Hearing Agenda

Statutory Accounting Principles (E) Working Group

Hearing Agenda

November 15, 2018

ROLL CALL

Dale Bruggeman, Chair
Jim Armstrong, Vice Chair
Richard Ford
Kim Hudson
Kathy Belfi
Dave Lonchar
Eric Moser
Caroline Brock / Stewart Guerin

Ohio
Iowa
Alabama
California
Connecticut
Delaware
Illinois
Louisiana

Judy Weaver
Doug Bartlett
Stephen Wiest
Joe DiMaggio
Doug Slape / Jamie Walker
Doug Stolte / David Smith
Amy Malm

Michigan
New Hampshire
New York
Pennsylvania
Texas
Virginia
Wisconsin

NAIC Support Staff: Julie Gann, Robin Marcotte, Fatima Sediqzad, Jake Stultz

REVIEW AND ADOPTION OF MINUTES


REVIEW AND ADOPTION of NON-CONTESTED POSITIONS

The Working Group may elect to discuss the following items even though no comments were received.

1. Ref #2018-23: SSAP No. 68 Mergers
4. Ref #2018-28: Life and Annuity Liquidity Disclosures
5. Ref #2018-29: Consistency Revisions to A-820
6. Ref #2018-30: Hedge Effectiveness Documentation

<table>
<thead>
<tr>
<th>Ref #</th>
<th>Title</th>
<th>Attachment #</th>
<th>Agreement with Exposed Document?</th>
<th>Comment Letter Page Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018-23 SSAP No. 68 (Julie)</td>
<td>SSAP No. 68 Mergers</td>
<td>3</td>
<td>Supportive of Changes</td>
<td>IP - 9</td>
</tr>
</tbody>
</table>

Summary:
During the Summer National Meeting, the Working Group exposed nonsubstantive revisions to SSAP No. 68—Business Combinations and Goodwill to clarify that statutory mergers include scenarios in which the stock ownership of an owned entity is cancelled, with the parent entity incorporating the assets and liabilities directly on their financial statements.

For example:
- Insurance reporting entity owns 70% of SCA Entity A outstanding common stock
- Insurance reporting entity acquires remaining 30% of SCA Entity A outstanding common stock
- Insurance reporting entity cancels SCA’s common stock thereby dissolving the corporate structure of the SCA and reports the SCAs assets and liabilities directly on the insurance reporting entity’s financial statements.
Interested Parties’ Comments:
Interested parties are supportive of the changes.

Recommended Action:
NAIC staff recommends adopting the exposed revisions to SSAP No. 68—Business Combinations and Goodwill as final. These revisions clarify that statutory mergers include scenarios in which the stock of an owned entity is cancelled, with the parent entity incorporating the assets and liabilities directly on their financial statements. This clarification confirms that these transactions are subject to the merger guidance in SSAP No. 68.

<table>
<thead>
<tr>
<th>Ref #</th>
<th>Title</th>
<th>Attachment #</th>
<th>Agreement with Exposed Document?</th>
<th>Comment Letter Page Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>SSAP No. 86</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SSAP No. 97</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>App A-010</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(Julie/Robin)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Summary:
During the Summer National Meeting, the Working Group exposed nonsubstantive revisions to incorporate editorial and maintenance revisions as follows:

- **SSAP No. 86—Derivatives**: The guidance in SSAP No. 86, paragraph 57.j, details the Dec. 31, 2017, effective date for the aggregate derivative financing premiums disclosures. With the 2018 adoption of additional individual disclosures in paragraph 57.h.ii. (captured in Schedule DB), the reference for the 2017 effective date for paragraph 57.h is no longer accurate. Revisions were proposed to remove the effective date from the guidance.

- **SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities**: SSAP No. 97, paragraph 49, detailing effective date and transition guidance, references guidance that was incorporated into SSAP No. 97 and then deleted. Proposed revisions remove old paragraph numbers, which are not applicable in the current SSAP, and update the description of the changes to reference the new SSAPs, which describe the changes.

- **Appendix A-010 Minimum Reserve Standards for Individual and Group Health Insurance Contracts**
  - Update paragraph reference in Exhibit 1, paragraph 1.c.i.(b)(iii). These revisions were adopted in agenda item 2017-09 regarding the 2016 Cancer Claim Cost Valuation Tables (2016 CCCVT). This update is needed because the paragraph numbering in Appendix A-010 is slightly different from Model 10.
  - The language incorporated into Exhibit 1, paragraph 1.a.ii., regarding the 2013 Individual Disability Income Valuation Table (2013-IDI) referenced an incorrect date, which was updated to be consistent with changes to the Model 10 previously adopted by the Health Actuarial (B) Task Force, and with the revisions adopted by the Statutory Accounting Principles (E) Working Group in agenda item 2016-17.

Interested Parties’ Comments:
Interested parties have no comments.

Recommended Action:
NAIC staff recommends adopting the editorial and maintenance revisions to SSAP No. 86, SSAP No. 97 and Appendix A-A010, as described above and in the agenda item.
Summary:
During the Summer National Meeting, the Working Group exposed nonsubstantive revisions to SSAP No. 22 to reject ASU 2018-01, Leases – Land Easement Practical Expedient for Transition to Topic 842. It was noted that the rejection would be captured initially in SSAP No. 22, and then also identified in the substantively revised SSAP No. 22R being developed in response to ASU 2016-02, Leases.

Interested Parties’ Comments:
Interested parties support the proposed rejection of ASU 2018-01.

Recommended Action:
NAIC staff recommends adopting the exposed revisions to SSAP No. 22—Leases to reject ASU 2018-01. Reference of this rejection will also be captured in the proposed substantively revised SSAP No. 22R being developed under ASU 2016-02, Leases.

Summary:
During the Summer National Meeting, the Working Group exposed nonsubstantive revisions to SSAP No. 51—Life Contracts, SSAP No. 52—Deposit-Type Contracts and SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance to add life liquidity disclosures and expand the variable annuity liquidity disclosures for year-end 2019.

The revisions proposed within this agenda item were referred by the Financial Stability (EX) Task Force. Additionally, the Blanks (E) Working Group has already adopted disclosure modifications to reflect the changes. (Since the disclosures are not effective until year-end 2019, if the Statutory Accounting Principles (E) Working Group modifies the disclosures, a subsequent blanks proposal will be submitted to incorporate the changes.)

Interested Parties’ Comments:
Interested parties are supportive of the changes.

Recommended Action:
NAIC staff recommends adopting the exposed revisions to SSAP No. 51—Life Contracts, SSAP No. 52—Deposit-Type Contracts and SSAP No. 61R—Deposit-Type and Accident and Health Reinsurance. NAIC staff notes that blanks revisions have already been considered by the Blanks (E) Working Group, therefore a blanks proposal does not need to be sponsored by the Working Group.
## Hearing Agenda

<table>
<thead>
<tr>
<th>Ref #</th>
<th>Title</th>
<th>Attachment #</th>
<th>Agreement with Exposed Document?</th>
<th>Comment Letter Page Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018-29</td>
<td>Consistency Revisions to A-820</td>
<td>7</td>
<td>Support Revisions</td>
<td>IP - 12</td>
</tr>
<tr>
<td>App A-820</td>
<td>(Robin)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Summary:

During the Summer National Meeting, the Working Group exposed nonsubstantive revisions to *Appendix A-820—Minimum Life and Annuity Reserve Standards* to remove the phrase “good and sufficient” reserve as it is not consistent with the related NAIC *Standard Valuation Law Model 820*.

### Interested Parties’ Comments:

Interested parties support the removal of the phrase “good and sufficient reserve” because it is not consistent with the NAIC *Standard Valuation Law* (Model 820).

### Recommended Action:

NAIC staff recommends adopting the exposed revisions to *Appendix A-820—Minimum Life and Annuity Reserve Standards* to remove the phrase “good and sufficient.”

<table>
<thead>
<tr>
<th>Ref #</th>
<th>Title</th>
<th>Attachment #</th>
<th>Agreement with Exposed Document?</th>
<th>Comment Letter Page Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018-30</td>
<td>Hedge Effectiveness Documentation</td>
<td>8</td>
<td>No Comments</td>
<td>IP - 1</td>
</tr>
<tr>
<td>SSAP No. 86</td>
<td>(Julie)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Summary:

On Nov. 15, 2018, the Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions to *SSAP No. 86—Derivatives* to incorporate hedge effectiveness documentation provisions reflected in *ASU 2017-12, Derivatives and Hedging*. The revisions proposed to SSAP No. 86 reflect a limited adoption of ASU 2017-12 to incorporate the following provisions:

- Allow companies to perform subsequent assessments of hedge effectiveness qualitatively if certain conditions are met.
- Allow companies more time to perform the initial quantitative hedge effectiveness assessment.
- Clarify that companies may apply the “critical terms match” method for a group of forecasted transactions if the transactions occur and the derivatives mature within the same 31-day period or fiscal month, and the other requirements for applying the critical terms match method are satisfied.

The revisions are proposed to be effective Jan. 1, 2019, with early adoption permitted for year-end 2018. A restriction is included that limits U.S. GAAP filers in early adopting only if they have early adopted ASU 2017-12 for year-end 2018.

### Interested Parties’ Comments:

Interested parties have no comment.

### Recommended Action:

NAIC staff recommends that the Working Group adopt revisions to incorporate limited provisions from *ASU 2017-12 pertaining to the documentation of hedge effectiveness, as exposed in agenda item 2018-30.*
with an effective date of Jan. 1, 2019. The revisions propose to allow early adoption for year-end 2018 in accordance with the provisions reflected in the SSAP.

<table>
<thead>
<tr>
<th>Ref #</th>
<th>Title</th>
<th>Attachment #</th>
<th>Agreement with Exposed Document?</th>
<th>Comment Letter Page Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018-31</td>
<td>Extension of Ninety-Day Rule for the Impact of Hurricane Florence and Hurricane Michael</td>
<td>9 &amp; 10</td>
<td>TBD</td>
<td>Pending</td>
</tr>
<tr>
<td>INT 18-04</td>
<td>(Jake)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Summary:**
On October 26 the Working Group exposed, via evote, an agenda item and tentative interpretation (INT) to provide a 60-day extension from the ninety-day rule for uncollected premium balances, bills receivable and amounts due from agents and policyholders directly impacted Hurricane Florence, Hurricane Michael, tropical storm Florence and tropical storm Michael, or the related flooding. This INT is consistent with previous temporary extensions granted for other nationally significant catastrophes. This agenda item and tentative INT were exposed for a two-week comment period ending Nov. 9, 2018

**Interested Parties’ Comments:**
Pending – Comments due Nov. 9, 2018

**Recommended Action:**
NAIC staff recommends adoption of the exposed INT. Due to the short-term nature of the applicability of this extension, which expires March 6, 2019, this interpretation will be publicly posted on the Statutory Accounting Principles (E) Working Group’s website. This interpretation will be automatically nullified on March 7, 2019 and will be included as a nullified INT in Appendix H – Superseded SSAPs and Nullified Interpretations in the “as of March 2019” Accounting Practices and Procedures Manual.

Note that the proposed extension temporarily overrides SSAP No. 6, paragraph 9 for affected policies, therefore the policy statement in Appendix F (see authoritative literature) requires 2/3rd (two-thirds) of the Working Group members to be present and voting and a supermajority of the Working Group members present to vote in support of the interpretation before it can be finalized.
REVIEW of COMMENTS on EXPOSED SUBSTANTIVE ITEMS

The Working Group will consider each of the following items separately.
1. Ref #2016-03: Derivatives Hedging Variable Annuity Guarantees
2. Ref #2016-20: ASU 2016-13, Credit Losses
3. Ref #2017-28: Reinsurance Credit
4. Ref #2017-32: SSAP No. 30 – Investment Classification Project

<table>
<thead>
<tr>
<th>Ref #</th>
<th>Title</th>
<th>Attachment #</th>
<th>Agreement with Exposed Document?</th>
<th>Comment Letter Page Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016-03</td>
<td>Derivatives Hedging Variable Annuity Guarantees</td>
<td>11 &amp; 12</td>
<td>Limited Comments</td>
<td>ACLI - 14</td>
</tr>
</tbody>
</table>

Summary:
During the Summer National Meeting, the Working Group exposed an issue paper and new SSAP to prescribe specific accounting and reporting guidance for derivatives that hedge interest rate risk of variable annuity guarantees. The issue paper and proposed SSAP included revisions from previously submitted comments from the ACLI and regulators.

ACLI Comments:
We have commented previously on many elements of the Exposure Draft and will therefore limit our comments to remaining open issues.

Comments on Timing and Effective Date

ACLI has stated previously that we support making the proposed guidance effective as soon as possible, because we do not believe the accounting changes need to wait until the work of the Variable Annuity Issues Working Group (VAIWG) related to reserves is complete. The framework for reserve changes was adopted by the NAIC in August and will likely be effective in 2020, with early adoption in 2019 under active consideration. Therefore, we recommend making the effective date January 1, 2020, with early adoption permitted.

Variable annuity reserves will not be fully sensitive to changes in interest rates, even after introduction of the updated framework. Timely adoption and implementation of SSAP 108 will reduce the accounting mismatch and potential negative consequences of a rising interest environment for companies that do not have the special accounting treatment in place. It will also facilitate migration away from existing Permitted Practices.

Comments on Transition

We appreciate the efforts by regulators and NAIC staff to draft the transition language in a way that will help insurers with existing Permitted Practices transition to the new guidance. We believe the intent is that the use of a transition method approved by a domiciliary state regulator would not result in a new Permitted Practice. We suggest adding clarifying language that an approved transition method should not be considered a new Permitted Practice, as long as the insurer is fully compliant with the provisions of the SSAP for new deferrals after implementation.

Other Comments

The following additional comments reflect changes in the reserving guidance being developed by industry and regulators:
Paragraph 6b – We suggest modifying the first sentence as follows: “Actuarial certifications of VM-21 reserves, consistent with VM-21 Valuation Manual requirements”. We believe the actuarial certification requirements could end up in another section of the Valuation Manual and removing this phrase would accommodate this potential change.

Paragraph 13eii and Appendix A: We suggest clarifying with a footnote the result of this calculation (the coverage ratio) should not exceed 100% nor drop below zero.

Paragraph 14: The Standard Scenario will likely be replaced by the Standard Projection. Therefore, we suggest modifying the following statement as follows: “The amortization timeframe shall equal the Macaulay duration of the guarantee benefit cash flows based on the VM-21 Standard Scenario”. As an alternative, a technical correction could be made to the SSAP once the reserving guidance is finalized.

Appendix A: The illustration contains two references to paragraph 14 that should be updated to paragraph 13. The reference to 14.b.1 should be replaced with 13.e.i and (14b.i less 14.b.iii) should be changed to (13.e.i less 13.e.iii).

**Recommended Action:**

NAIC staff recommends adopting the proposed SSAP No. 108—Derivatives Hedging Variable Annuity Guarantees and corresponding Issue Paper 159—Special Accounting for Limited Derivatives with modifications to address the issues identified by the ACLI as discussed below.

