ACLI
Financial Security for Life

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Ms. Hillary H. Salo
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: File Reference No. 2021-004 – Invitation to Comment – Agenda Consultation

Dear Ms. Salo:

The American Council of Life Insurers ("ACLI") appreciates the opportunity to comment on File Reference No. 2021-004 – Invitation to Comment – Agenda Consultation. We ask the Board to elevate its research project, Hedge Accounting Phase 2, to an active project that includes further consideration of portfolio hedging for insurance contracts.

Portfolio hedging is particularly important for insurance companies since insurance companies manage contracts on a portfolio basis in order to achieve pooling of risks. Insurance companies are financial institutions for which hedging financial risks is a critical risk management tool. Applying hedge accounting guidance for portfolios of insurance contracts is either operationally cumbersome (using a dynamic approach requiring frequent re-balancing) or precluded altogether. As a result, hedge accounting of insurance liabilities is not frequently applied, with non-qualifying derivatives driving significant non-economic income statement volatility in the financial statements. This can result in (a) misleading financial information to investors, (b) need for non-GAAP measures, and (c) discouragement from applying hedges in some instances where the hedges would be economically sensible. Also, significant income statement volatility that is not reflective of the economics of the business, and ultimately causes financial statements to be misleading. The relevance of this goes beyond financial statement geography. Studies have shown that companies with more volatile earnings patterns have lower stock prices, thereby causing a disadvantage for the insurance industry in the capital markets.

The ACLI has previously commented on the need for portfolio hedge accounting for insurance entities, since several provisions of Topic 815 preclude hedge accounting treatment on portfolios of insurance contracts.[1] For example, ASC 815-20-55-14 requires that "individual liabilities within a portfolio hedged in a fair value hedge shall share the risk exposure for which they are designated as being hedged." Since an insurance contract portfolio is generally made up of contracts sold to policyholders of varying ages (hence a contract sold to a 20 year old is generally expected to remain in force longer than a contract sold to a 50 year old) and in varying financial circumstances (one policyholder may be more likely to take an early cash surrender than another), this criterion often cannot be met for the individual contracts in the portfolio, even though the portfolio as a whole can be hedged effectively.

We stand by our previous comments, although we note that the FASB has issued ASUs since the 2011 and 2016 previous comment letters.

ASU 2017-12 – Portfolio Layer Method

The FASB issued ASU 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, which introduced a portfolio layer method for fair value hedges of certain portfolios. However, the scope was limited to portfolios of prepayable financial assets.

The FASB subsequently issued an Exposure Draft in 2021, which the ACLI responded to on July 2, 2021, clarifying certain application issues of the portfolio layer method while still limiting the scope of instruments eligible for the method to prepayable financial assets. We continue to believe the portfolio layer method could be expanded to include insurance and other liabilities. We request the FASB to further consider these comments as part of its Hedge Accounting – Phase 2 project.

ASU 2018-12 – LDTI

The FASB issued ASU 2018-12, *Financial Services – Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts*, which will provide some relief from some of the circumstances in which portfolio hedging is necessary. In particular, the market risk benefit (MRB) concept will require certain guarantees which currently are reported using an accrual model to be reported at fair value. Fair value for MRBs will better match the fair value of any derivatives used to hedge these guarantees, alleviating the need for hedge accounting for these items. ASU 2018-12 also will require that liabilities for future policyholder benefits (FPBs) use a current market-based discount rate. This will better align with any derivatives used to hedge

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[1] https://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175822377451&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=333698&blobheadervalue1=filename%3DAFIHEDG.DP.0058.ACLI.MICHAEL_MONAHAN.pdf&blobcol=urldata&blobtable=MungoBlobs
https://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175834200361&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=708506&blobheadervalue1=filename%3DAFIHEDG.ED.0011.ACLI_MIKE_MONAHAN.pdf&blobcol=urldata&blobtable=MungoBlobs

interest rate risk on these liabilities on the balance sheet. But since the impact to the liability of market interest rate changes will be reported through other comprehensive income (OCI) while the impact of market interest rate changes on any derivatives used to hedge interest rate risk will be reported through net income, an accounting mismatch will remain in the income statement.

