**Life Actuarial (A) Task Force/ Health Actuarial (B) Task Force**

**Amendment Proposal Form\***

1. Identify yourself, your affiliation and a very brief description (title) of the issue.

**Identification:**

Brian Bayerle, ACLI

**Title of the Issue:**

Revise hedge modeling language to address index credit hedging.

2. Identify the document, including the date if the document is “released for comment,” and the location in the document where the amendment is proposed:

VM-01, VM-21 Section 4.A.4, VM-21 Section 6.B.3, VM-21 Section 9, VM-21 Section 9.C.2, VM-21 Section 9.E.7, VM-31 Section 3.F.8.d

January 1, 2023 NAIC Valuation Manual, APF 2020-12

3. Show what changes are needed by providing a red-line version of the original verbiage with deletions and identify the verbiage to be deleted, inserted or changed by providing a red-line (turn on “track changes” in Word®) version of the verbiage. (You may do this through an attachment.)

See attached.

4. State the reason for the proposed amendment? (You may do this through an attachment.)

Index credit hedging is fundamentally different than the dynamic GMxB hedging which formed the conceptual underpinnings for VM-21. For example, the relatively fixed parameters of traditional GMxBs drive the hedging approach. In contrast, indexed products (including RILAs) have flexible crediting parameters which are continually reset based on hedge availability and costs, as well as current market conditions. In short, GMxB contract features drive hedging, while index product hedging drives contract features.

Since the reforms of VM-21 and C3P2, ILVA products have experienced major market growth. Several carriers, with the agreement of regulators and auditors, have interpreted the current VM-21 guidance as permitting the effects of index credit hedging to be reflected in product cash flows instead of within the “best efforts” and “adjusted” scenarios. Both regulators and industry would benefit from the codification of this approach within VM-21.

ACLI’s proposal borrows heavily from the Academy’s draft VM-22. The “error” for index credit hedging is describes as a percentage reduction to hedge payoffs. The percentage reduction must be supported by relevant, credible, and documented experience. A minimum of [1%/2%] is proposed as a regulatory guardrail.

The ACLI proposal would subject index credit hedging to the “clearly defined” documentation requirements of VM-21. Substantively, the change would (a) include index credit hedge purchases with the VM-21 “adjusted” run, and (b) permit index credit hedging to reflect a different, and potentially lower, level of ineffectiveness.

ACLI supports aligning the index credit hedging guidance between VM-21 and VM-22. We started with draft VM-22 verbiage in creating this APF. In a few areas, our members have suggested technical improvements to the draft VM-22 definitions. It may be appropriate to carry these over to VM-22.

\* This form is not intended for minor corrections, such as formatting, grammar, cross–references or spelling. Those types of changes do not require action by the entire group and may be submitted via letter or email to the NAIC staff support person for the NAIC group where the document originated.

NAIC Staff Comments:

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**VM-01**

The term “Index Credit Hedge Margin” means a margin capturing the risk of inefficiencies in the company’s hedging program supporting index credits. This includes basis risk, persistency risk, and the risk associated with modeling decisions and simplifications. It also includes any uncertainty of costs associated with managing the hedging program and changes due to investment and management decisions.

The term “Index Credit” means any interest credit, multiplier, factor, bonus, charge reduction, or other enhancement to policy or contract values that is directly linked to one or more indices. Amounts credited to the policy or contract resulting from a floor on an index account are included. An Index Credit may be positive or negative.

The term ‘Index Crediting Strategies” means the strategies defined in a contract to determine index credits for a contract. For example, this may refer to underlying index, index parameters, date, timing, performance triggers, and other elements of the crediting method.

**VM-21 Section 4.A.4**

4. Modeling of Hedges

1. For a company that does not have a future hedging strategy supporting the contracts:
2. 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.
3. 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.
4. For a company with one or more future hedging strategies supporting the contracts:
   1. For a future hedging strategy with hedge payoffs that solely offset index credits associated with indexed interest strategies (index credits):
      1. In modeling cash flows, the company shall include the cash flows from future hedge purchases or any rebalancing of existing hedge assets that are intended solely to offset index credits to contract holders.
      2. Existing hedging instruments that are currently held by the company for offsetting the index credits in support of the contracts falling under the scope of these requirements shall be included in the starting assets.
      3. An Index Credit Hedge Margin for these hedge instruments shall be reflected in both the “best efforts” and the “adjusted” runs, as applicable, by reducing index credit hedge payoffs by a margin multiple that shall be justified by sufficient and credible company experience and account for model error. It shall be no less than [1%/2%] multiplicatively of the portion of the index credit that is hedged. In the absence of sufficient and credible company experience, a margin of at least 20% shall be assumed. There is no cap on the index credit hedge margin if company experience indicates actual error is greater than these minimums.
   2. For a company with one or more future hedging strategies supporting the contracts that do not solely offset indexcredits, the detailed requirements for the modeling of the hedges are defined in Section 9. The following requirements do not supersede the detailed requirements.
      1. 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.
      2. 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 only future hedge purchases associated solely with index credits. 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 determined following the guidance of Section 9.C.4.
      3. The company is responsible for verifying compliance with all requirements in Section 9 for all hedging instruments included in the projections.
      4. 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.
   3. If a company has a more comprehensive hedge strategy combining index credits with guaranteed benefit and/or other risks (e.g., full fair value or economic hedging), no portion of this hedge strategy is eligible for the treatment described in section 4.A.4.b.i.

**VM-21 Section 6.B.3 Footnote**

1 Throughout this Section 6, references to CTE70 (adjusted) shall also mean the SR for a company that does not have a future hedging strategy supporting the contracts that does not solely offset index credits as discussed in Section 4.A.4.

# **VM-21 Section 9**

# Section 9: Modeling Hedges under a Future Non-Index Credit Hedging Strategy

## A. Initial Considerations

1. This section applies to modeling of hedges other than situations where the company only hedges index credits.
2. Subject to Section 9.C.2, 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 calculation of the SR, determined in accordance with Section3.D and Section 4.D.

(Subsequent sections to be renumbered)

# **VM-21 Section 9.C.2**

1. The company shall calculate a CTE70 (adjusted) by recalculating the CTE70 assuming the company has no future hedging strategies supporting the contracts except hedge purchases solely related to strategies to hedge index credits, therefore following the requirements of Section 4.A.4.a and 4.A.4.b.i.

However, for a company with a future hedging strategy supporting the contracts, existing hedging instruments, except hedging instruments solely related to strategies to hedge index credits, that are currently held by the company in support of the contracts falling under the scope of these requirements may be considered in one of two ways for the CTE70 (adjusted):

a) Include the asset cash flows from any contractual payments and maturity values in the projection model.

b) No hedge positions, in which case, the hedge positions held on the valuation date are replaced with cash and/or other general account assets in an amount equal to the aggregate market value of these hedge positions.

# **VM-21 Section 9.E.7**

7. The company may also consider historical experience for similar current or past hedging programs on similar products to support the error factor or Index Credit Hedge Margin determined for the projection.

# **VM-31 Section 3.F.8.d.x (new subsection)**

1. Justification for the margin for any future hedging strategy that offsets index credits associated with indexed interest strategies (index credits), including relevant experience, other relevant analysis, and an assessment of potential model error
2. Ten years of historical experience on hedge gains/losses as a percent of index credited for hedge programs supporting index credits.
3. If there is less than five years of historical experience of this hedging program or a hedging program on similar products, an explanation of how the company considered increases in the error factor to account for limited historical experience.