**Effective Date Discussion:** The ACLI has suggested a January 1, 2020 effective date, with early adoption permitted. Although the ACLI supports the SSAP being effective as early as possible, however, this effective date was suggested as the Variable Annuity Issues (E) Working Group work related to reserves is likely to be effective in 2020, with early adoption in 2019 permitted. **NAIC staff recommends discussion from the Working Group on when SSAP No. 108 will be effective:**

- **Option 1: Effective Date Jan. 1, 2020, Early Adoption for Year-End 2018** – This would allow companies to eliminate permitted practices and follow the established SSAP, however, the new reporting schedules and disclosure templates will not be available. *(This would eliminate Note 1 reporting for permitted / prescribed practices if the company follows the adopted SSAP, but would require narrative disclosures, as required in the SSAP, in Note 21. With this option, there would be no data-captured disclosures, but information would be captured as narrative disclosures.)*

- **Option 2: Effective Date Jan. 1, 2020, Early Adoption for Year-End 2019** – This would require companies to retain permitted practices for year-end 2018 (which will likely be consistent with prior year) and allow early adoption of the SSAP at the same time that the new reporting schedule and disclosure templates will be available. *(This would require Note 1 reporting if there are permitted / prescribed practices approved for 2018, but would eliminate that requirement in 2019 if the company follows the adopted SSAP. For 2019, assuming the disclosure and schedule templates have been adopted through blanks, information would be data-captured in the 2019 year-end financial statements.)*

- **Option 3: Specify an effective date of January 1, 2020 without early adoption permitted** – This will ensure that all companies move to the new SSAP at the same time at a time that is expected to correspond with the work of the Variable Annuity Issues (E) Working Group. *(This would require Note 1 reporting if permitted / prescribed practices are approved for 2018 and 2019, but would eliminate that requirement in 2020 if the company follows the adopted SSAP. For 2020, assuming the disclosure / templates have been adopted through blanks, information would be data-captured in the 2020 financial statements.)*

- **Option 4: Specify that the effective date will correspond to the effective date of the Variable Annuity Issues (E) Working Group work on reserves** – This approach will not specify an effective
date in the SSAP, but rather allow the Working Group to continue monitoring the work of the VAIWG and subsequently identify the effective date that corresponds with the actual effective date of the VAIWG reserve changes. *(This would require Note 1 reporting if permitted/prescribed practices are granted until the effective date of the standard. Once the SSAP is effective, assuming the disclosure/templates have been adopted through blanks, that information would be data-captured in the financial statements.)*

**Modifications Reflected:** In accordance with comments of the ACLI, NAIC staff recommends adopting SSAP No. 108, and the corresponding issue paper, with the modifications noted below. *(NAIC staff has presented the revisions as they would be reflected in the SSAP. Identical revisions will be reflected in the issue paper.)* The only change proposed by the ACLI not reflected is in paragraph 14. The ACLI comments proposed to remove “Standard Scenario” as that may change in the future. NAIC staff recommends retaining the reference until that change occurs. At that time, an editorial change can occur to reference the updated calculation.

**• Transition:** The ACLI suggested adding language that an approved transition method should not be considered a new permitted accounting practice as long as the insurer is fully compliant with the provisions of the SSAP after implementation.

**Proposed Revision:**

24. **This statement is effective** ___. The guidance in this SSAP is required to be applied on a prospective basis for qualifying hedge programs in place on or after the effective date. This prospective application prohibits deferred asset and deferred liability recognition from fair value fluctuations previously recognized as unrealized gains or losses that occurred prior to the effective date of the guidance.

25. Reporting entities that have previously received permitted or prescribed practices for qualifying hedge programs, resulting with the recognition of deferred assets/deferred liabilities from unrecognized fair value fluctuations, shall work with their domiciliary state regulator to determine the appropriate method in transitioning from previously approved permitted practices. The reporting entity shall include disclosure of the transition approach approved by the domiciliary state in their financial statements in the first year of application. The approved transition approach is not considered a permitted practice as long as the reporting entity is fully compliant with the provisions of this Statement after implementation. After the effective date of this Statement, domiciliary state provisions that differ from this Statement must be disclosed as a permitted or prescribed practice pursuant to SSAP No. 1.

**• Other Comments:** The following modifications reflect the additional comments of the ACLI:

6. With the provisions in this standard to allow for flexibility in the hedged item (changes to variable annuity contracts within a portfolio) coupled with a dynamic hedging approach (rebalancing of derivative hedging instruments), there is a greater risk of misrepresentation of successful risk management and achievement of a highly effective hedging relationship. Although this risk cannot be eliminated, the following provisions intend to ensure governance of the program and provide sufficient tools to allow for regulator review:

a. Prior to implementing a hedging program for application within scope of this standard, the reporting entity must obtain explicit approval from the domiciliary state commissioner allowing use of this special accounting provision. The domiciliary state commissioner may subsequently disallow use of this special accounting provision at their discretion. Although this guidance does not restrict the state domiciliary commissioner on when to prohibit future use, disallowance should be considered upon finding that the reporting entity’s documentation, controls, measurement, prior execution of strategy or historical results are not adequate to support future use.

b. Actuarial certifications of VM-21 reserves, consistent with **VM-24—Valuation Manual** requirements, which explicitly include the following:
i. Certification as to whether the hedging strategy is incorporated within the establishment of VM-21 reserves, and the impact of the hedging strategy within the VM-21 Conditional Tail Expectation Amount.

ii. Certification by a financial officer of the company (CFO, treasurer, CIO, or designated person with authority over the actual trading of assets and derivatives) that the hedging strategy meets the definition of a Clearly Defined Hedging Strategy within VM-21 and that the Clearly Defined Hedging Strategy is the hedging strategy being used by the company in its actual day-to-day risk mitigation efforts. This provision does not require reporting entities to use a hedging strategy in determining VM-21 reserves, nor does it require entities to use the special accounting provision within this standard. However, it does require reporting entities that use the special accounting provisions within this standard to certify that the hedging strategy within scope of this standard is a Clearly Defined Hedging Strategy and is reflected in the establishment of VM-21 reserves.

13.e. Reporting entities shall utilize the following calculation for establishing the deferred asset (also illustrated in Appendix A) unless a different method has been approved by the domiciliary state commissioner:

I. Calculate the fair value gain or loss in the hedged item attributable to the hedged risk.

II. Express the quantity calculated in paragraph 13.e.i. as a percentage of the change in the full-contract fair value (i.e., with all product cash flows) attributed to interest rate movements.

III. Calculate the VM-21 liability change attributed to the hedged risk as the quantity calculated in paragraph 13.e.ii. multiplied by the VM-21 liability change attributable to interest rate.

IV. Establish the deferred asset or deferred liability in the amount of the fair value loss or (gain) of the designated hedging instruments attributed to the hedged risk less the VM-21 liability decrease or (increase) attributed to the hedged risk as calculated in paragraph 13.e.iii.

V. Allocate an amount equal to the net deferred asset and deferred liability (net amount from all hedging strategies / programs captured within this guidance) to special surplus.

Footnote: The result of this calculation (the coverage ratio) should not exceed 100% nor drop below zero.

14. Deferred assets and deferred liabilities recognized under paragraph 13.b. shall be amortized using a straight-line method into realized gains or realized losses over a finite amortization period. The amortization timeframe shall equal the Macaulay duration of the guarantee benefit cash flows based on the VM-21 Standard Scenario, but shall not exceed a period of 10 years.

Appendix A – Calculation of Deferred Asset or Deferred Liability

Under the special accounting provisions within this issue paper, as detailed in paragraph 13.e., fair value fluctuations in the hedging instruments attributable to the hedged risk that do not offset the current period change in the hedged item (the change in the VM-21 reserve liability) can be recognized as deferred assets (admitted) and deferred liabilities.

The ability to recognize a deferred asset and deferred liability is limited to only the portion of the fair value fluctuation in the hedging instruments that is attributed to the hedged risk and does not immediately offset changes in the hedged item. As detailed in the standard, the hedged risk may be designated as a specific component of the hedged item. For example, if the variable annuity reserve benefits are matched to
bonds, the hedged risk could only be the portion of interest rate risk remaining after the natural hedge based on the asset-liability matching.

Unless a different method has been approved by the domiciliary state commissioner, reporting entities shall utilize the following calculation (detailed in paragraph 13) for establishing the deferred asset:

13.e.i Calculate the fair value gain or loss in the hedged item attributable to the hedged risk (Step 1);

13.e.ii Express the fair value gain or loss calculated (Step 1) as a percentage of the change in the full-contract fair value (i.e., with all product cash flows) attributed to interest rate movements (Step 2).

13.e.iii Calculate the VM-21 liability change attributed to the hedged risk as the quantity calculated in Step 2 multiplied by the VM-21 liability change attributable to interest rate (Step 3).

13.e.iv Establish the deferred asset or deferred liability in the amount of the fair value loss or (gain) of the designated hedging instruments attributed to the hedged risk less the VM-21 liability decrease or (increase) attributed to the hedged risk as calculated in Step 3.

13.e.v Allocate an amount equal to the net deferred asset and deferred liability (net amount from all hedging strategies / programs captured within this guidance) to special surplus.

Footnote: The result of this calculation (the coverage ratio) should not exceed 100% nor drop below zero.

To illustrate the above calculation:

**Clearly Defined Hedging Strategy (CDHS) characteristics**

<table>
<thead>
<tr>
<th>Hedged item</th>
<th>Rider claims less rider fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedged risk</td>
<td>50% of the rho (first-order IR level sensitivity)</td>
</tr>
</tbody>
</table>

**Calculation of the deferred asset or liability**

*Note: positive values = increase in liability*

| Fair value gain (loss) in hedged item attributable to interest rate movement | (500) |
| 13.e.i. - Fair value gain (loss) in hedged item attributable to hedged risk | (250) |

Hence, if the insurer were hedging per the CDHS perfectly, then the insurer should see a 250 fair value loss in the designated IR hedge instruments. To determine how much of that loss should be deferred:

| Fair value gain (loss) in full-contract cash flows attributable to IR movement | (700) |
| 13.e.ii - Quantity calculated in 134.eb.i as a % of the (700) above | 36% |

| VM-21 liability increase (decrease) from beginning of period to end of period | 400 |
| VM-21 liability increase (decrease) attributable to interest rate movements | (100) |
| 13.e.iii - VM-21 liability increase (decrease) attributable to the hedged risk | (36) |

In this example, even though the VM-21 liability increased by 400 during the reporting period, interest rate movements actually contributed to a 100 decrease. The hedged risk (50% of the interest rate sensitivity of rider cash flows) accounts for 36% of this, or $36 of the liability decrease. As such, $36 of the fair value loss on the interest rate hedge instruments should be reflected immediately and the remainder deferred via a deferred asset equal in amount to 250 – 36 = 214.

| 13.e.iv – Deferred asset (134.be.i less 134.eb.iii) attributable to hedged risk | (214) |
| (This is shown as a negative – to be consistent with the decrease in VM-21 liability – but represents a deferred asset. Deferred assets reflect fair value losses.) |
Summary:
This agenda item is working to clarify the determination of reinsurance credit. In addition, it is addressing a Financial Analysis (E) Working Group (FAWG) referral which noted issues with reinsurance including trends regarding the use of reinsurance noted in financial analysis reviews. FAWG noted that the while the number of contracts may be limited, they appear to be more prevalent in troubled company situations and are being offered by otherwise well-regarded reinsurers. The April 2017 FAWG referral noted concerns with risk limiting features. The referral noted that the motivation for the contracts appears to be surplus relief, without a significant amount of insurance risk being transferred to the reinsurer.

The Working Group previously exposed language in August 2017 and then formed two informal drafting groups (1-life and health and 2-property and casualty) to develop detailed recommendations. During the 2018 Summer National Meeting, the Working Group exposed revisions recommended by the informal reinsurance drafting groups as follows:

- Exposed substantive revisions to SSAP No. 62R—Property and Casualty Reinsurance to incorporate guidance from EITF 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises and from EITF D-035, FASB Staff Views on Issue No. 93-6. (Drafting notes are not planned to be in the final document.) The Working Group also requested, input on the effective date.

- Exposed nonsubstantive revisions to SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance to incorporate disclosures. The proposed revisions also update the question-and-answer guidance in Appendix A-791—Life and Health Reinsurance Agreements (A-791) to clarify the applicability of A-791. The Life and Health exposure was noted as an interim exposure to gain more input for the informal drafting group’s continued work. The Financial Analysis (E) Working Group was notified of the exposure with a request for comments on whether the proposed disclosures adequately address the referral.

Note as the full agenda item is over 35 pages only exposed revisions were included the materials.

Interested Parties’ Comments:
Interested parties have no comments.

Connecticut Department of Insurance in response to notice sent to the Financial Analysis (E) Working Group:
We have reviewed SSAP Agenda Item # 2017-28 with respect to the proposed disclosures and updates to Appendix A-791 and SSAP No. 61R. Our primary objective was to provide feedback on whether the enhanced disclosures in SSAP No. 61R would be sufficient to address FAWG’s concern with life reinsurance contracts incorporating risk-limiting features.

We have recently become aware of experience-rated YRT treaties that cede group term life risk with the primary purpose of achieving RBC relief for the cedant. The experience–refund feature is combined with “excessively high” YRT premiums, substantially mitigating and/or all but eliminating risk transfer to the assuming reinsurer.

The existence of these treaties will not be captured by the proposed disclosures to SSAP No. 61R (paragraphs 82-87). We, therefore, propose modifying the end of the second sentence of paragraph 83 to read “… a loss ratio
corridor or YRT premiums in excess of amounts collected on the ceded policies.”. We do not cite the experience-refund feature, as non-abusive experience refunds are common, accepted and not readily attackable. Further, it is the excessive level of reinsurance premiums that in practice limits the risk transfer and makes the net cost to the cedant (when combined with the experience-refund feature) attractive to the cedant.

We note that the blanket exclusion accorded to YRT reinsurance in Appendix A-791 remains unchanged in the proposed revision, which focuses instead on elaborating on the phrase “certain non-proportional reinsurance”. To address the concern mentioned above, three changes should be considered. Specific to Appendix A-791, we suggest expanding the second sentence of the current language to read “… does not meet the intended definition of YRT if (1) the surplus relief … from the reinsurer, or (2) the YRT premium paid to the reinsurer exceeds the equivalent amount collected by the ceding insurer.” and modifying the third line of the first paragraph to read “significant surplus relief or RBC ratio enhancement”. The third change does not impact Appendix A-791 but instead modifies paragraph 19 of SSAP No. 61R. We would add “2.e.” to the list of objectionable Appendix A-791 paragraphs cited (i.e. … paragraphs 2.b., 2.c., 2.d., 2.e., 2.h., …).”

