



AMERICAN ACADEMY of ACTUARIES

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October 17, 2014

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

RE: Request for Comments on the *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* Discussion Paper

To Whom It May Concern:

On behalf of the American Academy of Actuaries'¹ Financial Reporting Committee, I am pleased to provide comments on the International Accounting Standards Board (IASB) discussion paper *Accounting for Dynamic Risk Management: A Portfolio Revaluation Approach to Macro Hedging*. We encourage the development the portfolio revaluation approach so that it can be applied to hedged risks and mitigate non-economic accounting mismatches, increasing the relevance and representational faithfulness of accounting information. However, the approach should not be limited to bank risks but rather encompass other hedged risks, including risks within insurance contracts.

Because the discussion paper is focused primarily on bank risks, our comments will be limited to questions that are related to hedging of risks within insurance contracts. Based on IASB decisions through September 2014, a portfolio hedge accounting model is needed for insurance contracts in order to avoid accounting mismatches. This concept could be incorporated into the insurance contracts model; however, we would not want this to cause a significant delay in adopting the insurance contracts model. If such standards are not incorporated into the insurance contracts standard, insurance contracts would need to be included within a separate dynamic risk management project from the insurance contracts model. As applied to insurance contract risks, such a model would need to account for policyholder behavior, address assets and liabilities reported at fair value or current fulfillment value through other comprehensive income (OCI), and address hedging of joint risks.

¹ The American Academy of Actuaries is an 18,000+ member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists 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.

Question 1—Need for an accounting approach for dynamic risk management

There is a need for a specific accounting approach to represent dynamic risk management in entities' financial statements because risk management can result in accounting mismatches that do not reflect the economics of the dynamic risk management activities, which may not be transparent to the users of the financial statements. These accounting mismatches can cause a hedged risk to generate more volatility in the financial statements than the same risk would generate if it was unhedged. This result does not reflect the economics of risk management.

A specific accounting approach is needed to achieve consistent valuation methodologies between the values of hedging instruments and the values of the hedged risks. Although the discussion paper is focused on bank risks, the issue is critical for other situations as well, including insurance contracts.

The business model of a life insurer involves the matching of assets and liabilities by duration and cash flow to manage net interest rate exposure. Assets often have shorter maturities than the liabilities they support, which can extend beyond 50 years, and the inventory of available high-quality long duration assets is limited. The resulting gap or exposure is often narrowed through the use of derivatives. The duration gap is managed on a portfolio basis. In addition to interest rate market risks, life insurers manage other risks such as equity market risks.

Some sources of interest rate and other financial market exposures are:

- *Insurance contracts with long-term guarantees.* Many traditional insurance products provide guaranteed benefits at fixed premiums. These contracts may extend beyond the horizon of investable assets. If interest rates decline, future investment returns may not be adequate to cover the interest rates implicit in the guaranteed benefits.
- *Insurance contracts with future premiums that are based on an interest rate that are set at contract issue.*
- *Participating contracts.* Even for insurance contracts with participating features, such as dividend-paying whole life and universal life, there may be features, such as minimum interest guarantees and book value withdrawals, which expose the insurer to changes in interest rates.
- *Variable annuity guarantees.* Variable annuities allow policyholders to invest in mutual fund-like investments and may have guaranteed withdrawal, income, accumulation, or death benefits. These contract features create exposure to interest rate changes as well as to changes in equity prices and volatility.
- *Variable annuity guarantees* also expose the insurer to changes in equity prices and volatility since declines in equity prices can cause the guarantee to go into the money. Equity indexed products also can expose the insurer to risk from changes in equity prices and volatility.

Insurers hedge these risks using different mitigation techniques. These risks often are hedged on a portfolio basis because the policyholder behavior and mortality and morbidity experience are predictable for a portfolio of contracts but not for individual contracts. In addition, these risks often are hedged using dynamic hedging techniques. The hedge accounting guidance in IFRS 9 does not cover these situations, resulting in non-economic accounting mismatches for hedged insurance risks.

Within the insurance contracts project, the IASB has tentatively decided to permit an option to report the effect of changes in discount rates on the liability values in either other comprehensive income (OCI) or profit and loss.² This will help mitigate the accounting mismatches in some situations. However, it only addresses a small part of the problem. It does not address situations in which:

- Changes in discount rates are reported appropriately in OCI for the unhedged cash flows within an insurance contract portfolio, but OCI would create an accounting mismatch with the derivatives used to mitigate the hedged risks; or
- Changes in projected cash flows related to the hedged risks are offset by unlocking the contractual service margin (CSM), since there would be no mechanism comparable to CSM unlocking for the hedging instrument.

We are concerned about a statement in paragraph 74 of IFRS Staff Paper 2B for the May 2014 meeting that acknowledged potential accounting mismatches but stated “These economic hedges do not qualify for hedge accounting treatment under IFRS 9 and are not in the scope of the IASB’s project on dynamic risk management.” For the reasons described above, hedged risks within insurance contracts need to be included in the scope of the dynamic risk management project, unless portfolio hedges of risks within insurance contracts get fully addressed within the insurance project.

