ACLI
Financial Security for Life

Brian Bayerle
Senior Actuary

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Mike Boerner
Chair, NAIC Life Actuarial Task Force (LATF)

Re: March Exposure of APF 2020-12

Dear Mr. Boerner:

The American Council of Life Insurers (ACLI) appreciates the opportunity to submit comments on the 3/31 re-exposure of APF 2020-12 (the APF).

ACLI is appreciative of LATF for the continued effort to improve the APF. We believe this draft is a significant step forward to address the regulator concern around modeling of hedges while reducing the potential unintended consequences of the proposal. ACLI has several suggestions to improve upon the APF for the next and hopefully final exposure.

Addressing the inadvertent exclusion of immaterial hedging strategies

In at least one prior draft of the APF, explicit language was included to address immaterial hedging strategies. The APF currently does not contain this language. Based on the verbal comments on the 3/31 call, we believe this was an unintentional omission during redrafting. We support excluding immaterial hedging strategies from the requirements of the APF and have provided a markup of the language in Appendix A.

Improvements in text regarding new and changed hedging strategies in VM-21 Section 9.C.7

ACLI is suggesting a redrafting of this section for completeness and to promote consistent application . Our review of the exposure indicated (1) new hedging strategies were not explicitly addressed, (2) current VM-21 references to experience from a hedging strategy on similar annuity products had been omitted, and (3) there was no explicit instruction to use the results of mock testing in establishing the E factor. Moreover, given that the construct involves multiple layers of nested conditions, we felt that restructuring these provisions in an outline form would be beneficial.

We have provided a revised VM-21 Section 9.C.7 (Appendix B) that reflects all of the above improvements.

Editorial consistency for E-Factors

Through the Valuation Manual, there is an inconsistency with E-Factors, and are sometimes numeric and sometimes percentages. We would suggest revising this consistently, which is inherently an editorial change.

Implementation Date

We respectfully request a January 1, 2024 effective date or an optional 1-year deferral of aspects of the proposal if approved by the domestic regulator. If the former request is not feasible, we would propose an exception under the definition of "future hedging strategy" that, at the option of the company and with domestic regulator approval, hedging strategies that were not CDHS's under the 2022 Valuation Manual do not need to be considered future hedging strategies, however limit this request to 2023 Valuation Manual only (this could perhaps be addressed via a drafting note).

Companies that have hedge programs but not a CDHS, particularly those using the option found in VM-21 Section 4.A.4.a.ii.b, may need significant time and effort to integrate their hedge programs into statutory valuation modeling systems. Along with the large work effort needed to code the hedges into the software, significant additional time will be needed to vet the robustness and integrity of the model and to understand the impact and volatility of results. Many hedge programs are currently designed for and monitored under multiple metrics and we believe that a 2023 implementation will not allow sufficient time for coding plus critical review work to be effectively completed. A rushed implementation could unnecessarily expose companies to potential unexpected financial results, reporting errors, or both. The adoption of VM-21 was thoughtfully preceded by a long period of investigation, testing, and refinement. Rapidly changing a fundamental aspect of VM-21 without adequate lead time could be highly disruptive.

Thank you for your consideration.

cc: Reggie Mazyck, NAIC

Appendix A: Markup to exclude immaterial hedging strategies

VM-20 Section 2.H

The company shall establish, for the DR and SR, a standard containing the criteria for determining whether an assumption, risk factor, future hedging strategy, or other element of the principle-based valuation has a material impact on the size of the reserve. This standard shall be applied when identifying material risks under VM-20 Section 9.B.1. Such a standard shall also apply to the NPR with respect to VM-20 Section 2.G and when determining whether a future hedging strategy must be modeled.

VM-20 Section 6.A.1.b

A company may not exclude a group of policies for which there is one or more future hedging strategies supporting the policies from SR requirements, except in the case where all future hedging strategies supporting the policies are solely associated with product features that are determined to not be material under Section 7.B.1 due to low utilization or when all future hedging strategies are not required to be modeled as per 7.K.2.

VM-20 Section 7.K

K. Modeling of Derivative Programs

1. When determining the DR and the SR, the company shall include in the projections the appropriate costs and benefits of derivative instruments that are currently held by the company in support of the policies subject to these requirements. The company shall also include the appropriate costs and benefits of anticipated future derivative instrument transactions associated with the execution of future hedging strategies supporting the policies, as well as the appropriate costs and benefits of anticipated future derivative instrument transactions associated with non-hedging derivative programs (e.g., replication, income generation) undertaken as part of the investment strategy supporting the policies, provided they are normally modeled as part of the company's risk assessment and evaluation processes.
2. Notwithstanding the above requirements, a company may elect to not model a future hedging strategy if it can demonstrate that not modeling such a strategy does not understate the reserve by a material amount as defined in Section 2.H.