NAIC staff has illustrated the Connecticut recommended revisions as shaded changes to A-791 and the exposed SSAP No. 61R below.

CT proposed disclosure edit to SSAP No.61R:

83. Disclose any reinsurance contracts (or multiple contracts with the same reinsurer or its affiliates) not subject to A-791, for which reinsurance accounting was applied and includes a provision that limits the reinsurer’s assumption of risk. Examples of risk limiting features include provisions such as a deductible, a loss ratio corridor, or YRT premiums in excess of the equivalent amounts collected on the ceded policies; a loss cap, an aggregate limit or similar effect. If true, indicate the number of reinsurance contracts to which such provisions apply. If affirmative, indicate if the reinsurance credit was reduced for the risk limiting features. (Drafting Note: Similar to SSAP No. 62R, paragraph 93.)

9. Yearly renewable term (YRT) reinsurance agreements that transfer a proportionate share of mortality or morbidity risk inherent in the business being reinsured and do not contain any of the conditions described in Appendix A-791, paragraphs 2.b., 2.c., 2.d., 2.e., 2.h., 2.i., 2.j. or 2.k., shall follow the guidance for reinsurance accounting, including paragraphs 55-57 that apply to indemnity reinsurance. Contracts that fail to meet the requirements for reinsurance accounting shall follow the guidance for Deposit Accounting. For all treaties entered into on or after January 1, 2003, the deferral guidance in paragraph 3 of A-791 shall also apply to YRT agreements. Since YRT agreements only transfer the mortality or morbidity risks to the reinsurer, the recognition of income shall be reflected on a net of tax basis, as gains emerge based on the mortality or morbidity experience.

Q – Aside from assumption reinsurance, what other types of reinsurance are exempt from the accounting requirements?

A – Yearly renewable term (YRT) and certain nonproportional reinsurance arrangements, such as stop loss and catastrophe reinsurance are exempt because these do not normally provide significant surplus relief or RBC ratio enhancement and therefore are outside the scope of this Appendix. If a catastrophe arrangement takes a reserve credit for actual losses beyond the attachment point or the unearned premium reserve (UPR) of the current year’s premium, there will most likely be no regulatory concern.

Similarly, if a YRT treaty provides incidental reserve credits for the ceding insurer’s net amount at risk for the year with no other allowance to enhance surplus, there will most likely be no regulatory concern. For purposes of this exemption, a treaty labeled as YRT does not meet the intended definition of YRT if [1] the surplus relief in the first year is greater than that provided by a YRT treaty with zero first year reinsurance premium and no additional allowance from the reinsurer [2] the YRT premium paid to the reinsurer exceeds the equivalent amount collected by the ceding insurer.

Additional pertinent information applicable to all YRT treaties and to non-proportional reinsurance arrangements is contained in paragraphs 19 and 20 of SSAP No. 61R.
To further elaborate on the phrase "certain non-proportional reinsurance" in paragraph 1, the beginning of the answer notes that contracts such as stop-loss and catastrophe do not normally provide significant surplus relief, and are therefore not subject to the accounting guidance in Appendix A-791. Non-proportional reinsurance agreements are considered not to provide significant surplus relief if they possess all of the following features. For the purposes of defining these features, the term "triggering event" means the event or sequence of events that would lead to a loss being reimbursable by the reinsurer pursuant to the terms of the reinsurance agreement.

1. The triggering event has not occurred at the time of the inception of the reinsurance agreement.

2. The triggering event is materially less likely than not to occur during each settlement period of the reinsurance agreement.

3. There is no initial reinsurance credit for ceded policy reserves and any reinsurance expense allowance or commission is reported so that surplus is not impacted until the related premium is reported as earned.

These criteria shall be evaluated separately for each measurement period under the reinsurance agreement, where the measurement period is that period of time for which the direct writer's experience is used to determine the amounts owed to and from the reinsurer. If there are carry-forwards of experience debits or credits from one calendar year to the next, then those multiple years will be considered one settlement period.

The fact that the triggering event does eventually occur, is not itself evidence that the second criterion above has not been met. The criterion should be evaluated based on reasonable expectations rather than posteriori results.

**NJ Comments on YRT**

We understand that SAPWG is currently reviewing a referral from the Financial Analysis (E) Working Group (FAWG) regarding risk limiting features in reinsurance contracts.

The New Jersey Department of Banking and Insurance (NJDOBI) has recently become aware of a practice for Group Life YRT Reinsurance which may also require interpretive guidance and/or changes to SSAP No. 6/R - Life and Health Reinsurance and Appendix A-791 - Life and Health Reinsurance Agreements. We understand there are Group Life YRT Reinsurance arrangements which significantly reduce net amount at risk subject to RBC charges for ceding insurers with limited transfer of risk of the business to the assuming reinsurers. We also understand that the companies are interpreting and treating the reinsurance arrangements as qualifying for reinsurance accounting under statutory accounting (STAT), but not under GAAP.

Features within the treaties that limit the transfer of risk of the business to assuming reinsurers include (but may not be limited to):

1. Ceding insurers may pay reinsurance premium well in excess of the proportionate direct YRT premiums.

2. Ceding insurers may be subject to annual re-pricing by the assuming reinsurers that can be multiple times (3x-4x) of the proportionate direct YRT premiums.

3. The arrangements may employ both a Loss Carryforward Account" and an "Experience Refund." Any amounts advanced to the ceding insurer by the reinsurers under the treaties for negative experience will be notionally tracked in an off-balance sheet loss carryforward account and credited with interest at rates stipulated in the treaties. Repayment of the outstanding loss carryforward balance occurs upon the generation of subsequent positive experience. Positive experience must be used first to reduce the balance included in the loss carryforward account; any excess positive experience remaining after full payment of the loss carryforward balance (and any associated risk charges owing) will be retained by the ceding...
The STAT analyses apparently hinge on the "transfer of proportionate share of mortality risk" under paragraph 19 of SSAP 61R (which limits the application of A-791 for YRT arrangements) and the overarching criteria of paragraph 17. The parties to the contracts believe that reinsurers do assume a theoretical, ultimate risk of loss under the treaties if everyone was to die in the same year or every group insurance policyholder were to cancel or lapse and there was an outstanding loss carryforward. Absent these events, the reinsurer has little or no risk of loss. However, this position results in a circumstance where SSAP 61R would be less stringent than its GAAP counterpart ASC 944-20. This appears contrary to the intent and approach of statutory accounting.

The impact of these transactions may be tracked within the Annual Statement. Typically, the arrangements are listed on Schedule S - Part 3 - Section 1 (life reinsurance ceded). The reinsured ceded in-force amount is reported on the Exhibit of Life Insurance, Column 9, Line 22 which reduces the total Group Life Amount of Insurance on Column 9, Line 23 (amount of insurance adjusted for reinsurance). The RBC C-2 Charges are based on the Exhibit of Life Insurance, Column 9, Line 23, resulting in the elimination of any risk-based charge for the YRT reinsurance arrangements. As the accounting issues are reviewed, the applicable statutory reporting implications would also need to follow (i.e., treaties subject to deposit accounting should not receive a reduction in RBC.)

Similar in nature to the original FAWG referral, we are concerned that reinsurance contracts with these types of risk-limiting features will continue to mask the true financial performance and position of insurers, as well as the risks they are exposed to. Therefore, we recommend the current Statutory Accounting Principles (E) Working Group work be expanded to take on the above issue.

**Recommended Action:**

NAIC staff recommends adopting the revisions to SSAP No. 62R with a January 1, 2019 effective date and directing NAIC staff to draft an issue paper documenting the substantive revisions. NAIC staff recommends forwarding Connecticut and New Jersey feedback on the SSAP No. 61R and A-791 exposure to the informal life and health reinsurance drafting group to continue their work.

Both and Connecticut and New Jersey have raised some concerns regarding reinsurance credit and risk transfer on yearly renewable term (YRT) contracts. Connecticut provide recommend edits on YRT issues in their comments on the A-791 and SSAP No. 61R exposed revisions.

New Jersey comments are regarding group life YRT reinsurance arrangements which significantly reduce net amount at risk subject to RBC charges for ceding insurers while limiting the transfer of (risk of the business) to the assuming reinsurers. These features may greatly reduce the possibility of loss to the reinsurer, however insurers are taking large risk-based capital benefits.

Both states noted concerns with YRT contracts that are taking a greater proportion of reinsurance premium than the proportional premium on the underlying direct premium. The greater proportion can be either by direct charges or through the use of loss carryforward or experience refund features which can make the possibility of reinsurer loss remote. NAIC staff recommendation is to forward these comments to the informal life and health reinsurance drafting group and expand the work of the informal drafting group. In addition, staff recommends soliciting additional states to join the informal drafting group.
Summary:
During the Summer National Meeting, the Working Group exposed an issue paper and substantively revised SSAP No. 30R—Unaffiliated Common Stock. Key revisions detailed within the proposed guidance improve the common stock definition and include closed-end funds and unit-investment trusts within scope.

Interested Parties’ Comments:
Interested parties are supportive of the proposed changes to SSAP No. 30, the related Issue Paper, and a January 1, 2019 effective date.
Some in industry have noted that existing SSAP No. 30 scope language includes “shares of mutual funds” while the new exposure only specifically scopes in SEC registered mutual funds. Foreign open-ended mutual funds that are structured similarly to SEC registered mutual funds with an NAV that is calculated and published periodically and used as the basis for purchases and redemptions should be included in SSAP No. 30. Additionally, foreign open-ended mutual funds are often registered with and regulated by competent regulatory bodies. Interested parties believe a case can be made to expand the scope of SSAP No. 30 to include such registered foreign open-end mutual funds, with similar structure and regulation, and respectfully ask the Working Group to explore this idea during 2019. Interested Parties can provide further information on such foreign open-end mutual funds upon the Working Group’s request.

Recommended Action:
NAIC staff recommends that the Working Group adopt the exposed substantially revised SSAP No. 30R—Unaffiliated Common Stock, and the corresponding Issue Paper (to be named Issue Paper No. 158—Unaffiliated Common Stock) with an effective date of Jan. 1, 2019. NAIC staff recommends sponsoring a blanks proposal to capture information on Unit Investment Trusts and Closed End Funds on Schedule D-2-2. (Currently mutual funds have a separate reporting line.)

NAIC staff has prepared an agenda item to begin considering the issue of foreign mutual funds as requested by interested parties. This item is included on the Meeting agenda with a request for exposure.
The Working Group will consider each of the following items separately:

1. Ref #2017-17: Structured Settlements
2. Ref #2017-18: Structured Notes
3. Ref #2018-19: Elimination of MFE
4. Ref #2018-20: Debt Forgiveness Between Related Parties
5. Ref #2018-21: SSAP No. 72 Distributions
6. Ref #2018-22: Participation Agreement in a Mortgage Loan
7. Ref #2018-26: SCA Loss Tracking – Accounting Guidance
8. Ref #2018-27: SSAP No. 48 Entities’ Loss Tracking

<table>
<thead>
<tr>
<th>Ref #</th>
<th>Title</th>
<th>Attachment #</th>
<th>Agreement with Exposed Document?</th>
<th>Comment Letter Page Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018-17</td>
<td>SSAP No. 21 (Julie)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Structured Settlements</td>
<td>16 -Agenda &amp; 17- VOSTF</td>
<td>Supports Revisions</td>
<td>IP - 3</td>
</tr>
</tbody>
</table>

Summary:
During the Summer National Meeting, the Working Group exposed nonsubstantive revisions proposing accounting and reporting guidance for structured settlement income streams acquired by insurers as investments. The proposed accounting and reporting reflected the following concepts:

1. Structured settlement income streams acquired by insurance reporting entities, when the reporting entity is not the owner or payee of a corresponding annuity, through acquisition of an interest in a securitized pool that meets the scope requirements of SSAP No. 43R—Loan-backed and Structured Securities shall follow the accounting and reporting guidance of that SSAP. (This is not a change from existing guidance.)

2. Period certain (non-life contingent) structured settlement income streams acquired by insurance reporting entities, when the reporting entity is not the owner or payee of a corresponding annuity, as individual investments (not as securitizations), are considered other long-term investments, captured on Schedule BA, and permitted as admitted assets when the structured settlement income stream has been legally acquired in accordance with all state and federal requirements. These acquisition requirements include court-approval of the income stream transfer from the original beneficiary. If a structured settlement income stream has not been legally transferred from the original beneficiary to the insurer acquirer, the structured settlement shall be fully nonadmitted by the insurance reporting entity. (Unless there is legal transfer, nonadmittance is required as the acquirer may not be entitled to receive the future income streams.) In addition to nonadmittance, the insurer acquirer must also appropriately report the excise tax required under the IRS code.

3. Life contingent structured settlement income streams acquired by insurance reporting entities, when the reporting entity is not the owner or payee of a corresponding annuity, as individual investments (not as securitizations), are considered other long-term investments, captured on Schedule BA, and shall be fully nonadmitted. (With life contingent income streams, nonadmittance is required as it is uncertain whether any future income streams will be received. As such, these items should not be considered admitted assets available for policyholder claims under SSAP No. 4—Assets and Nonadmitted Assets.)

4. As this agenda item is focusing on structured settlements, the guidance should not be inferred to “life settlement” acquisitions. Life settlements are not structured settlements. A life settlement transaction is when an investor purchases an insurance policy from an insured and continues to pay the premium payments so that when the insured event occurs (e.g., death of the insured), the investor receives the death benefit. In life settlements, the investor often pays the insured an amount greater than the cash surrender.
value of the insurance policy, with an expectation that the insured event will occur in a timeframe that the death benefit received is greater than the cost of the purchase price and the future premium payments to keep the policy active. As detailed in this agenda item, a structured settlement is the legal right to future cash flows and does not reflect the acquisition of an insurance policy. Unlike life settlements, there is no cash surrender value to structured settlements, and payments under the structured settlement are not renegotiable once set.

**Interested Parties’ Comments:**
Interested parties support the proposed accounting and reporting guidance on structured settlements.

**Recommended Action:**
NAIC staff recommends adopting the exposed revisions to SSAP No. 21—Other Admitted Assets to prescribe accounting guidance when a reporting entity acquires the legal rights to receive payments from a structured security. With adoption, NAIC staff recommends direction from the Working Group on whether the proposed revisions should be considered substantive or nonsubstantive. At this time, NAIC staff does not suggest a dedicated reporting line on Schedule BA for structured settlements. Rather, NAIC staff recommends a blanks proposal to incorporate annual statement instructions to clarify that each structured settlement can be reported separately as “any other class of asset” on Schedule BA, unless the structured settlement can be aggregated with other structured settlements with similar terms and payout streams.

As detailed in the exposed guidance, reporting entities that acquire period-certain structured settlement income streams shall reported these as other long-term invested assets (on Schedule BA). These assets shall be admitted if the rights to the future payment stream had been legally acquired in accordance with state and federal requirements. All life contingent structured settlements as well as any period-certain structured settlements not acquired in accordance with all legal requirements, shall be reported on Schedule BA as nonadmitted assets.