Despite ASU 2018-12, insurance entities will have a need for portfolio hedging under a number of circumstances, including the following examples:

1. Certain guarantees will not be considered MRBs under ASU 2018-12, even if they contain other-than-nominal capital market risk. For example, 944-40-25-25D (b) precludes the "death benefit component of a life insurance contract" from being considered an MRB. As a result, certain death benefits will continue to be reserved using an accrual model rather than fair value. An example would be a no-lapse guarantee on a variable universal life contract. No-lapse guarantees keep the death benefit in force even if capital market experience (such as a negative equity market) cause the contract's account balance to go to zero. An entity that attempts to hedge the risk from no-lapse guarantees would have an accounting mismatch between the accrual model used to value the liability and the fair value of any hedging instruments.

2. Certain liabilities for FPBs can have durations[2] exceeding 30 years. Examples include long term care insurance and certain payout annuities. Since fixed-income USD instruments with durations greater than 30 years are scarce, derivatives are often needed to properly duration-match or immunize the portfolio against losses due to changes in interest rates (and in many currencies other than USD the longest available fixed-income instruments are much less than 30 years). As noted above, although ASU 2018-12 requires that FPB liabilities be measured using current market discount rates, the impact of the change in discount rate is recorded in OCI rather than net income, while the impact of changes in interest rates on the fair value of derivatives is reported in net income. Other sources of accounting mismatch on FPB liabilities hedged with derivatives occur because of basis differences such as:
    a. The FPB liability uses a net premium reserve model, which mutes the impact of changes in discount rates, while derivatives have no corresponding mechanism
    b. The FPB liability uses an upper-medium grade (low credit risk) fixed-income yield, generally interpreted as a single-A rated instrument yield, as its discount rate while derivatives typically are valued using risk free rates

3. Certain account balance liabilities can have durations exceeding 30 years. An example is universal life with secondary guarantees (ULSG). These are general account universal life contracts with a secondary guarantee that keeps the contract in force even if low credited interest rates cause the account balance to go to zero. Since the guarantee protects the death benefit of a life insurance contract, the guarantee is not an MRB and is valued using an accrual model for the liability for death or other insurance benefits similar to no-lapse guarantees in item (1). This creates an accounting mismatch similar to very long duration FPBs in item (2). But the accounting mismatch is even more significant for these products because the accrual model for the liability for death or other insurance benefits uses a

[2] Duration in the context of this letter refers to Macaulay, modified or option-adjusted duration, i.e., the sensitivity of the value of the instrument to changes in interest rates.

locked in discount rate from contract inception.

4. Many account balance products, including universal life and fixed deferred annuities, contain minimum interest guarantees. Since these guarantees are clearly and closely related to the host contract they are not bifurcated and measured at fair value. If an insurance entity uses derivatives to hedge the minimum interest guarantees, there will be an accounting mismatch between the change in fair value of the derivatives and the unchanging value of the minimum interest guarantee liability.[3]

5. Insurance entities doing business in foreign jurisdictions often sell contracts denominated in currencies other than the functional currency. For example, an entity may sell insurance contracts denominated in Euros or Australian dollars in Japan. In some cases certain payments may be made in one currency while other payments may be made in a different currency (for example, premiums in JPY but death and surrender benefits in USD). In many cases it would be desirable to hedge the foreign currency risk inherent in these contracts but that would create an accounting mismatch between the hedging instruments and the underlying insurance contracts.

Accounting mismatches resulting from these types of hedging transactions, which are part of the normal course of business for many insurance companies, reduce the relevance and reliability of insurance entity financial statements. We therefore encourage the FASB to add a project to its agenda to address and improve accounting for portfolio hedging.

We appreciate the opportunity to provide our comments on the – Invitation to Comment and respectfully request that FASB consider our comments. We would be happy to engage in further discussion or provide clarification on this, or any other matter at your request. Please do not hesitate to contact me if you have further questions.

Sincerely,

M Monahan

Mike Monahan
Senior Director, Accounting Policy

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[3] An exception would be if the minimum interest guarantee becomes so far in the money as to cause a premium deficiency. But premium deficiencies on universal life contracts are expected to be rare after the adoption of ASU 2018-12, and the impact to the liability of recognizing the premium deficiency is unlikely to match the current period change in the fair value of any derivatives hedging the guarantee. And investment products such as fixed deferred annuities are not subject to premium deficiency testing.