However, we would be concerned if incorporating the macro hedging concept within the insurance contracts model caused a significant delay in that project. One possible way to address portfolio hedging for insurance contracts without delaying the project may be to permit hedged cash flows within insurance contracts to exclude OCI (even if the remaining contract cash flows use OCI) and exclude CSM unlocking if the hedging program meets regulatory/statutory requirements for use of derivatives. This would permit insurers to avoid accounting mismatches for hedged risks, using the fact that insurers are regulated entities as a means to prevent abuse or “free choice.”

Question 2—Current difficulties in representing dynamic risk management in entities’ financial statements

There are some key issues that entities face when applying the current hedge accounting requirements to dynamic risk management that are not included in the discussion paper . For instance, the examples show assets and liabilities held at amortized cost but not assets at fair value through OCI or liabilities at current fulfillment value through OCI. A dynamic hedge accounting model should address the full range of valuation methodologies for hedging instruments and for assets and liabilities containing hedged risks.

The Committee recommends the concept of the portfolio revaluation approach (PRA) to address the issues identified because the approach can be relevant for insurance contracts and insurance companies. This concept, as it relates to insurance, could be included within the insurance

² “Insurance Contracts (Agenda Paper 3),” *IASB Update*, July 22, 2014. <http://media.ifrs.org/2014/IASB/July/IASB-Update-July-2014.html#2>

contracts standard rather than in a separate standard. Nevertheless, they need to be captured somewhere in order to avoid non-economic accounting mismatches on hedged risks

Question 4 – Behaviouralisation

For the purposes of applying the PRA, we recommend using cash flows on a behaviouralised, rather than a contractual basis, when the risk is managed on a behaviouralised basis. The effect of policyholder behavior is important for insurance contracts. It would not make sense to hedge cash flows without taking into account, for example, expected lapses or mortality. Thus, the accounting model also needs to take policyholder behavior and other policyholder experience (such as mortality or morbidity) into account in order to avoid accounting mismatches.

Question 15—Scope

The PRA should not be restricted to circumstances in which an entity has undertaken risk mitigation through hedging (i.e., a scope focused on risk mitigation). The PRA should be applied when the risk is hedged, not merely for risks that are identified but not hedged. However, hedge accounting should not be required, consistent with hedge accounting under IFRS 9. Other accounting standards should be applied if hedge accounting is not being performed. Nevertheless, hedge accounting should be permitted in order to avoid an accounting mismatch from hedging. We are concerned about limiting PRA to open portfolios but not addressing dynamic hedging, since dynamic hedging is important to insurers as well as banks.

Question 18—Presentation alternatives

In terms of presentation alternatives, the example on page 67 of the discussion paper shows the revaluation that would apply to assets at amortized cost, including debt securities. But debt securities can be at fair value, with changes in value related to changes in discount rates reported in OCI. Further, within the insurance contracts project, liabilities can be at current fulfillment value, with changes in value related to changes in discount rates reported in OCI. To the extent that assets and liabilities include hedged cash flows for which changes in discount rate are reported in OCI, the revaluation adjustment should not change the value shown on the balance sheet, since the balance sheet amounts already reflect the current value. Rather, the revaluation adjustment should be moved from OCI to profit and loss. This would avoid an accounting mismatch in profit and loss between changes in the value of the hedging instrument due to the change in interest rates being reported in profit and loss and the corresponding changes in the value of the hedged risk being reported in OCI.

However, for contracts that are valued at current fulfillment value, whether or not OCI is elected, the revaluation adjustment should impact the balance sheet for insurance contract cash flows that would otherwise be offset by CSM. Unlike amounts recorded in OCI, amounts offset by CSM unlocking would not be recorded on the balance sheet. Amounts offset by CSM unlocking are analogous to amounts reported at amortized cost. Therefore, the revaluation adjustment needs to adjust both balance sheet and profit and loss in order to avoid accounting mismatches, similar to assets and liabilities reported at amortized cost.

Question 24—Dynamic risk management of foreign currency instruments

While we do not have an opinion on applying the PRA to the dynamic risk management of foreign exchange (FX) risk in conjunction with interest rate risk that is being dynamically managed, we see no reason why macro hedge accounting should not apply to joint risks. This may be interest risk and FX risk, but it also could be interest risk and equity price risk, as described in the response to question 25 below.