Additionally, at the time of exposure, the Working Group directed a referral to the Valuation of Securities Task Force. A referral response has been received indicating that the Task Force and the NAIC Investment Analysis Office (IAO) support the proposal to establish statutory accounting guidance for structured settlements. This response identifies that purchases of cash streams by assignment of the right to payments due under structured settlements are already filed with, and designated for credit quality, by the SVO.

**Substantive / Nonsubstantive:** NAIC staff notes that the exposure requested input on whether the proposed changes should be considered substantive or nonsubstantive changes. No input was received from interested parties on this element.

- If considered nonsubstantive, the revisions would be considered effective immediately unless the Working Group chooses to specify a separate effective date. Although it is an option, nonsubstantive revisions do not normally have a related issue paper.

- If considered substantive, the revisions should have a stated effective date and be accompanied by a corresponding issue paper. (Even if substantive, the Working Group could prescribe a year-end 2018 effective date, and the issue paper could be subsequently developed for historical purposes.)
<table>
<thead>
<tr>
<th>Ref #</th>
<th>Title</th>
<th>Attachment #</th>
<th>Agreement with Exposed Document?</th>
<th>Comment Letter Page Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018-18</td>
<td>Structured Notes</td>
<td>18</td>
<td>Comments Received</td>
<td>IP - 3</td>
</tr>
<tr>
<td>SSAP No. 2</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SSAP No. 26R</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SSAP No. 43</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SSAP No. 86 (Julie)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Summary:**
During the Summer National Meeting, the Working Group exposed nonsubstantive revisions to revise guidance for structured notes when the reporting entity holder assumes a risk of principal loss based on an underlying component unrelated to the credit risk of the issuer. The exposed revisions are summarized as follows:

- **SSAP No. 2—Cash, Cash Equivalents, Drafts and Short-Term Investments:** Revisions clarify that derivative instruments shall not be reported as cash equivalents or short-term instruments regardless of their maturity date and shall be reported as derivatives regardless of maturity.

- **SSAP No. 26R—Bonds:** Revisions remove securities from the bond definition when the contractual amount of the instrument to be paid at maturity is at risk for other than the failure of the borrower to pay the contractual amount due. This guidance identifies that the instrument may be in the form of a debt instrument, but the issuer obligation to return principal is contingent on the performance of an underlying variable (e.g., equity index or performance of an unrelated security.) The revisions also delete the structured note disclosure.

- **SSAP No. 43R—Loan-backed and Structured Securities:** Revisions explicitly capture mortgage-reference securities in scope. This is an explicit exception to the LBSS definition, as the items do not qualify as “loan-backed securities” as the pool of mortgages are not held in trust, and the amounts due under the investment are not backed by the referenced mortgages.

- **SSAP No. 86—Derivatives:** Revisions capture structured notes in scope when there is a risk of principal loss based on the terms of the agreement (in addition to default risk).

**Interested Parties’ Comments:**
Interested parties agree with NAIC staff that the accounting for such structured notes, where the investor assumes risk of principal loss based on an underlying component unrelated to the credit risk of the issuer, warrants scrutiny given today’s amortized cost treatment currently afforded under SSAP No. 26R. Such scrutiny is also warranted because, unlike US GAAP, embedded derivatives are not bifurcated from the host investment under statutory accounting. Fair value measurement of such securities may be appropriate under statutory accounting.

However, interested parties believe these bonds, where the investor assumes some risk of principal loss based on an underlying component unrelated to the credit risk of the issuer, can be better addressed within SSAP No. 26R. Specifically, by requiring their measurement at fair value, through unrealized gain/loss, similar to 1) an insurer that maintains an Asset Valuation Reserve (AVR), for bonds with an NAIC designation of 6, 2) an insurer that does not maintain an AVR, for bonds with an NAIC designation of 3-6 and 3) mandatory convertible bonds, when fair value is below cost. This achieves the following three objectives:

1) Requires fair value reporting as suggested is appropriate per the exposure draft,

2) Does not require the host bond investment, with an embedded derivative, to be reported under SSAP No. 86 as a derivative, along with its embedded derivative component, and
3) Reduces the likelihood that an insurance company may inadvertently run afoul of certain state investment limitations, that may prohibit insurers from holding speculative derivative instruments. That is, by classifying a whole bond investment, as a derivative, just because the bond investment hosts an embedded derivative component.

Interested parties are supportive of the NAIC staff’s proposed definition of structured notes (i.e., the investor assumes the risk of principal loss unrelated to the credit risk of the issuer) and are supportive of NAIC’s staff’s view that all such structured notes, regardless of maturity, should be recorded at fair value. However, interested parties believe all such structured notes, including those acquired with a remaining maturity of year or less at the time of acquisition, should also be reported at fair value within SSAP No. 26R.

Lastly, interested parties are supportive of the NAIC staff’s proposed exception that would include mortgage-referenced securities within the scope of SSAP No. 43R as such securities are, in substance similar, to other SSAP No. 43R securities and where the credit risk can be assessed by existing methodologies of the NAIC Securities Valuation Office and/or the NAIC Structured Securities Group. However, interested parties would propose one small change (underlined) to the NAIC staff’s proposed changes to paragraph 33 of SSAP No. 43R to ensure consistency with other in substance similar securities:

(For mortgage-referenced securities, an OTTI is considered to have occurred when there has been a delinquency or other credit event in the reference pool of mortgages, such that the entity does not expect to recover the entire amortized cost basis of the security.)

**Recommended Action:**

In reviewing the interested parties’ comments, NAIC staff has provided the following discussion points:

- It is correct that the form of a structured note is a debt instrument. However, the debt instrument is a “wrapper” around the underlying derivative component. **It is the derivative component that impacts the amount of principal, or original investment amount, that will be returned at maturity.**

- The amount of principal repayment is often determined based on the underlying component **as of the date of maturity.** As such, even if the underlying component appears to be on the upside on prior reporting dates, if on the date of maturity, the underlying component drops below the downside threshold, any principal repayment will be calculated based on that maturity date (resulting in principal loss). Additionally, there is an extremely limited secondary market, and if attempting to sell the security in advance of the maturity date, the holder should expect to sell at a significant discount to its value. Although NAIC staff agrees that fair value is likely still the most appropriate reporting value, any reported “fair value” will be a level 3 measurement (determined without observable inputs), and **any fair value amount reported on a financial statement reporting date will not approximate the principal repayment that would be calculated as of the date of maturity.**

- NAIC staff agrees that if these items are captured in scope of SSAP No. 26R, the guidance for mandatory convertibles is likely most appropriate, however, **the differences between structured notes and mandatory convertibles are significant.** With a mandatory convertible, the instrument will convert to an equity instrument on a specific date, or in response to a specific trigger, but the reporting entity is not required to liquidate the equity instrument at the time of conversion. As such, the reporting entity could continue to hold the equity instrument and benefit from potential future increases in value. **With a structured note, the instrument terminates on the date of maturity and the holder receives the principal repayment based on the underlying trigger (e.g., equity performance) as of the point in time.** As such, there is no potential for a reporting entity to continue holding the instrument to regain value. **This structure is a derivative forward, in which two parties commit to transact at a future specified date in accordance with terms of the agreement established at acquisition.**
Guidance for mandatory convertibles requires measurement at the lower of amortized cost or fair value. Mandatory convertibles are not reported with NAIC designations or CRP ratings. For RBC purposes, the formula adjusts mandatory convertibles to reflect what would be owned at the time of conversion. (For example, if the mandatory convertible was to result in common stock at the time of conversion, the RBC charge for the convertible results in the common stock charge.) The lack of NAIC designations for these items is problematic as all Schedule D-1 items are presumed to be reported with NAIC designations. Even with the specific process for mandatory convertibles, the RBC and AVR instructions are not clear on where these are captured (by NAIC designation bucket) prior to the adjustments for the convertible component.

- NAIC staff does not agree with the interested parties’ objective to prevent these instruments from being considered speculative derivatives and limited under state investment limitations. It is NAIC staff’s opinion that these instruments are speculative derivatives. **NAIC staff believes the structure of these items has occurred to allow classification as a debt instrument (based on form), when the instrument is in substance a derivative instrument. As such, NAIC staff believes these instruments should be captured in state derivative investment limitations.**

- The reporting for cash equivalents and short-term investments is designed for situations in which the investment is so near maturity there is limited expected change in the credit quality of the instrument. (This is why such investments are not reported with NAIC designations and the RBC charge is minimal.) **For structured notes, regardless of the timeframe till maturity, the creditworthiness of the issuer has no bearing on the formula that determines the amount of principal repayment, or return of original investment, as of the date of maturity.** (Remittance could be impacted by the credit quality of the issuer, but the key issue with these securities is the uncertainty of the actual principal repayment that will be owed based on the underlying derivative component.) As such, **based on the design and underlying derivative components, these instruments should never be reported as short-term or cash equivalents.**

Pursuant to the discussion points above, NAIC staff supports reporting structured notes, when the contractual amount of the instrument to be paid at maturity is at risk for other than failure of the borrower to pay the amount due, as derivatives. Reporting as derivatives is more appropriate based on the substance of the transaction, rather than the design to reflect a debt instrument.

**For the Fall NM, NAIC staff suggests the Working Group to take action under one of the following options:**

- **Option 1:** Adopt the exposed revisions, with the modification suggested by interested parties to SSAP No. 43R. If preferring adoption, the Working Group could consider a Jan. 1, 2019 effective date, to prevent a change in reporting immediately before year-end.

- **Option 2:** Re-expose the proposed revisions with the modification to SSAP No. 43R suggested by interested parties. This re-exposure would reflect the same concepts as the original exposure but allow more time for further review of the classification of structured notes as either bonds or derivatives. **(This is NAIC staff’s preferred option to give the regulators more time to consider interested parties’ and NAIC staff comments on this issue.)**

- **Option 3:** Direct NAIC staff to draft revisions to incorporate the interested parties’ proposal to treat structured notes in scope of SSAP No. 26R, with provisions for measurement and NAIC designations to be similar to mandatory convertibles. (This re-exposure would retain the prior concepts for all items except for the structured notes that were originally proposed to be moved to SSAP No. 86 as derivatives.)

NAIC staff notes that the original agenda item was classified as nonsubstantive. If a substantive classification is considered more appropriate, the Working Group could reclassify this agenda item as substantive and direct NAIC staff to prepare an issue paper for subsequent exposure.
NAIC staff also notes that it may be appropriate to proceed with notifying the Blanks (E) Working Group and the Capital Adequacy (E) Task Force of this issue and sponsor a blanks proposal. Regardless of the ultimate decision between bond / derivative for structures notes, NAIC staff would also recommend reporting revisions to separately identify the government sponsored enterprises captured in SSAP No. 43R. If the Working Group is leaning towards SSAP No. 26R for structured notes, NAIC staff would also recommend reporting revisions to identify these investments on Schedule D-1. This would also require RBC revisions as they would not be reported with an NAIC designation and would need to be addressed accordingly.

### Summary:
During the Summer National Meeting, the Working Group exposed nonsubstantive revisions to eliminate the MFE process in determining NAIC designation in accordance with the VOSTF referral. As noted in the agenda item, although the Working Group is recommended to proceed with exposure on this agenda item and solicit comments for consideration, final action will not occur on this item until revisions eliminating the MFE process have been adopted by the Valuation of Securities (E) Task Force.

### Interested Parties’ Comments:
Interested parties are supportive of the Proposal and an effective date as of March 31, 2019, with early application permitted. We understand that any company electing early application would apply this approach to all applicable securities held at December 31, 2018.

### Recommended Action:
NAIC staff recommends adopting the exposed revisions to SSAP No. 43R to remove the Modified Filing Exempt (MFE) process, with the proposed March 31, 2019 effective date recommended by interested parties. The Valuation of Securities (E) Task Force adopted revisions to eliminate the MFE process during their Oct. 11, 2018 conference call. With adoption, NAIC staff recommends a blanks proposal to eliminate the MFE concept from all annual statement reporting instructions.

With the proposed effective date:

- All reporting entities will be permitted to early adopt the provision and report NAIC designations in accordance with the CRP rating (without adjustment based on purchase price) for the year-end 2018 financial statements. If electing to early adopt, reporting entities electing shall not use the Modified Filing Exempt (MFE) process for any SSAP No. 43R securities.

- Reporting entities that do not elect to early adopt shall report the NAIC designation for all applicable SSAP No. 43R securities in accordance with the MFE process for year-end 2018. These reporting entities must report NAIC designations based on CRP ratings (without purchase price adjustment) beginning with the first quarter 2019 statutory financial statements.
<table>
<thead>
<tr>
<th>Ref #</th>
<th>Title</th>
<th>Attachment #</th>
<th>Agreement with Exposed Document?</th>
<th>Comment Letter Page Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018-20</td>
<td>Debt Forgiveness Between Related Parties</td>
<td>20</td>
<td>No Comment on Revisions</td>
<td>IP - 4</td>
</tr>
<tr>
<td>SSAP No. 15</td>
<td>(Julie)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SSAP No. 25</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Summary:**
During the Summer National Meeting, the Working Group exposed nonsubstantive revisions to SSAP No. 15—Debt and Holding Company Obligations and SSAP No. 25—Affiliates and Other Related Parties to reference existing guidance in SSAP No. 72—Surplus and Quasi-Reorganization when there has been a forgiveness of debt owed. Pursuant to SSAP No. 72:

- Transactions involving the forgiveness of debt owed by a reporting entity to its parent shall be accounted for as contributed surplus. (SSAP No. 72—Paragraph 7)

- Transactions involving the forgiveness of any debt, surplus note, or other obligation owed to the reporting entity from its parent, or other stockholders, shall be accounted for as a dividend. (SSAP No. 72, paragraph 12.i.)

With the exposed revisions information was requested on the following questions:

- **Exposure Question 1** - Should uncollectibility of an amount loaned or advanced to a parent be considered a dividend, instead of a write-off to income? Is it clear when an amount owed from a parent has been deemed uncollectible instead of when debt has been forgiven?

- **Exposure Question 2** – Should additional guidance for the recording of related party service transactions be captured? NAIC staff is aware of instances in which intercompany service costs have been forgiven and not recorded. Generally, the intercompany transaction (and service cost expense / payable) should be recognized at the onset of the contract. Then, if the amount owed is forgiven, the offset to the payable should be to contributed capital. However, if a company does not record the initial entry, then expense recognition is not shown in the F/S.

  Initial Entry for service contract:
  
  Debit - Service Expense / Credit - Payable

  If the payable was forgiven, the entry would be:

  Debit – Payable / Credit - Contributed Capital

  This would ensure both the expense entry and the impact to contributed capital were recognized.

