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HOUSE INSURANCE COMMITTEE
Testimony on House Bill 2177

February 18, 2019

By: Chris Swickard, Vice President and Associate General Counsel
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Mr. Chairman and members of the Committee:

Thank you for the opportunity to be here today. My name is Chris Swickard. I am Vice President and Associate General Counsel for Security Benefit Life Insurance Company and I am here to testify on behalf of Security Benefit in favor of House Bill No. 2177.

The purpose of this bill is to allow life insurance companies to utilize certain accounting practices that provide a truer and fairer representation of their capital position and financial results in connection with hedging of fixed index annuity products (or "FIAs"). The accounting treatment permitted by the bill is the exact same treatment that Security Benefit currently enjoys under what is referred to as a "permitted practice" that it has requested and received each year from the Kansas Insurance Department since 2011. It is also the same accounting treatment enjoyed by our many competitors in the State of Iowa where a regulation has been promulgated allowing Iowa based life insurers to use this accounting treatment. Passage of this bill would put all Kansas life insurers on the same footing (i.e., it would be available to all Kansas life insurers without the need to seek a permitted practice from the KID) and would level the playing field for them with competitors in Iowa.

FIAs have become very popular by providing consumers with some level of upside potential coupled with principal protection if markets fall. Industry-wide, FIA product sales were $54 billion and $60 billion in 2017 and 2016 respectively, which represented 28% of total annuity sales in both those years.

FIAs provide for a return of principal and also provide for interest based on the performance of an index, such as the Standard & Poor's 500 Index ("S&P 500"). The interest rate is typically

subject to a cap and/or other limitations, but cannot be negative. For example, an annual point-to-point index crediting option may pay interest based on the positive movement in the index during the one-year index term, but capped at 4% in the event that the index return is greater than 4%.

Insurers offering FIAs hedge the risk that they will be obligated to credit interest based on index performance, typically by purchasing call options on the index that is used in the FIA. Thus, if the value of the index to which the FIA is tied (e.g., the S&P 500) increases, the proceeds from the call option purchased by the insurer will fund the interest the insurer must credit on the FIA.

These call options are considered derivative instruments for statutory accounting purposes. Under statutory accounting, derivative instruments that are not considered "effective hedges" are accounted for at fair value (i.e., market value) and changes in fair value are recorded as unrealized gains or losses directly to surplus and not through the income statement. While highly effective on an economic basis (i.e., the proceeds from the call options are tightly matched to the insurer's interest crediting obligation), they do not meet the effective hedge criteria under statutory accounting. This is because the options payout over the index term of the crediting strategy (e.g., 1 year or 2 years), while the payments to policyholders under the annuity contracts can be (and typically are) longer.

A mismatch in financial statement reporting results from this since, under statutory accounting, the fair value of changes in the options are reported on the balance sheet as part of unrealized gains or losses directly to surplus, while changes in the hedged item, the reserve liability, are reported through the income statement.

The solution for a more accurate method of accounting for FIA hedging and associated reserves is as set forth in the bill. Specifically, the bill would allow Kansas-based life insurers, once certain criteria are met, to value call options (referred to as "eligible derivative assets" in the bill) used to hedge FIAs at amortized cost rather than fair value and apply a methodology for calculating FIA reserves such that index interest credits are included in the reserve only after they are actually credited to the annuity. This accounting treatment permitted by the bill brings into alignment

both the amount and timing for reporting of the hedging instrument (the call option) and the hedged item (the reserve liability for the FIA).

The bill would require insurers relying on this statute to maintain records documenting the economic hedging relationship and the insurer's risk management objective and strategy for undertaking the hedge. In addition, on a quarterly basis, the insurer would have to provide, to the commissioner of insurance, information about the market value of options it has bought and information about what the reserve would be if the methods set forth in the statute were not being used.

Key Take Aways - This bill (1) puts into statute a permitted practice the KID has provided to Security Benefit since 2011 so that it doesn't have to request and the KID doesn't have to issue one every year (thus giving Security Benefit certainty), (2) levels the playing field with our many competitors in Iowa, and (3) thereby, makes Kansas a more attractive place for life insurance companies to locate. I will also note that Security Benefit has not had any issues or problems in using this accounting practice, nor to our knowledge, have any Iowa companies following the same practice.

During the drafting process, Security Benefit visited with the Kansas Insurance Department on this bill and they have no issues with it. We also understand that the American Council of Life Insurers is in support of this bill.

Thank you for the opportunity to appear here today. I respectfully request the passage of this bill. I would be happy to answer any questions at this time.