Brian Bayerle
Senior Actuary

June 11, 2021

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

Re: APF 2020-12

Dear Mr. Boerner:

The American Council of Life Insurers (ACLI) appreciates the opportunity to submit the following comments on the May 20th re-exposure of APF 2020-12.

In previous letters, ACLI has expressed concern with the direction and implications of this APF. ACLI understands that this APF has been intended for potential adoption or rejection prior to the finalization of the 2022 Valuation Manual. We submit that more time is needed to understand, assess, and deliberate this APF, and request that formal action be postponed until later in 2021. Such a delay is a prudent course of action for the reasons explained below.

1) ***The APF does not appear to address a pressing problem***

ACLI understands that the primary motivations behind the APF are (a) harmonizing CDHS requirements, (b) addressing the guidance note, and (c) addressing “unintended optionality” regarding the fulfillment of CDHS criteria. Of these motivations, the only one that would seem to merit immediate LATF action would be “unintended optionality.” However, the optionality addressed within the APF—which is whether a company can decide to disqualify a hedging strategy from being a CDHS—has been in effect through AG43/C3P2 for more than a decade.

As explained below, given the many disconnects between the statutory framework and other reporting frameworks to which insurers manage, ACLI’s view is that CDHS optionality is entirely appropriate and that new restrictions may have unintended consequences. The remaining motivations seem to lack the same urgency; thus, we ask LATF allow more time to assess the implications of this APF before adoption.

2) ***Stakeholders have had inadequate time to assess the current iteration of the APF***

Since the initial version of this APF was distributed, the industry has faced challenges in assessing it. One recurring challenge is that the APF tends to blur the distinction between

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existing hedges and assumed future hedging transactions within a single hedging strategy, thus creating challenges in understanding and engaging on the APF.

An example of this blurring is proposed language for VM-20, Section 7.K.4, where we believe the intent is to reference future hedging transactions. "If a SHS supporting the policies is not a CDHS but modeling it would result in a material increase to the company's minimum reserve, then the company shall model the SHS as if it were a CDHS when calculating reserves under VM-20." The antecedent of "it" would seem to be the SHS in its entirety, but we understand the intended antecedent to be future hedging transactions associated with the SHS.

In addition, the scope of the APF was only recently revised. As ACLI observed in its April 30, 2021, comment letter, the previous version of this APF could have been interpreted as being relevant to few, if any, hedging programs. The insertion of the word "any" in the most recent version modifies the APF in a manner that vastly expands the number of hedging programs that could be in scope. We believe a 21-day exposure period is inadequate to evaluate the full implications of this change.

3) ***The APF creates inconsistencies within VM-21***

ACLI's evolved understanding of the APF is that it is intended to apply primarily to assumed future hedging within PBR modeling.
Underlying the APF appears to be a view that the statutory framework and non-statutory frameworks are substantially similar. The recent VA reform project, however, was based on a much different paradigm. It acknowledged that the elements of the statutory PBR framework are significantly different than other frameworks to which companies manage, such as GAAP or internal economic capital. The VA reform project recognized that a significant portion of hedging is motivated by non-statutory frameworks, and that hedging motivated by non-statutory frameworks could result in unintuitive and undesirable statutory outcomes. VA reform viewed the reflection of hedging as meriting significant company discretion because different companies employ different hedging strategies for different purposes, and a "one-size-fits-all" statutory rule might work for some situations but might be unintentionally harmful in others.

One new measure introduced within VM-21 to reduce unintuitive outcomes allows companies to liquidate currently held hedges immediately in the CTE "adjusted" run, which is the basis for reflecting non-CDHS hedging strategies. Companies can also choose to run-off existing hedges. Oliver Wyman observed that liquidation "mitigates the penalty on long-dated hedges" created by the then-required run-off approach. The APF, however, would conflict with this measure. As a result of having an SHS that is not a CDHS, the company would seemingly be required to calculate TAR with and without assumed future hedging, and to hold the higher of the two results. If the liquidation option is chosen, the company would be calculating TAR without currently held hedges but with assumed future hedges.