**Interested Parties’ Comments:**
Interested parties note that existing guidance contained within SSAP No. 25—Affiliates and Other Related Parties (SSAP No. 25), and SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets (SSAP No. 5R) should be considered in determining the proper accounting treatment for the exposed questions. In addition to the relevant accounting guidance, the exposed questions must also consider specific legal and regulatory requirements related to affiliated company transactions. The comments below are based upon the current guidance contained in SSAP No. 25 and SSAP No. 5, as well as the requirements of the Insurance Holding Company System Regulatory Act (i.e., MDL-440) and the Insurance Holding Company System Model Regulation with Reporting Forms and Instructions (i.e., MDL-450).
Hearing Agenda

NAIC staff Note: Per email confirmation on Oct. 9, 2018, the interested parties are ok with the exposed revisions. The additional detail provided in the comment letter responds to the exposure questions.

Related Party Loans

Exposure Question 1 - Should uncollectibility of an amount loaned or advanced to a parent be considered a dividend, instead of a write-off to income? Is it clear when an amount owed from a parent has been deemed uncollectible instead of when debt has been forgiven?

Interested parties believe the relevant facts and circumstances should be evaluated to determine the appropriate accounting treatment. For example, if the reporting entity has classified this transaction as an admitted asset, the transaction would have required prior regulatory approval, along with a consideration of the parent’s independent payment ability. The reporting entity would also be required to continuously review the asset for impairment in accordance with both SSAP No. 25 and SSAP No. 5R.

As provided in SSAP No. 25, paragraph 8: “...An affiliate’s ability to pay shall be determined after consideration of the liquid assets or revenues available from external sources (i.e., determination shall not include dividend paying ability of the subsidiary making the loan or advance) which are available to repay the balance and/or maintain the account on a current basis. Evaluation of the collectibility of loans and advances shall be made periodically. If, in accordance with SSAP No. 5R – Liabilities, Contingencies and Impairments of Assets, it is probable that the balance is uncollectible, any uncollectible balance shall be written off and charged to income in the period the determination is made.”

In most instances, the uncollectible determination will be clearly supported by the parent’s financial statements and its ability to pay based upon its liquid assets or revenues from external sources. If the preparer concludes, based upon the application of SSAP No. 5R that the asset is impaired, any uncollectible balance shall be written off and charged to income in the period the determination has been made.

There may be instances where the application of SSAP No. 5R may not be self-evident and the preparer’s determination of the parent’s ability to repay the loan may differ from the domiciliary regulator’s conclusion. These situations may be further complicated by the fact the debtor controls the reporting entity and may conclude there is an impairment rather than a forgiveness of debt. In instances where it may not be clear whether the reporting entity is forgiving the debt, rather than writing off an impaired amount, interested parties recommend that further dialogue with the domiciliary regulator occur to discuss the overall impact of the impairment to the insurance holding company system, and also to determine whether the transaction would be subject to the insurance holding company statutes and regulations. If it is concluded in these situations that the amount due is not impaired, the transaction should be considered either a dividend or a capital contribution.

Transactions Involving Services

Exposure Question 2 – Should additional guidance for the recording of related party service transactions be captured? NAIC staff is aware of instances in which intercompany service costs have been forgiven and not recorded. Generally, the intercompany transaction (and service cost expense / payable) should be recognized at the onset of the contract. Then, if the amount owed is forgiven, the offset to the payable should be to contributed capital. However, if a company does not record the initial entry, then expense recognition is not shown in the F/S.

Initial Entry for service contract:

- Debit - Service Expense / Credit - Payable

If the payable was forgiven, then the entry would be:

- Debit – Payable / Credit - Contributed Capital

This is intended to ensure both the expense entry and the impact to contributed capital were recognized.
Interested parties recommend that no additional guidance is required, as the current guidance included in SSAP No. 25, paragraph 18 explicitly provides that transactions involving services provided between related parties shall be recorded at the amount charged. This guidance does not support the fact pattern outlined in the exposed question where a company does not record the initial expense.

The failure to record the expense associated with the affiliated services is further emphasized in SSAP No. 25, where regulatory scrutiny of related party transactions which do not meet the fair and reasonable standard established by Appendix A-440 may result in (a) amounts charged being re-characterized as dividends or capital contributions, (b) transactions being reversed, (c) receivable balances being nonadmitted, or (d) other regulatory action.

As affiliated service agreements either require prior regulatory approval or are subject to the insurance department’s oversight through financial analysis or financial examination, the insurance regulator has the regulatory authority to determine if the requirements of SSAP No. 25 and the respective service agreements are being followed. In the event that a reporting entity is not following the proper recording of expenses, the current guidance would re-characterize the amounts as a dividend or as a capital contribution.

Recommended Action:
NAIC staff recommends that the Working Group adopt the exposed nonsubstantive revisions to SSAP No. 15—Debt and Holding Company Obligations and SSAP No. 25—Affiliates and Other Related Parties to reference existing guidance in SSAP No. 72—Surplus and Quasi-Reorganization when there has been a forgiveness of debt owed.

In review of the interested parties’ comments responding to the exposure questions, at this time NAIC staff does not suggest additional revisions to statutory accounting principles.

<table>
<thead>
<tr>
<th>Ref #</th>
<th>Title</th>
<th>Attachment #</th>
<th>Agreement with Exposed Document?</th>
<th>Comment Letter Page Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018-21</td>
<td>SSAP No. 72 Distributions</td>
<td>21</td>
<td>Comments Received</td>
<td>IP - 7</td>
</tr>
</tbody>
</table>

Summary:
During the Summer National Meeting, the Working Group exposed nonsubstantive revisions to SSAP No. 72 to provide guidance for when a reporting entity provides a distribution that is a return of capital. This guidance indicates that distributions that reflect a return of capital shall be charged directly to the gross paid in and contributed surplus (which would reduce the adjusted cost basis in the reporting entity).

Interested Parties’ Comments:
The regulatory approval requirement is problematic because it conflicts with holding company laws and regulations on distributions, and it is not appropriate for the NAIC Accounting Practices and Procedures Manual to override these laws and regulations. If a company has the capacity to pay an ordinary dividend, where no regulatory approval is required, they can either pay as a dividend or return of capital. The decision of whether it’s legally a return of capital (and for tax purposes) is generally made by the board of directors when they approve the distribution. If the board approves the distribution as a return of capital and an insurer has ordinary dividend capacity, this proposed accounting requirement would require regulatory approval whereas the state laws/regulations do not.

If there are concerns or issues with the capital treatment of an ordinary dividend, we recommend that such issues be addressed through the applicable state laws and regulations. As an alternative to the proposal, SSAP No. 72 could be modified to state that the accounting treatment should follow the approach as approved by the board of directors, or if no classification was specified, the distribution should be recorded as a dividend to the extent
unassigned surplus is positive, with any remaining distribution treated as a return of capital once unassigned funds is reduced to zero. The disclosures could be modified to require identification of the accounting characterization of any distribution as a dividend or return of capital as follows:

“Reporting entities shall receive domiciliary state approval before providing a return of capital to a parent or other stockholder. Distributions that reflect a return of capital shall be charged directly to the gross paid in and contributed surplus. (A return of capital will reduce the adjusted cost basis of the parent/stockholder in the reporting entity.)”

Recommended Action:
NAIC staff recommends adopting nonsubstantive revisions to SSAP No. 72, modified from the original exposure as detailed below. (If preferred by the Working Group, the proposed language could be exposed to allow for additional review.) As the domestic regulator should have notice of distributions, and whether they are ordinary, extraordinary or a return of capital, a disclosure has not been proposed.

Proposed New Paragraph 11 – This paragraph has been modified to remove the domiciliary state approval requirement.

11. Reporting entities shall receive domiciliary state approval before providing a return of capital to a parent or other stockholder. Distributions that reflect a return of capital shall be charged directly to the gross paid in and contributed surplus. (A return of capital will reduce the adjusted cost basis of the parent/stockholder in the reporting entity.)

Proposed New Footnote to Paragraph 13 – This paragraph does not have any suggested revisions but has been reflected for illustration purposes.

4213. Unassigned funds (surplus) represents the undistributed and unappropriated amount of surplus at the balance sheet date. Certain components of unassigned funds (surplus) are addressed in more detail in other issue papers. Unassigned funds (surplus) is comprised of the cumulative effect of:

i. Dividends to Stockholders

Dividends declared are charged directly to unassigned funds (surplus) on the declaration date and are carried as a liability until paid. The amount of the dividend is the cash paid if it is a cash dividend, the fair value of the assets distributed if it is property dividend, or the par value of the company’s stock if it is a stock dividend. A stock dividend is recorded as a transfer from unassigned funds (surplus) to capital stock. Stock dividends have no effect on total capital and surplus while other forms of dividends reduce surplus. Forgiveness by a reporting entity of any debt, surplus note or other obligation of its parent or other stockholders shall be accounted for as a dividend. Dividends paid to related parties are subject to the requirements of SSAP No. 25—Affiliates and Other Related Parties;

New Footnote: As a dividend represents the distribution of earnings, in any event in which unassigned funds is negative, or goes below zero as a result of a distribution to a parent or stockholder, the distribution (or portion thereof that does not reflect undistributed accumulated earnings in unassigned funds) shall be considered a return of capital and captured in paragraph 11. Determining whether a distribution is a dividend or a return of capital does not impact consideration of whether the distribution is “extraordinary” as both dividends and other distributions (e.g., return of capital) are subject to that assessment. (Reporting entities with positive unassigned funds may choose to make return of capital distributions. Those distributions are also captured in paragraph 11.)
Summary:
During the Summer National Meeting, the Working Group exposed nonsubstantive revisions to SSAP No. 37—Mortgage Loans to clarify that a mortgage loan acquired through a mortgage loan participation agreement is limited to a single mortgage loan agreement with a sole borrower. Consistent with existing guidance in SSAP No. 37, investments that reflect ownership in a mortgage loan fund are not in scope of SSAP No. 37.

Additional Background Info: The guidance for acquiring mortgages through a “participation agreement” was adopted at the same time as the revisions to identify “participants” in mortgage loans. (A participant in a mortgage is defined when there is more than one lender identified on the loan documents as providing funds to a sole borrower.) Although the guidance for a “participant” in a mortgage loan is explicit that the guidance pertains to mortgages issued to a “sole borrower,” and there is explicit guidance in SAP No. 37 that identifies that investments that reflect involvement in a “mortgage loan fund” are not considered mortgage loans, the agenda item was drafted as the “participation agreement” language was being used as a reference to incorporate ownership interests in pool / funds of mortgages as SSAP No. 37 (Schedule B) mortgage loans.

Interested Parties’ Comments:
Interested parties understand from the “Description of Issue” of the Form A that the proposed revisions are intended to prohibit loans secured by “pools of mortgages” and “loan funds” from being accounted for as mortgage loans under SSAP No. 37. However, there are situations where a mortgage loan has multiple borrowers that are related parties to one another for operational ease and for additional security. There could also be instances where there is more than one borrower as is the case with “Tenant-in-Common” loans1 where the borrowers are jointly and severally liable as borrowers under one loan. Interested Parties do not believe that it is necessary to specify that a mortgage loan is to a “sole borrower” to preclude pools of mortgages and loan funds from being accounted for as a mortgage loan under SSAP No. 37. In fact, SSAP 37 already specifies that investments in mortgage loan funds are not within the scope of SSAP 37 per paragraph 2. Interested parties recommend that the proposed revisions strike the reference to a “sole borrower” and clarify that the mortgage loan agreement may include “one or more borrowers.” This will preserve the situation where related party borrowers on a loan agreement secured by multiple mortgaged real estate properties can appropriately be accounted for as a real estate mortgage loan as well as other situations where there is more than one borrower named in the loan agreement as could be typical for specific types of mortgage loans.

Also, after re-reading footnotes “a” and “b” in SSAP 37, interested parties would like to suggest some wording changes to both paragraphs to better clarify the distinction between co-lending agreements and participation agreements. We offer proposed edits, which we have tracked below from the SSAP No. 37 version currently in the Accounting Practices and Procedures Manual.

Proposed Wording Changes to SSAP 37:

a. Reporting entity is a “co-lender” participant in a single mortgage loan agreement that identifies more than one lender (which includes the reporting entity) providing funds to one or more a sole borrowers with the real estate collateral securing all lenders identified in the agreement. For these mortgage loan agreements, each lender is incorporated directly into the loan documents. The key differentiating characteristic of a mortgage loan provided under a group “mortgage loan participation agreement” rather than a solely-owned mortgage loan is that no one lender of the lending group may unilaterally foreclose on the mortgage. With these agreements, the lenders must foreclose on the mortgage loan as a group.

---

1 Tenancy-in-Common relates to a property’s joint ownership by two or more unrelated or related bodies in equal or unequal shares.
b. Reporting entity has a “participation agreement” to invest in a mortgage loan issued by another entity. The mortgage loan may have one or more borrowers. Although the reporting entity is not named on the original mortgage loan agreement, the original issuer sells a portion of the mortgage loan to an incoming participant lender (“participant”) co-lender and the sale is documented by an assignment of a participation interest or participation agreement between the selling lender and the participant co-lender. With these agreements, the participant co-lender acquires an undivided participation interest in the mortgage loan and will have receive direct interest in the amount of their participation in the rights related to repayment of the loan based on its pro-rata share of the loan and the collateral given to secure the loan. The financial rights and obligations of the participants lenders in these agreements shall be similar to those in a direct loan.

**Recommended Action:**

Although NAIC staff understands the intent of the interested parties’ proposed modifications, NAIC staff believes that if the interested parties’ proposed edits were incorporated, then the guidance would be inadvertently interpreted to specifically allow “bundled” mortgage loans (which would also be considered a mortgage loan “fund”) to be considered in scope of SSAP No. 37. This is contrary to the intent of the proposed agenda item.

The design of Schedule B, and RBC (particularly for life companies), is for single-mortgage loan reporting. Meaning, each mortgage shall be reported separately, and reported with the loan-to-value ratio (as applicable) in the RBC calculation. Although NAIC staff understands that a single mortgage loan agreement could have more than one lender (co-lender), and potentially more than one borrower (as in the “tenant-in-common” scenario), the interested party proposed language does not limit the “more than one borrower” to these limited situations.

NAIC staff recommends that the Working Group expose revisions to SSAP No. 37 to clarify that the intent is single mortgage loan agreements.