VM-21 1.E

Materiality
The company shall establish a standard containing the criteria for determining whether an assumption, risk factor, future hedging strategy, or other element of the principle-based valuation has a material impact on the size of the reserve or TAR. This standard shall be applied when identifying material risks and whether a future hedging strategy must be modeled.

VM-21 Section 4.A.4

Modeling of Hedges

a. For a company that does not have a future hedging strategy supporting the contracts:

   i. The company shall not consider the cash flows from any future hedge purchases or any rebalancing of existing hedge assets in its modeling, since they are not included in the company's investment strategy supporting the contracts.

   ii. Existing hedging instruments that are currently held by the company in support of the contracts falling under the scope of these requirements shall be included in the starting assets.

b. For a company with one or more future hedging strategies supporting the contracts, the detailed requirements for the modeling of hedges are defined in Section 9. The following paragraphs are a high-level summary and do not supersede the detailed requirements.

   i. The appropriate costs and benefits of hedging instruments that are currently held by the company in support of the contracts falling under the scope of these requirements shall be included in the projections used in the determination of the SR.

   ii. The projections shall take into account the appropriate costs and benefits of hedge positions expected to be held in the future through the execution of the future hedging strategies supporting the contracts. Because models do not always accurately portray the results of hedge programs, the company shall, through back-testing and other means, assess the accuracy of the hedge modeling. The company shall determine a SR as the weighted average of two CTE values; first, a CTE70 ("best efforts") representing the company's projection of all of the hedge cash flows, including future hedge purchases, and a second CTE70 ("adjusted") which shall use only hedge assets held by the company on the valuation date and no future hedge purchases. These are discussed in greater detail in Section 9. The SR shall be the weighted average of the two CTE70 values, where the weights reflect the error factor (E) I determined following the guidance of Section 9.C.4.

   iii. The company is responsible for verifying compliance with all requirements in Section 9 for all hedging instruments included in the projections.

   iv. The use of products not falling under the scope of these requirements (e.g., equity-indexed annuities) as a hedge shall not be recognized in the determination of accumulated deficiencies.

   v. Notwithstanding the above requirements, a company may elect to not model a future hedging strategy when determining the SR if it can demonstrate that not modeling such a strategy does not understate TAR by a material amount as defined in Section 1.E.

VM-31 Section 3.D.11.k

Non-modeled Future Hedging Strategies due to Immateriality – A description of each future hedging strategy that is not modeled due to immateriality, and a statement that the required VM-20 Section 7.K.2 demonstration is available upon request and shows that not modeling the future hedging strategy does not understate the reserve by a material amount.

VM-31 Section 3.F.2.f

Non-modeled Future Hedging Strategies due to Immateriality – A description of each future hedging strategy that is not modeled due to immateriality, and a statement that the required VM-21 Section 4.A.4.b.v demonstration is available upon request and shows that not modeling the future hedging strategy does not understate TAR by a material amount.

Appendix B: Revised language for new and materially changed hedging strategies
(Note: The additions for completeness are highlighted in green.)

VM-21 Section 9.C.7

7. When there is a new hedging strategy or a change to an existing hedging strategy, the E factor shall be set based on the materiality of the change, the amount of experience under the new or changed strategy, the existence of robust mock testing, and various principles and limits, as follows:
    a. For a new or materially changed hedging strategy with less than 12 months of experience, the E factor shall be determined on the following basis.
        i. When the new or materially changed hedging has less than 12 months of experience but not less than 3 months of experience
            1. If there is robust mock testing, the E factor should reflect the amount of experience available, the results of mock testing, and the limits of Section 9.C.4. For new strategies, the E factor should also reflect any historical experience with the strategy on similar products. For materially changed strategies, the E factor should also reflect the degree and nature of change, ~~as applicable; the results of mock testing; the limits of Section 9.C.4; and a margin to~~ including a margin to reflect uncertainty in future hedge effectiveness ~~based on the degree and nature of change, as applicable~~.
            2. Otherwise, the E factor shall be 1.0.
        ii. When the new or materially changed hedging strategy has less than 3 months of experience
            1. If the hedging is associated with a new product or newly acquired block and there is robust mock testing, the E factor should reflect the amount of experience available, the results of mock testing, and the limits of Section 9.C.4. For new strategies, the E factor should also reflect any historical experience with the strategy on similar products. For materially changed strategies, the E factor should also reflect the degree and nature of change, ~~as applicable; the results of mock testing; the limits of Section 9.C.4; and a margin to~~ including a margin to reflect uncertainty in future hedge effectiveness ~~based on the degree and nature of change, as applicable~~. For both new and materially changed strategies, the E factor shall also be subject to a floor of 0.3 unless prior approval is obtained from a domestic regulator to use a lower E factor.
            2. Otherwise, the E factor shall be 1.0 unless prior approval is obtained from a domestic regulator use a lower E factor, in which case the E factor approved by the domestic regulator should reflect the above considerations and limits.
    b. For a minor refinement within a hedging strategy, the E factor may need to reflect a margin to reflect any additional uncertainty associated with the refinement.