Thus, the APF appears to represent a substantive conceptual departure from the premises under which the treatment of hedging within VM-21 was developed. Adoption of the APF without additional vetting could therefore create a new set of problems for both industry and regulators.

4) ***The potential impact of the APF is extensive, as it attaches to non-statutory hedging frameworks***

The APF creates a new category of hedging strategy called a "Seasoned Hedging Strategy" (SHS), which is a hedging strategy in which future hedging transactions are "normally modeled as part of any of the company's risk assessment and evaluation processes." As a result, the APF brings non-statutory hedging programs into the statutory PBR framework.

We believe several aspects of this result should give regulators pause. First, the U.S. statutory framework is based on fundamentally different underlying concepts than many non-statutory frameworks. For example, some frameworks divorce liability valuation from asset valuation, while statutory PBR makes liability valuation a function of supporting assets. Many non-statutory frameworks have a short-term focus (e.g., one-year modeling for risk management is common), while statutory PBR requires a long-term projection. This is important because reflection of future hedging may be deemed immaterial in a short-term framework, while in a long-term framework some sort of reflection may be more desirable.

Second, inconsistency across the industry is virtually inevitable, as companies are subject to different frameworks. Public companies, for instance, will be subject by law to different types of GAAP reporting, while non-public companies may not do GAAP reporting at all. Internal risk, capital, and liquidity management frameworks will differ, as will product pricing and business planning. No two companies will be the same. Historically, this is one reason why statutory requirements have been kept separate from other risk assessment and evaluation processes.

Third, the APF may create new and significant operational challenges. In many non-statutory frameworks, hedging programs—including future hedging transactions—may be reflected on an approximate basis (a basis point cost) or the effects might be "layered on" outside of projected cash flows. Classification as an SHS, however, would trigger rigorous CDHS-type modeling requirements, requiring hedging to be reflected within projected cash flows within a real-world stochastic model. These burdens could be avoided by moving the entire hedging program outside of the statutory legal entity, but this would create the undesirable outcome in which the statutory framework would disincentivize hedging and unduly complicate risk management.

Fourth, inappropriate incentives may be created. For example, under the APF, it appears that no benefit exists to having a hedging program qualify as an SHS if does not also qualify as a CDHS. Since identification as an SHS involves the modeling of future hedging within any company "risk assessment and evaluation" process, the APF may create an incentive to avoid modeling of future hedging within these internal processes, thus undermining their efficacy.

Additional time should be taken for analysis and discussion of the merits and drawbacks of bringing non-statutory hedging programs into the statutory PBR framework, as the complications may be considerable.

5) ***The scope of the APF is exceptionally broad***

The potential scope of the APF extends beyond hedging for variable annuities, as it seeks to align hedging requirements between VM-20 and VM-21. The same construct has been recently suggested in a VM-22 context. Before proceeding with the APF, therefore, all stakeholders need the opportunity to review a broad swath of existing and potential future hedging programs.

Rather than making significant changes to the treatment of hedging within PBR, ACLI would suggest that a productive path forward might be to conduct a thorough review of the existing requirements as applied to common hedging strategies on existing products, such as indexed product hedging, RILAs, and macro hedging. It may be easier to reach consensus on any needed fundamental changes if the application of existing requirements to common hedging strategies is fully surveyed and understood.

In summary, the APF would represent a significant change to the treatment of hedging throughout Valuation Manual. Our understanding of the APF continues to evolve, but the potential implications appear to be significant. Core aspects of the APF merit additional scrutiny and review, including apparent conflicts with the new VA framework and the complications from bringing in non-statutory hedging frameworks. We ask the Task Force to defer action on this APF until work on the 2022 Valuation Manual is complete.

We appreciate the consideration of our comments and look forward to discussing on a future call. Thank you.

Sincerely,

cc:Reggie Mazyck, NAIC