**SSAP No. 37–Mortgage Loans**

2. A mortgage loan is defined as a debt obligation that is not a security, which is secured by a mortgage on real estate. In addition to mortgage loans directly originated, a mortgage loan also includes mortgages acquired through assignment, syndication or participation. Investments that reflect “participating mortgages,” “mortgage loan fund,” “bundled mortgage loans,” or the “securitization of assets” are not considered mortgage loans within scope of this SSAP.

a. A security is a share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

i. It is either represented by an instrument issued in bearer or registered form, or if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.

ii. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.

iii. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

2 Examples of agreements intended to be captured within this statement:

a. Reporting entity is a “co-lenderparticipant” in a single mortgage loan agreement that identifies more than one lender (which includes the reporting entity) providing funds to a sole borrower with the real estate collateral securing all lenders identified in the agreement. For these single mortgage loan agreements, each lender is incorporated directly into the loan documents. The key differentiating characteristic of a mortgage loan provided under a group “mortgage loan co-lending participation agreement” rather than a sole-own mortgage loan is that no one lender of the lending group may unilaterally foreclose on the mortgage. With these agreements, the lenders must foreclose on the mortgage loan as a group.

b. Reporting entity has a “participation agreement” to invest in a single mortgage agreement mortgages(sold borrower) originally issued by another entity. Although the reporting entity is not named on the original mortgage loan agreement, the original issuer sells a portion of the mortgage loan to an incoming participant lender (co-lender) and the sale is documented by an assignment of a participation interest or participation agreement between the selling lender and the co-lenderparticipant. With these agreements,
the participant-lender acquires an undivided participation interest in the single mortgage loan and will have rights related to repayment of the loan based on its pro-rata share of the single mortgage loan and the collateral given to secure the loan. The financial rights and obligations of the lenders-participants in these agreements shall be similar to those in a direct loan.

3 The scope of this SSAP is limited to single mortgage loan agreements. Although single mortgage loan agreements can potentially have more than one lender (e.g., co-lenders/participations) and more than one borrower (such as in a tenancy-in-common arrangement), the concept of a “single mortgage loan” does not include arrangements in which a reporting entity acquires more than one mortgage in a sole transaction. (For example, if a reporting entity was to acquire an interest in a “bundle” of mortgage loans with various unrelated borrowers and collateral, this agreement would be outside the scope of this SSAP.)

<table>
<thead>
<tr>
<th>Ref #</th>
<th>Title</th>
<th>Attachment #</th>
<th>Agreement with Exposed Document?</th>
<th>Comment Letter Page Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018-26 SSAP No. 97 (Fatima/Julie)</td>
<td>SCA Loss Tracking – Accounting Guidance</td>
<td>23</td>
<td>No</td>
<td>IP - 10</td>
</tr>
</tbody>
</table>

**Summary:**
During the Summer National Meeting, the Working Group exposed nonsubstantive revisions to SSAP No. 97 to clarify the existing reporting requirements when a reporting entity has a negative equity valuation in an SCA investment. Specifically, the proposed revisions clarify that a reporting entity’s negative equity value shall be reported as a contra-asset in the following scenarios:

- In all instances in which the limited statutory adjustments required by paragraph 9 results in a negative equity valuation of the investment. (This would apply to 8.b.ii and 8.b.iv entities.)

- When the reporting entity has guaranteed obligations or committed further financial support to an SCA. Recognition of the negative equity in the SCA is in addition to the guarantee liability required under SSAP No. 5R. (This applies to all SCA entities.)

**Interested Parties’ Comments:**
Interested parties do not agree with the proposed revisions to SSAP No. 97 paragraph 13e. With respect to proposed subparagraph i of paragraph 13e, adjustments pursuant to SSAP No. 97 paragraph 9 (the “limited statutory adjustments”) have nothing to do with SCA operational losses that drive a negative equity value. As such, any negative equity reported as a result of the paragraph 9 limited statutory adjustments would not be responsive to the new SSAP No. 97 paragraph 34 SCA loss tracking disclosure.

With respect to the proposed subparagraph ii of paragraph 13e, the proposed revisions include similar language to the original Agenda item 2018-09 exposure. As such, interested parties have significant concerns with respect to this proposed subparagraph and we reiterate our previous comments on the same issue (from Agenda item 2018-09) that is now included in the current exposure:

Interested parties believe this proposed guidance would erroneously understates the reporting entity’s surplus by double-counting the impact of the parent insurer’s guarantee or commitment of the SCA’s obligations. For example, assume a parent insurer has a guarantee to pay a fee to a third party if the SCA’s equity drops below zero, and no other commitment related to the SCA entity. Assume at year end that the SCA’s equity is negative $100,000 thousand and the parent insurer owes the third party $20,000 under the terms of the guarantee. Under current guidance, the parent insurer would carry its SCA investment at $0 and record a liability of $20,000 under the guarantee. The $20,000 liability represents the extent of the parent insurer’s obligation and exposure to loss related to the SCA. Under the proposed guidance, the parent insurer would record the $20,000 guarantee liability as well as a liability (in the form of a contra-asset) of $100,000, the latter of which is not an obligation of the parent insurer.
Recommended Action:
NAIC staff recommends that this agenda item be re-exposed with direction for NAIC staff to work with interested parties’ as well as research the applicable U.S. GAAP guidance to determine whether changes should occur to existing guidance that requires negative SCA reporting when there is a guarantee or commitment to provide financial support. With re-exposure, additional comments are requested on various situations that may exist.

NAIC staff notes that this agenda item clarifies existing accounting guidance in SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities and does not propose any new guidance. The intent of the agenda item was to clearly identify when a reporting entity is required to report negative equity in its investment in an SCA (rather than halt at a zero position). Pursuant to existing guidance in SSAP No. 97, when a reporting entity’s share of losses exceeds its investment in an SCA and there is guarantee or commitment to provide funding, the reporting entity is required to report its investment in the SCA at a negative equity value and report the guarantee in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets.

It should be noted that the obligation to report a guarantee / commitment is always governed by SSAP No. 5R and is not a provision that is “triggered” when the reporting entity’s share of losses exceeds its investment in the SCA. If there is a guarantee or commitment to fund, SSAP No. 5R requires liability recognition for that guarantee. The provisions under SSAP No. 5R require reporting the noncontingent (non-triggered) liability to represent the “fair value of the guarantee” at inception. A “contingent” guarantee (once triggered per the terms of the guarantee), is recognized under the provisions of paragraph 8 of SSAP No. 5R, which requires recognition with a charge to operations. (SSAP No. 5R has a limited exclusion for noncontingent guarantees (initial recognition) for wholly-owned subsidiaries, but if not wholly-owned, guarantees between parents and subsidiaries or between corporations under common control are subject to the initial recognition and disclosure requirements. Contingent guarantees (triggered) are always liabilities until paid.)

The guidance in SSAP No. 97, requiring both the negative position in the investment in the SCA and the guarantee obligation is not new, the revisions were simply highlighting the existing guidance in SSAP No. 97 in which negative equity in the SCA investment is required.

Staff highlights that if there are no revisions to SSAP No. 97, the following elements continue to exist:

- Paragraph 9 requires negative reporting for 8.b.ii entities as a result of limited statutory adjustments.
- Paragraph 13e requires negative equity reporting when the share of losses exceeds the investment in the SCA and there is a guarantee or commitment to provide further support. (This is also addressed in Question 7 in Exhibit C - Implementation Questions and Answers.)
- Paragraph 13e requires guaranteed obligations to be recorded in accordance with SSAP No. 5R.

(This agenda item captured the requirements in paragraph 9 (GAAP with statutory valuation adjustments) and the equity method adjustments in paragraph 13e in the equity method adjustments paragraph.)
### Summary:
During the Summer National Meeting, the Working Group exposed nonsubstantive revisions to SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies, to incorporate guidance and disclosures when a reporting entity’s share of losses in a SSAP No. 48 entity exceeds its investment in the SSAP No. 48 entity. (The provisions proposed for SSAP No. 48 entities are similar to the provisions already in place for SCAs in SSAP No. 97. The disclosure illustration is just expanded so that the disclosure captures both SCAs and SSAP No. 48 entities in a single location.)

### Interested Parties’ Comments:
Interested parties note that the proposed changes to paragraph 6 of SSAP No. 48 only apply to investments in SSAP No. 48 entities of more than a minor ownership interest. Such SSAP No. 48 entities are subject to the equity method accounting requirements of SSAP No. 97, including the requirements of SSAP No. 97 paragraph 13e (regarding a reporting entity’s share of losses exceeding the carrying value). Therefore, the proposed additions to paragraph 6 of SSAP No. 48 are not necessary. Notwithstanding this point, interested parties also note that, with respect to the proposed subparagraph “a” of paragraph 6 of SSAP No. 48, the proposed revisions to SSAP No. 48 include similar language to the original Agenda item 2018-09 exposure. Interested parties have significant concerns with respect to this proposed subparagraph and we reiterate our previous comments on the same issue (from Agenda item 2018-09) that is now included in the current exposure:

With respect to the proposed subparagraph “a” of paragraph 6 of SSAP No. 48, interested parties believe this proposed guidance would erroneously understate the reporting entity’s surplus by double-counting the impact of the parent insurer’s guarantee or commitment of the investee’s obligations. For example, assume a reporting entity has a guarantee to pay a fee to a third party if the investee’s equity drops below zero, and no other commitment related to the reporting entity. Assume at year end that the investee’s equity is negative $100,000 thousand and the reporting entity owes the third party $20,000 under the terms of the guarantee. Under current guidance, the reporting entity would carry its investment at $0 and record a liability of $20,000 under the guarantee. The $20,000 liability represents the extent of the reporting entity’s obligation and exposure to loss related to the investee. Under the proposed guidance, the reporting entity would record the $20,000 guarantee liability as well as a liability (in the form of a contra-asset) of $100,000, the latter of which is not an obligation of the reporting entity.

Because the SSAP No. 48 entities in question are subject to the equity method accounting requirements of SSAP No. 97, interested parties do not believe the proposed disclosure additions to paragraph 20 of SSAP No. 48 are necessary, especially the new proposed disclosure paragraph “20d” of SSAP No. 48. It appears this proposed disclosure is meant to replicate the SSAP No. 97 paragraph 34 disclosure. Interested parties note that the SSAP No. 97 paragraph 34 disclosure was meant to capture information related to the limited number of SSAP No. 97 noninsurance entities, primarily in response to questions that arose regarding the completeness and timeliness of SCA filings with the SVO. Detailed information about all SSAP No. 48 entities is already included in Schedule BA and no such SVO filings are required for SSAP No. 48 entities. These newly proposed disclosures would be excessive and duplicative.

Instead, interested parties suggest that the new paragraph 34.a of SSAP No. 97 be repurposed as a standalone paragraph (i.e., a new paragraph 35) and made applicable to all subsidiary, controlled and affiliated entities, including SSAP No. 48 entities. In addition, in order to make it clear to a reader of SSAP No. 48 that certain SSAP No. 97 disclosures may apply, interested parties recommend the following additional language to paragraph 6 of SSAP No. 48:

<table>
<thead>
<tr>
<th>Ref #</th>
<th>Title</th>
<th>Attachment #</th>
<th>Agreement with Exposed Document?</th>
<th>Comment Letter Page Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018-27 SSAP No. 48 (Fatima/Julie)</td>
<td>SSAP No. 48 Entities’ Loss Tracking</td>
<td>24</td>
<td>No</td>
<td>IP - 10</td>
</tr>
</tbody>
</table>
“Investments in these ventures, except for joint ventures, partnerships and limited liability companies with a minor ownership interest, shall be reported using an equity method as defined in SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities (SSAP No. 97), paragraphs 8.b.i. through 8.b.iv. A reporting entity whose shares of losses in such an SSAP No. 48 entity exceeds its investment in the SSAP No. 48 entity shall disclose the information required by paragraph 34a SSAP No. 97.”

**Recommended Action:**
NAIC staff recommends that the Working Group adopt the proposed edits to SSAP No. 48, paragraph 6 as recommended by interested parties. With this adoption, the loss-tracking disclosure for SSAP No. 48 entities will be required for year-end 2018. **NAIC staff recommends that continued discussion of additional revisions be postponed, or occur in conjunction with, agenda item 2018-26.** NAIC staff notes that blanks revisions will also be incorporated to reflect this change.

**Proposed Edits to SSAP No. 48:**

6. Investments in these ventures, except for joint ventures, partnerships and limited liability companies with a minor ownership interest, shall be reported using an equity method as defined in SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities (SSAP No. 97), paragraphs 8.b.i. through 8.b.iv. A reporting entity whose shares of losses in such an SSAP No. 48 entity exceeds its investment in the SSAP No. 48 entity shall disclose the information required by SSAP No. 97, paragraph 34a.

The 18 pages of comment letters are included in Attachment 25.

g:\frs\data\acctg\3. national meetings\a. national meeting materials\2018\fall\hearing\0 - 11 2018 - hearing_agenda.doc
This page intentionally left blank.
The Statutory Accounting Principles (E) Working Group of the Accounting Practices and Procedures (E) Task Force conducted an e-vote that concluded Oct. 26, 2018. The following Working Group members participated: Dale Bruggeman, Chair (OH); Jim Armstrong, Vice Chair (IA); Richard Ford (AL); Kim Hudson (CA); Kathryn Belfi (CT); Stewart Guerin (LA); Judy A. Weaver (MI); Doug Bartlett (NH); Joseph DiMemmo (PA); and Amy Malm (WI).

1. Exposed Agenda Item 2018-31 and INT 18-04

The Working Group conducted an e-vote that concluded Oct. 26 to consider exposure of agenda item 2018-31: Extension of Ninety-Day Rule for the Impact of Hurricane Florence and Hurricane Michael and the related interpretation, INT 18-04: Extension of Ninety-Day Rule for the Impact of Hurricane Florence and Hurricane Michael (INT 18-04). The interpretation proposes an optional temporary 60-day extension of the existing 90-day rule in the Statement of Statutory Accounting Principles (SSAP) No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due from Agents and Brokers. This allows for a total of 150 days for policies impacted by Hurricane Florence, Hurricane Michael, and related tropical storms and flooding before premium receivables are nonadmitted. This extension is consistent with the previous extensions that have been granted for other major national catastrophes.

Mr. Hudson made a motion, seconded by Mr. Armstrong, to expose agenda item 2018-31 and the related INT 18-04. The motion passed without opposition, with nine members voting. The exposure has a public comment period ending Nov. 9 to facilitate discussion at the Fall National Meeting.

Having no further business, the Statutory Accounting Principles (E) Working Group adjourned.
Statutory Accounting Principles (E) Working Group
E-Vote
August 15, 2018

The Statutory Accounting Principles (E) Working Group of the Accounting Practices and Procedures (E) Task Force conducted an e-vote that concluded Aug. 15, 2018. The following Working Group members participated: Dale Bruggeman, Chair (OH); Jim Armstrong, Vice Chair (IA); Richard Ford (AL); Kim Hudson (CA); Stewart Guerin (LA); Judy Weaver (MI); Doug Bartlett (NH); Joe DiMemmo (PA); and Amy Malm (WI).

1. Exposed Agenda Item 2018-30

The Working Group conducted an e-vote to consider exposure of agenda item 2018-30: SSAP No. 86 – Hedge Effectiveness Documentation, which proposes nonsubstantive revisions to reflect hedge documentation and assessment efficiencies from ASU 2017-12, Derivatives and Hedging. The proposed revisions are consistent with a request received from interested parties in their July 9 comment letter and would incorporate the following concepts:

- Allow companies to perform subsequent assessments of hedge effectiveness qualitatively if certain conditions are met.
- Allow companies more time to perform the initial quantitative hedge effectiveness assessment.
- Clarify that companies may apply the “critical terms match” method for a group of forecasted transactions if the transactions occur and the derivatives mature within the same 31-day period or fiscal month, and the other requirements for applying the critical terms match method are satisfied.

