers." The complete text of this 86-page handbook can be downloaded from *http://www.occ.treas.gov/handbook/liquidity/pdf.*

It appears that the efforts of this working group could result in a significant broadening of the responsibility of the Valuation Actuary. The current Actuarial Opinion deals only with reserve adequacy. Liquidity risk deals with capital adequacy and company solvency. Small companies that fought against the expansion of the Actuarial Opinion and Memorandum Regulation may have only been seeing the tip of the iceberg. Regulators are deeply disturbed and embarrassed by company insolvencies especially of major companies. The issue of liquidity risk is unlikely to go away. For additional information, please contact me by telephone at 800-308-2672 or by e-mail at *jon_niehus-fmsi-actuaries.com*

Jon E. Niehus, FSA, MAAA, is a consulting actuary and principal at FMSI in Deerfield, IL.