Interest Rate Swap Spreads in the Valuation Manual

NAIC Life Actuarial (A) Task Force Call
May 7, 2020
Background

- The NAIC Valuation Manual prescribes interest rate swap spreads for VM-20 and VM-21 modeling (VM-20 Section 9.F.8.d and Appendix 2). The NAIC publishes these rates monthly.

- VM-20 Section 9.F.8.d states in part:
  Interest rate swap spreads over Treasuries shall be prescribed by the NAIC for use throughout the cash-flow model wherever appropriate for transactions and operations including, but not limited to, purchase, sale, settlement, cash flows of derivative positions and reset of floating rate investments.

- Use of the NAIC published Swap Spreads increased substantially when writers began implementing the new VM-21 requirements for inforce variable annuity business effective 1/1/2020.

- The swap spreads are currently linked to LIBOR, which will be likely be phased out by 2021. While it is anticipated LIBOR will be replaced by SOFR, no market consensus has been reached yet.
Background

- Current spreads are market-observable values, and not assumptions.
- The NAIC is currently receiving current spread data from Bank of America and JP Morgan daily.
- Data published by the NAIC has not consistently been tracking market-observable values in the derivatives market. These differences are most notable at the 3-month and 6-month tenors.
- Absolute differences between the NAIC Table J Spread and market-observable spreads have been as large as 19bps.
Issue Raised by Industry

- Charts showing differences in recent spreads:

1 Market observed swap spreads source is Bloomberg data
Issues Raised by Industry

- Review current calculated rates and verify data sources

- Address elimination of LIBOR: includes both direct replacement for LIBOR as well as potential LIBOR fallback rates

- Request increased clarity in VM-20/VM-21 as company observed spreads will differ from published spreads:
  - Swap contract specifics – Plain Vanilla Swap terms are not uniformly defined. For example, which LIBOR rate, 3-month or 6-month? Other terms such rate reset frequency and payment dates should also be disclosed. Also, assume these are exchange cleared contracts.
  - How the swap rates are determined (short, intermediate, and long end).
  - How the Treasury rates are determined/source.

- Importance of other uses of swap spreads
  - Market value determination (e.g. buying/selling of assets impact)
  - Hedging
Actions to Address this concern

- LATF formed an informal VM-20 Spreads Drafting Group to review industry concerns.

- The Drafting Group and industry/ACLI had a call on 2/3/2020 to discuss the identified issue and possible path forward.

- Industry favors finding a solution as soon as possible. We would seek an APF for the 2021 Valuation Manual, and if possible, data source modification for 2020 reporting.

- ACLI will work on a proposal to LATF to modify the Valuation Manual so that the any guidance around Swap Spreads allows for a data source that:
  - (1) aligns with use in the actuarial models and reflects the market economics appropriately;
  - (2) is accessible for Industry to use independent of NAIC;
  - (3) is flexible to address the expected end of LIBOR in 2021.
Questions?