Mr. Ford made a motion, seconded by Mr. Hudson, to expose agenda item 2018-30 for a public comment period ending Sept. 14. The motion passed without opposition, with eight members voting.

Having no further business, the Statutory Accounting Principles (E) Working Group adjourned.
The Statutory Accounting Principles (E) Working Group of the Accounting Practices and Procedures (E) Task Force met in Boston, MA, Aug. 4, 2018. The following Working Group members participated: Dale Bruggeman, Chair (OH); Jim Armstrong, Vice Chair, and Carrie Mears (IA); Richard Ford (AL); Kim Hudson (CA); Kathy Belfi and William Arfanis (CT); Rylynn Brown (DE); Eric Moser (IL); Stewart Guerin and Caroline Brock (LA); Judy Weaver (MI); Pat Gosselin and Doug Bartlett (NH); Stephen Wiest (NY); Joe DiMemmo and Kim Rankin (PA); Jamie Walker (TX); Doug Stolte and David Smith (VA); and Amy Malm (WI).

1. **Adopted its May 24 and Spring National Meeting Minutes**

Ms. Walker made a motion, seconded by Ms. Malm, to adopt the Working Group’s May 24 (Attachment One-A) and March 24 (see NAIC Proceedings – Spring 2018, Accounting Practices and Procedures (E) Task Force, Attachment One) minutes. The motion passed unanimously.

2. **Reviewed Comments and Considered Action on Exposed Items**

The Working Group held a public hearing to review comments (Attachment One-B) on previously exposed items.

   a. **Agenda Item 2017-35**

Mr. Bruggeman directed the Working Group to agenda item 2017-35: Policy Loans. Julie Gann (NAIC) stated that this agenda item had been exposed during the Spring National Meeting to clarify the reporting of policy loans, particularly for policy loans issued related to separate account (SA) policies. Ms. Gann advised that the exposed revisions to *Statement of Statutory Accounting Principles (SSAP) No. 49—Policy Loans* and *SSAP No. 56—Separate Accounts* reflected prior comments received from interested parties, with additional provisions that required funding of the policy loan from the SA to the general account (GA) in order for the policy loan to be reported as an admitted asset.

Ms. Gann advised that interested parties’ comments received from the exposure requested consideration of a 30-day settlement time frame before the policy loan would be nonadmitted. She stated that if the Working Group would like to allow a settlement time frame, additional revisions had been drafted that could be considered for exposure. However, if the Working Group prefers to require funding for admittance, without a settlement time frame, the revisions exposed during the Spring National Meeting could be adopted.

Mike Reis (Northwestern Mutual), representing interested parties, stated support for the overall proposal. He noted that some companies have procedures in place for subsequent settlement, but the vast majority of companies have procedures where the policy loan is initially funded. Mr. Bruggeman stated support for the funding requirement, noting that companies do not have to issue policy loans until the funding occurs.

Mr. Hudson made a motion, seconded by Ms. Weaver, to adopt the exposed revisions to SSAP No. 49 and SSAP No. 56, with the requirement that all policy loans related to the SA be funded to the GA in order for the policy loan to be admitted (Attachment One-C). The motion passed unanimously.

   b. **Agenda Item 2018-03**

Mr. Bruggeman directed the Working Group to agenda item 2018-03: Reporting NAIC Designations as Weighted Averages Under SSAP No. 43R. Ms. Gann stated that this agenda item was exposed during the Spring National Meeting with proposed revisions on reporting a loan-backed or structured security (LBSS) if the security has different NAIC designations by lot.
Ms. Gann stated that interested parties’ comments disagreed with the overall proposal, but also noted that the Valuation of Securities (E) Task Force is considering elimination of the modified filing exempt (MFE) process from the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual). The interested parties’ comments suggested deferral of this agenda item until the MFE project has been addressed.

Ms. Gann stated that NAIC staff do not recommend continued allowance of the weighted average reporting approach, noting existing annual financial statement reporting instructions that require reporting at a lower level of detail to prevent inaccurate reporting in the aggregate, but agreed with the recommendation to defer this project until consideration of the MFE elimination has occurred.

Mr. Bruggeman inquired whether use of the weighted average approach is a reasonable approximation in accordance with the existing annual financial statement instructions. Although no specific information was provided in response to this inquiry, Mr. Hudson stated support for deferral and, with no Working Group members noting objection, Mr. Bruggeman directed deferral of this agenda item.

c. **Agenda Item 2018-04**

Mr. Bruggeman directed the Working Group to agenda item 2018-04: VOSTF Bank Loan Referral. Ms. Gann stated that during the Spring National Meeting, the Working Group exposed a draft referral response to the Valuation of Securities (E) Task Force’s request to review their proposed guidance and methodology for bank loans. The exposed draft response noted concern with identifying borrowing base loans and debtor-in-possession financings as bank loans in scope of SSAP No. 26R—Bonds as these items are supported by collateral and may be more appropriately classified as collateral loans in scope of SSAP No. 21—Other Admitted Assets.

Ms. Gann stated that interested parties’ comments supported classifying these instruments as bank loans, as the structure of these investments is primarily focused on the credit worthiness of the borrower, and not the collateral securing the loan.

Ms. Gann stated that after considering the comments received, and then discussing it with the NAIC support staff for the Task Force, she is recommending that the Working Group defer this item, with a direction to NAIC staff to conduct further analysis of these structures before further discussion. With no Working Group members noting objection, Mr. Bruggeman noted the deferral of this agenda item and directed NAIC staff as recommended.

d. **Agenda Item 2018-06**

Mr. Bruggeman directed the Working Group to agenda item 2018-06: Regulatory Transactions – Referral from the Reinsurance (E) Task Force. Ms. Gann stated that during the Spring National Meeting, the Working Group exposed revisions to indicate that items acquired as part of “regulatory transactions” as defined in the P&P Manual, that meet the definition of an asset, shall only be admitted with approval of the domestic state insurance department as a permitted or prescribed practice.

Ms. Gann stated that comments received from interested parties noted that the definition of a “regulatory transaction” in the P&P Manual is broad, and the proposed guidance could have unintended consequences, as it would capture various transactions not contemplated in the proposal. She stated that the intent of the agenda item is to address the reporting issue that currently exists for invested assets and that revisions from the prior exposure had been drafted to clarify that the focus is on “invested assets.”

Mr. Bruggeman stated that the existing guidance in the P&P Manual prevents companies from receiving NAIC designations from the Securities Valuation Office (SVO), and prevents use of the filing exempt process, for regulatory transactions. As such, without any guidance in how to report these transactions, companies that have invested assets acquired through regulatory transactions do not have a current mechanism on how to report. Mr. Bruggeman stated that this agenda item is providing a means for these items to be reported in the investment schedules in a way that complies with existing P&P Manual restrictions and avoids crosscheck errors.
Ms. Malm made a motion, seconded by Mr. Wiest, to expose the changes to SSAP No. 4—Assets and Other Admitted Assets, revised from the prior exposure to clarify that the guidance for regulatory transactions is limited to those that are considered invested assets. The motion passed unanimously.

e. Agenda Item 2018-07

Mr. Bruggeman directed the Working Group to agenda item 2018-07: Surplus Notes – Referral from the Reinsurance (E) Task Force. Ms. Gann stated that during the Spring National Meeting, the Working Group exposed revisions to SSAP No. 41R—Surplus Notes to indicate that surplus notes linked to other structures are not subordinate and do not qualify for reporting as statutory equity by the issuer. Furthermore, the proposed revisions indicated that assets linked to surplus notes are not available for policyholder claims and shall be nonadmitted.

Ms. Gann stated that the interested parties’ comments noted agreement with the general principle, but they had proposed a rewrite of the suggested guidance. In reviewing the interested parties’ suggested language, it was noted that the language incorporated specific provisions (e.g., reference to contractual terms) to determine when a surplus note is linked to another asset or agreement. This language could be utilized to allow transactions to be designed to seemingly comply with the guidance, but that would ultimately be contrary to the overall intent. Ms. Gann stated that new guidance had been drafted that focuses on the primary intent of the provisions. She stated that the guidance is intended to be broad to ensure that it captures all “linked” scenarios in which an issued surplus note is no longer fully subordinate or that circumvents the commissioner’s control.

Mr. Reis stated that interested parties agree with overall concept, but the proposed language may result with unintended consequences, as it may pull in additional transactions and agreements not expected to be captured within the guidance. He stated that interested parties will work with Ms. Gann during the interim.

Ms. Walker made a motion, seconded by Mr. Bartlett, to expose NAIC staff’s revised SSAP No. 41R language for comment. The motion passed unanimously.

e. Agenda Item 2018-14

Mr. Bruggeman directed the Working Group to agenda item 2018-14: Update Medicare Part D Definitions in INT 05-05. Robin Marcotte (NAIC) stated that during the Spring National Meeting, the Working Group exposed proposed revisions to Interpretation (INT) 05-05—Accounting for Revenues Under Medicare Part D Coverage to add a description of the Coverage Gap Discount Program, amend existing guidance on program payments and update definitions.

Ms. Marcotte stated that interested parties suggested additional language clarify how the funds flow between the federal Centers for Medicare and Medicaid Services (CMS), the insurance company and the drug manufacturer. She also noted that the interested parties’ comments also recommended additional language to reference SSAP No. 47—Uninsured Plans for the GAP Discount Program. She agreed with the suggestions by interested parties and noted that additional wording had been proposed by NAIC staff to describe the flow of funds in more detail. She stated that the proposed modifications had been discussed with health industry representatives.

Joe Zolecki (Blue Cross and Blue Shield Association—BCBSA) stated agreement with the proposed modifications and for adoption of the revised INT 05-05.

Mr. Wiest made a motion, seconded Mr. DiMemmo, to adopt INT 05-05 with the modifications discussed during the meeting (Attachment One-D). The motion passed unanimously.

e. Agenda Item 2017-32

Mr. Bruggeman directed the Working Group to agenda item 2017-32: SSAP No. 30 – Investment Classification Project. Ms. Gann stated that on May 2, the Working Group exposed an issue paper proposing substantive revisions to SSAP No. 30—Unaffiliated Common Stock. She stated that the exposure included improvements to the common stock definition, revisions to
include closed-end funds (CEF) and unit investment trusts (UIT) in scope, and support for capturing NAIC designations on the reporting schedule for qualifying investments.

Ms. Gann stated that the comments received from interested parties noted overall support for the revisions proposed by NAIC staff. With the comments, interested parties requested that all stock warrants be captured within scope of SSAP No. 30 and proposed clarifying language that use of net asset value (NAV) should be permitted for mutual funds, CEFs and UITs that do not have a determinable fair value. Ms. Gann stated that under existing guidance, only publicly traded stock warrants are in scope of SSAP No. 30, and all other stock warrants are captured in scope of SSAP No. 86—Derivatives. She stated revisions have not been proposed to move all stock warrants to SSAP No. 30 as recommended by interested parties, and if there was a desire for a single location, NAIC staff would recommend that all stock warrants be captured as derivatives.

At this time, the proposed issue paper retains the existing approach, with publicly traded stock warrants in scope of SSAP No. 30, and all others in scope of SSAP No. 86. Ms. Gann stated that proposed revisions have been added to clarify that the non-publicly traded stock warrants are in scope of SSAP No. 86. She stated agreement with the interested parties’ suggested language to clarify the use of NAV.

Ms. Gann stated that a revised issue paper and a substantively revised SSAP No. 30 had been prepared for exposure and comments would be specifically requested on whether the guidance should be effective Jan. 1, 2019, or some other date. She also stated that with the support for capturing NAIC designations on the reporting schedule, referrals are recommended to the Blanks (E) Working Group, the Valuation of Securities (E) Task Force and the Capital Adequacy (E) Task Force. She advised that these groups would be responsible for determining whether the column could be incorporated, whether NAIC designations could be provided and whether a reported NAIC designation has an impact on risk-based capital (RBC).

Mr. Hudson made a motion, seconded by Ms. Brown, to expose the revised issue paper and substantively revised SSAP No. 30, and to send referrals to the Blanks (E) Working Group, the Valuation of Securities (E) Task Force and the Capital Adequacy (E) Task Force communicating support for capturing NAIC designations on the common stock reporting schedule (Schedule D, Part 2, Section 2) for qualifying investments, with corresponding RBC charges. The motion passed unanimously.

f. Agenda Item 2017-33

Mr. Bruggeman directed the Working Group to agenda item 2017-33: Derivatives and Hedging. Ms. Gann stated that during the Spring National Meeting, the Working Group exposed an issue paper detailing the U.S. generally accepted accounting principles (GAAP) revisions from Accounting Standards Update (ASU) 2017-12—Derivatives and Hedging with initial staff assessments.

Ms. Gann stated that comments received from interested parties suggested bifurcating the review of ASU 2017-12, with an initial nonsubstantive review of the simplified disclosure requirements adopted for U.S. GAAP, with subsequent substantive review of the overall revised U.S. GAAP derivative guidance in accordance with SSAP No. 86. She agreed with this approach, noting that the efficiencies gained under U.S. GAAP under the simplified documentation requirements would be lost if the documentation requirements under statutory accounting principles were not updated accordingly. She stated that interested parties are working on proposed revisions to reflect the simplified disclosure requirements and, once received, the proposed edits will be distributed to the Working Group with a request for interim exposure.

Ms. Gann stated that the ASU is considered an improvement standard; therefore, it has an early effective date of Jan. 1, 2019. She stated that the interim exposure is intended to allow consideration of the simplified disclosure requirements in a timeframe that would allow for application concurrently with the U.S. GAAP guidance.

Greg Hendler (Brighthouse Financial), representing interested parties, stated that proposed revisions to SSAP No. 86 are prepared and they will be sent immediately to NAIC staff.

Noting no opposition by the Working Group, Mr. Bruggeman directed NAIC staff to bifurcate the review of the ASU into the nonsubstantive and substantive projects, as recommended by interested parties. He noted that Working Group members...
should expect to receive a request to expose the nonsubstantive disclosure revisions, via e-vote, shortly after the national meeting.

g. Agenda Item 2018-08

Mr. Bruggeman directed the Working Group to agenda item 2018-08: Private Placement Variable Annuities. Ms. Gann stated that during the May 24 conference call, the Working Group exposed revisions to paragraph 6 of SSAP No. 21, to limit the products that can be captured as “life insurance” where the reporting entity is owner and beneficiary or has otherwise obtained rights to contract the policy. She advised that the proposed revisions were originally drafted in response to information received that investment products in the form of private placement variable annuities with limited death benefits were being captured within scope of the guidance.