Question 25—Application of the PRA to other risks

The PRA should be allowed for dynamic risk management other than banks' dynamic interest rate risk management. There are fact patterns related to insurance contracts, which should be included in the macro hedging project. Some examples include:

- *Participating contract guarantees.* Insurance companies do significant hedging of guarantees within participating and universal life contracts, which can create non-economic accounting mismatches under existing accounting models. Such risks include minimum interest guarantees on many par contracts; variable annuity guarantees (e.g., guaranteed income, death, withdrawal, or accumulation benefits); and secondary guarantees on certain universal life contracts, which keep the contract in force under certain conditions even if the account balance is zero. To the extent that hedged risks are impacted by OCI or unlocked CSM, which would not impact the hedging instruments, there could be similar mismatches under the proposed insurance accounting model unless the participating insurance contracts model makes explicit provision to permit hedge accounting to be applied to these items. These risks generally are hedged on a portfolio basis, since it is unclear which specific contracts will terminate in the next period but there are expectations of the aggregate terminations and new sales. This hedging is often done dynamically, in which the hedging instruments are rebalanced regularly—possibly daily, or even several times a day—to reflect updated exposure to interest rate, equity, and volatility. The OCI option does not necessarily fully address this issue because OCI must be elected for the entire portfolio and OCI may be appropriate for most of the cash flows in the insurance portfolio except for those relating to the hedged risk. Furthermore, the OCI option does not address the issue that the cash flows related to the hedged risk could be offset by CSM unlocking.
- *Interest rate risk.* This could impact both par and non-par contracts. Insurers often use derivatives to hedge the reinvestment risk related to long-term guaranteed contracts. Affected contracts include long-term care insurance, disability income insurance, and payout annuities. This is conceptually similar to the interest rate risk described in the macro hedging discussion paper, which is often done on a portfolio level. Accounting mismatches also can arise on the hedged risks due to OCI and CSM unlocking.
- *Future new products.* The insurance contracts standard is being developed in a principles-based manner but is informed by the types of insurance contracts that are in force today. Even if the insurance contracts standard addresses all the hedging issues described above, future contract types that we cannot anticipate today may require more general hedging solutions.

Joint risks also need to be addressed, such as joint equity/interest rates hedges of risks on certain variable annuity benefits. An example is a guaranteed minimum interest benefit (GMIB) that is included on many variable annuity contracts. Without the guarantee, policyholders can always convert their current account balance to a lifetime payout annuity at current rates. But with the GMIB, if the account balance has declined, the policyholder can convert a minimum guaranteed amount to a payout annuity, although the conversion may be at conservative annuity payout rates. If the equity market goes down, the GMIB can go in the money. But even if the minimum amount is greater than the actual account balance, if interest rates are high enough, the policyholder still may be better off converting their current account balance at current rates than by converting the higher minimum amount at conservative rates.

For example, assume a policyholder has a current account balance of currency unit (CU) 500, the balance associated with the minimum guarantee is CU 650, and current interest rates are 7 percent. If the policyholder converts the CU 500 actual balance for a payout annuity priced at 7 percent interest with a realistic mortality assumption,³ they would likely receive a higher payout than if they converted the CU 650 minimum balance for a payout annuity priced using the conservative assumptions available on the guaranteed balance, such as a 2 percent interest rate and a lower than expected mortality assumption.⁴ But if current interest rates are low (e.g., 2.5 percent), the policyholder would likely receive a higher benefit by converting the CU 650 minimum balance, even at conservative rates, than by converting the CU 500 current account balance at current rates. Here, the insurer is exposed to equity risk, but also jointly to interest rate risk because the guarantee generally only pays off if both equity prices and interest rates fall. Hedging programs for these benefits often reflect the joint exposure to the combination of equity and interest rate risks.

There are other examples of joint risks that can be important. For example, even for a risk that is exposed to interest rates only, there may be exposure to both interest rate levels and interest rate volatility. This is typically the case with interest rate options, such as minimum interest guarantees.

Finally, applying the PRA model to hedged cash flows subject to any of the risks described above, including joint risks, would cause the hedged risk to be reported at a current value, consistent with the hedging instrument, mitigating the non-economic accounting mismatch. This would be the case even for changes in cash flows that would be offset by CSM unlocking under the current fulfillment value model. For contracts for which OCI is elected that contain hedged risks, if the interest expense from the PRA is appropriately transferred from OCI to profit and loss, the non-economic accounting mismatch in interest expense between the hedged risk and the hedging instrument also would be appropriately mitigated.

Thank you for this opportunity to provide our views on the IASB's discussion paper *Accounting for Dynamic Risk Management: A Portfolio Revaluation Approach to Macro Hedging*. If you have any questions or would like to discuss these issues in more detail, please contact Lauren

³ That is, the expected mortality for the policyholder.

⁴ Such as the mortality of someone 7 years younger than the actual policy holder.

Sarper, the Academy's senior policy analyst for risk management and financial reporting, at 202.223.8196 or sarper@actuary.org.

Sincerely,

Leonard Reback, MAAA, FSA
Chairperson, Financial Reporting Committee
Risk Management and Financial Reporting Council
American Academy of Actuaries

cc: Financial Accounting Standards Board's Financial Accounting Standards Advisory Council