March 23, 2022

Mr. Mike Boerner
Chair
National Association of Insurance Commissioners (NAIC)
Life Actuarial Task Force (LATF)

Re: APF 2020-12; Hedging strategies in VM-20 and VM-21

Dear Mr. Boerner,

The American Academy of Actuaries[1] Life Valuation Committee (LVC) appreciates the opportunity to provide comments on APF 2020-12 regarding hedging in VM-20 and VM-21.

As various Academy Life Practice Council (LPC) groups have stated in the past, the LVC believes companies should model their investment strategies as part of a principle-based reserve calculation, which includes the modeling of hedging activities. With respect to VM-21, the LPC/LVC recommends that a principle-based approach for hedges that applies margins for modeling and strategy risks be adopted. This eliminates the need for VM-21 metrics such as conditional tail expectation (CTE) 70 (adjusted) and the error "E" factor that results in questionable measurements of the error/residual risk margin for hedging strategies.

Additionally, the LVC does not believe the concept of a clearly defined hedging strategy (CDHS) or "future hedging strategy" definition is needed in a principle-based approach. However, we understand that the NAIC may wish to incorporate guardrails that would highlight the necessity for companies to reflect higher margins for certain hedging strategies.

Below are additional comments and recommendations for three of the stated reasons contained in the proposal.

1. *Reflect all of a company's future hedging strategies but reflect the additional error (VM-21) or residual risk (VM-20) that is presented by a future hedging strategy not being clearly defined.*

   The LVC agrees that companies should be required to model their hedging strategies and recommends that a more principle-based approach (conceptually similar to the current VM-20) in determining the margin for error/residual risk be incorporated in VM-21.

[1] The American Academy of Actuaries is a 19,500-member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

The VM-21 approach currently uses a weighted average of CTE70 (best efforts) and CTE70 (adjusted) to determine an error/residual margin. CTE70 (adjusted) is determined by only using hedge assets held by the company as of the valuation date. It assumes the investment strategy for such hedge assets is to runoff the assets or to convert them to cash/other general account assets. Neither of these options may be representative of the company's actual hedging policy. A metric that does not reflect a company's investment policy is not principle-based and is less likely to properly reflect the error/residual risk one is trying to measure. Additionally, we note that if CTE70 (adjusted) is less than CTE70 (best efforts), the error/residual risk is assumed to be $0. This is also not principle-based and fails to properly measure the underlying risk. In order to properly measure the underlying risk, companies should model their investment strategy (CTE70 best efforts) and then apply an appropriate level of margin.

A VM-20-like principle-based approach to modeling hedge cash flows is consistent with how other cash flows are projected; margins are added to best estimate cash flows with the level of such margins based on the confidence in the modeling of the cash flows. Such an approach avoids issues associated with trying to bifurcate hedging between in force and future hedges or multiple hedging strategies. It also eliminates the current lack of a margin when CTE70 (adjusted) is less than CTE70 (best efforts).

2. *Remove optionality for liquidating currently held hedges (despite liquidation not being a part of the company investment strategy) if not modeling a future hedging strategy*.

   The LVC recommends that companies model their investment strategies, with appropriate margins. Companies should not have the option to liquidate currently held hedges as this would not be consistent with their investment strategy. Moving to a VM-20-like principle-based approach in the modeling of hedges would remove the need for this option.

3. *New hedging strategies (<6 months experience) have an E factor of 1.0 for VM-21. For comparison, the current draft VM-22 only allows modeling hedges after they have been in place for 6 months. When only CDHS were modeled in VM-21, new hedging strategies with no experience had E factors as low as 0.5 even without meaningful analysis. This treatment was much too lenient for new hedging strategies.*

   The reserve requirement should encourage companies to adopt strategies that serve to reduce risk. Limiting E factors for new hedging strategies can have the unintended effect of discouraging hedging strategies that reduce risk. Adopting the principle-based approach in VM-20 would eliminate the need for an E factor and allow companies to pursue hedging strategies without the potential for an increase in reserve created by artificial limits.

   Investment strategies, including hedging strategies, will change over time. These changes may be marginal, such as minor modifications to sector allocations, credit limits, or hedge targets. At other times—such as during changes in a company's risk appetite—the changes may be more substantial. In either event, changes in strategies should be reflected in the reserves as they are adopted by the company. Redeterminations of the error/residual margin calculations should be required when significant changes occur and be supported by robust simulation testing or other meaningful analysis. Changes should be clearly disclosed with adequate supporting documentation.

Thank you for your consideration of these comments. We would be pleased to answer any questions you may have and to provide additional support as needed. Please feel free to contact Devin Boerm, the Academy's deputy director of public policy, to arrange for discussion of these comments.

Sincerely,

Craig Morrow
Chairperson, Life Valuation Committee
American Academy of Actuaries

CC: Reggie Mazyck, NAIC