Ms. Gann noted that this assessment is occurring pursuant to the guidance in SSAP No. 50—Classification of Insurance or Managed Care Contracts, which indicates that variable annuity contracts with a minimum death benefit are classified as life contracts. She stated that products captured within the SSAP No. 21 guidance are considered other than invested assets; therefore, the items are not included on an invested asset schedule, there are no RBC charges, and there is uncertainty on whether the underlying assets are limited under the applicable SSAP admittance asset requirements or state investment law restrictions.

Ms. Gann stated that the revisions exposed May 24 would limit the products that can be captured in the SSAP No. 21 guidance to those that qualify as “life insurance” under Internal Revenue Code (IRC) § 7702, and for which the insurer holder is not subject to investment risk. She stated that five comment letters were received in response to the exposure that could be categorized in three general positions:

1. Comments supporting exclusive use of the IRC § 7702 to determine whether contracts should be captured in scope of SSAP No. 21, paragraph 6. [Commenters supporting this position included the American Council of Life Insurers (ACLI), the Institutional Insurance Group (IIG) and Nationwide.]

2. Comments supporting the inclusion of private placement variable annuities, as well as private placement life insurance, in scope of SSAP No. 21, paragraph 6. These comments note that it would be punitive to exclude the annuity products, as without specific guidance noting their admittance, these products would be nonadmitted under the provisions of SSAP No. 4. (Lombard International provided these comments.)

3. Comments identifying that the current guidance in SSAP No. 21, paragraph 6 was developed at a time when the amount of insurance company-owned life insurance (ICOLI) was not significant, and it would be appropriate to take a look at the issues, evaluate the RBC framework and assess whether the underlying assets should be admitted or nonadmitted. [MB Schoen & Associates (MBSA) provided these comments.]

Ms. Gann stated NAIC staff are most supportive of the comments received from MBSA, as those comments identify the need to consider the quality of the underlying assets held via the “wrapping” insurance product in determining admittance, as well as RBC assessments. She stated that there is concern if investment products are “wrapped” by an insurance product that results with the investment risk being excluded from RBC assessments and other investment safeguards. However, she stated that use of the IRC assists in limiting the investment products captured in scope of SSAP No. 21, as compliance with the IRC requires the product to meet specific insurance assessments. She stated that for this national meeting, the following modifications from the exposure have been drafted for the Working Group’s consideration:

1. Revisions to require the exclusive use of IRC § 7702 to determine whether contracts should be captured in scope of SSAP No. 21, paragraph 6. These revisions eliminate the provision excluding products if the insurance entity was to bear the investment risk, but incorporate provisions specifying that the product must always remain compliant with IRC § 7702 in order to be an admitted asset.

2. Revisions to capture disclosure of the amount of the cash surrender value that is within an investment vehicle by investment category (e.g., bonds, common stock, joint ventures, derivatives, etc.)
3. Revisions to specifically identify that the life insurance products captured within the guidance were acquired with the expectation that the proceeds will be utilized to cover employee benefit obligations or costs related to a key man. Ms. Gann stated that the comment letters received noted that these products are used for these purposes.

Ms. Gann stated that if the Working Group moves forward with proposed revisions to limit SSAP No. 21, paragraph 6 to products that are compliant with IRC § 7702, the Working Group should then consider whether specific accounting and reporting guidance is needed for the products that are not compliant with IRC § 7702. She stated that without any specific guidance, by default, the products would be nonadmitted under SSAP No. 4. If preferred by the Working Group, an explicit nonadmittance statement could be included, or the Working Group could direct NAIC staff to consider accounting and reporting guidance, potentially allowing admittance of these items.

Mr. Bruggeman stated that he had been working with the industry to understand the use of these ICOLI products by reporting entities. He stated that after working with industry, proposed revisions to the modified guidance to identify the intent of these products in the new footnote 2 is proposed to be “these life insurance products shall be acquired with primarily considering the costs related to employee benefit obligations or the loss of a key person.”

Mike Monahan (ACLI) stated support for this language, noting that this language is simple and does not have any unintended consequences. He stated that if the Working Group proceeds with adoption, it would remove the “cloud” over this basic protection product.

Mr. Bruggeman stated that the language is different from the suggested modification in the agenda item, with the terms “primarily considering” versus “expectation.”

Ms. Walker inquired as to how an examiner would determine whether a company is in compliance with the “primarily considering” requirement. She inquired whether a company would have to document why it acquired these products so the examiner could see the consideration process. Mr. Bruggeman and Mr. Monahan both responded affirmatively.

Mr. Bruggeman stated that the company should document the risk-mitigation strategy of these administration expenses. He stated that the primary focus of these products should be employee benefits and costs related to the loss of a key person, but the guidance does not restrict excess proceeds from being used in another capacity. Mr. Bruggeman stated that these products should not be acquired as a mechanism to hold investments intended to be cover claims, losses or other insurance (underwritten) obligations, but they are expected to be acquired for operational or employee-related costs.

Ms. Walker stated that she would like to ensure the expectation is that the “primarily considering” language would include documentation in the reporting entity’s records that could be reviewed by examiners.

Mr. Hudson stated that the language addresses the intent of SSAP No. 21. Mr. Smith suggested the use of “primary consideration” for sentence structure. Mr. Monahan agreed with this revised language. He also provided the revised statement as “these life insurance products shall be acquired with the primary consideration of the costs related to employee benefit obligations or the loss of a key person.”

Ms. Gann stated that if the Working Group proceeds with adopting the revisions to SSAP No. 21, then the new disclosure would be required for year-end 2018 as a narrative disclosure. A blanks proposal would be sponsored to have the disclosure data-captured for 2019.

Ms. Walker made a motion, seconded by Mr. Hudson, to adopt the revisions to SSAP No. 21, with the modifications discussed during the meeting, and to sponsor a blanks proposal to capture the new disclosure for year-end 2019 (Attachment One-E). The motion passed unanimously.

Mr. Bruggeman then requested Working Group members to provide direction for products that are not compliant with IRC § 7702, including variable annuity products. He stated that under the provisions of SSAP No. 4, because such products are not specifically identified as admitted, by default they would be nonadmitted. The Working Group could decide to explicitly nonadmit, or could direct the development of an agenda item that considers specific accounting and reporting guidance that
allows for admittance. Mr. Bruggeman stated that the extent to which such products are held by insurance companies is uncertain.

Mr. Hudson stated that he did not believe additional action is needed, as such products would be nonadmitted under SSAP No. 4. However, if considered necessary, he was not against an explicit statement noting nonadmittance. Ms. Walker agreed and stated that if something else is preferred by the industry, then the industry should submit a proposal for consideration.

Mr. Monahan stated that products that are not compliant with IRC § 7702 are considered investment products. He stated that there is no reason to pursue guidance for these products, as insurance companies are not in the business of buying insurance products that are not compliant with IRC § 7702. Mr. Bruggeman stated that instead of purchasing an insurance product that “wraps” investment holdings, such as a private placement variable annuity, an insurance company should simply acquire the underlying investment product and report the investment in accordance with the appropriate SSAP and reporting schedule.

Mr. Bruggeman inquired whether the insurance company holder receives additional protections from holding the investment in an annuity product wrapper. Mr. Hedgepeth stated that there are advantages to a long-term holding strategy from an investment management perspective.

Ms. Weaver inquired on the types of insurance companies acquiring these annuity products as investments. Mr. Hedgepeth stated that a wide range of insurers acquire these products as an asset management approach to back surplus, not immediate liabilities, with a long-term capital appreciation perspective.

In response to Mr. Bruggeman’s inquiry on whether property/casualty (P/C), life, health and title insurers are all acquiring these products, Mr. Hedgepeth confirmed, noting his experience is that even life and annuity companies are purchasing these products.

As Working Group members were not indicating a need for the cash surrender value of these annuity “wrapper” products to be admitted assets, Mr. Bruggeman stated that NAIC staff would not be directed to draft a proposal. However, he said the industry could develop a proposal for subsequent consideration. If submitted, the Working Group would want information on why companies would be compelled to hold investments through annuity products.

Mr. Hedgepeth stated he would work with NAIC staff to submit a proposal.

h. Agenda Item 2018-15

Mr. Bruggeman directed the Working Group to agenda item 2018-15: Additional Elements Under the Tax Cuts and Jobs Act (TCJA). Ms. Gann stated that on May 14, via an e-vote, the Working Group exposed a tentative INT 18-03—Additional Elements Under the Tax Cuts and Jobs Act, to provide accounting and reporting guidance for the Repatriation Transition Tax (RTT), Alternative Minimum Tax (AMT) Credit and the Global Intangible Low-Taxed Income (GILTI) Tax.

Ms. Gann stated that interested parties’ comments proposed several clarifying revisions to the exposed INT. After reviewing the comments received, NAIC staff are proposing adopting the exposed INT with modifications to reflect a majority of the interested parties’ comments. She stated revisions to the interested parties’ comments are proposed on two elements:

1. In paragraph 8, regarding the AMT Credit, the interested parties had proposed to delete the sentence indicating that the AMT Credit qualifies as a current tax recoverable under SSAP No. 101—Income Taxes. Ms. Gann stated that this statement is accurate and should be retained. A slight modification was proposed to the sentence to indicate that
reporting entities may elect (rather than prefer) to report the AMT Credit as a deferred tax asset (DTA), although it qualifies as a current income tax recoverable.

2. In paragraph 9, regarding the AMT Credit, NAIC staff were supportive of the revisions to the proposed disclosure, but have suggested that information on whether a reporting entity has elected to nonadmit the AMT Credit be disclosed. With the changes to this disclosure, it was noted that the rollforward illustration would be limited to the current reporting year, and would separately detail amounts recovered and adjustments.

Rick Carlson (John Hancock), representing the ACLI, stated support for the timely review of accounting guidance responding to the TCJA, due to the magnitude of the impact to insurance entities. He noted that the ACLI is fine with the retention of the language in paragraph 8, as well as the disclosure of an election to nonadmit the AMT Credit if completed prior to application of the DTA admittance limitations. He stated that the ACLI would also support a slight amendment to clarify that the disclosures shall be made on an accrual basis.

Mr. Bruggeman stated that the phrase “on an accrual basis” would be added to the disclosure direction captured in the INT.

Mr. Bartlett made a motion, seconded by Mr. Hudson, to adopt INT 18-03 with the edits proposed by interested parties and the modifications discussed during the meeting (Attachment One-F). The motion passed unanimously.

i. Agenda Item 2018-16

Mr. Bruggeman directed the Working Group to agenda item 2018-16: Summary Investment Schedule Update. Ms. Marcotte stated that on May 24 the Working Group exposed revisions to Appendix A-001, Section 2 of the Summary Investment Schedule to allow better crosschecks to the investment schedules and less manual work in developing the schedule. With the exposure, comments were requested on the column headings, particularly on whether the current column headings should be retained.

Ms. Marcotte stated that interested parties’ comments supported retaining the existing columns in the Summary Investment Schedule, divided between gross investment holdings and admitted assets as reported in the annual statement. She stated that an effective date would be needed for the schedule, so minor revisions have been proposed to SSAP No. 1—Accounting Policies, Risks & Uncertainties and Other Disclosures to detail a Jan. 1, 2019, effective date.

Ms. Walker made a motion, seconded by Mr. Wiest, to adopt the exposed Summary Investment Schedule, with the proposal to retain the existing column headings and establish a Jan. 1, 2019, effective date (Attachment One-G). The motion passed unanimously.

Ms. Marcotte noted that the blanks proposal 2018-02BWG will be updated and exposed accordingly.

j. Agenda Item 2016-03

Mr. Bruggeman directed the Working Group to agenda item 2016-03: Special Accounting for Limited Derivatives. Ms. Gann stated that this agenda item relates to a specific charge to consider accounting guidance for certain limited derivatives hedging interest rate risk of variable annuity guarantees. She stated that on May 24, the Working Group had exposed a revised issue paper detailing special accounting guidance for these limited derivative arrangements.

Ms. Gann stated that comments had been received from the ACLI, as well as regulators who had previously provided permitted or prescribed practices for these arrangements. She stated that the comments received were considered in proposing revisions to the issue paper, as well as in drafting a new SSAP for initial exposure, and she provided a quick overview of the revisions noted in the documents:

1. Revisions remove the proposed “option 2” (using Rho) as a method to calculate the deferred assets and liabilities. The original “option 1” using fair value is included as the prescribed method.
2. Revisions retain the special surplus allocation requirement, with inclusion of a new provision that reporting entities shall provide estimations of RBC, upon domestic regulator request, as if the special accounting provisions reflected in the proposed new SSAP had not been applied.

3. Revisions update references from *Actuarial Guideline XLIII—CARVM for Variable Annuities (AG 43)* to VM-21, Requirements for Principle Based-Reserves for Variable Annuities. A footnote has been included to identify that AG 43 shall apply for the states that have not adopted the *Valuation Manual*.

4. Revisions remove descriptions of the “hedged item” throughout, as it is a defined term in the guidance.

5. Revisions clarify the paragraph on assessing hedge effectiveness, as recommended by the ACLI.

6. Revisions remove the proposed transition options, and instead identify that reporting entities shall work with their domestic state regulator to determine the appropriate method in transitioning from previously approved permitted or prescribed practices. These revisions identify that disclosure of the transition approach approved by the domiciliary state shall be included in the financial statements in the first year of application. After the effective date of the proposed new SSAP, domiciliary state provisions that differ from the new SSAP must be disclosed as a permitted or prescribed practice pursuant to SSAP No. 1.

Ms. Gann stated that with exposure, comments are specifically requested on the effective date for the new SSAP. She stated that various positions have been communicated, including year-end 2018, Jan. 1, 2019, as well as a date that corresponds with the Variable Annuities Issues (E) Working Group project. She stated that NAIC staff are still working on a schedule template and disclosure illustrations for the new derivative guidance. She stated that she plans to send an initial draft to the ACLI in the interim in order to work together on the development, with plans to submit the schedule template and disclosure illustrations subsequently to the Working Group for review.

Mr. Bruggeman stated that the Financial Condition (E) Committee recently adopted the framework of the Variable Annuities Issues (E) Working Group, and comments are requested on the extent the projects should be coordinated. He stated that the focus is to ensure that the project is completed correctly, resulting with mitigation of volatility without unintended consequences.

Ms. Brown made a motion, seconded by Mr. Armstrong, to expose the revised issue paper and the proposed new SSAP to provide special accounting guidance for derivatives hedging the interest rate risk of variable annuity guarantees. The motion passed unanimously.

Ms. Marcotte stated that the Financial Condition (E) Committee is expecting to send new charges related to this issue, and the Accounting Practices and Procedures (E) Task Force is providing a memorandum requesting to extend the projected completion date of the charges related to this project from fall 2018 to the 2019 Summer National Meeting.

3. **Considered Maintenance Agenda – Pending Listing**

Ms. Weaver made a motion, seconded by Mr. Bartlett, to move agenda items 2018-17 through 2018-29 to the active listing, categorized as nonsubstantive, and expose all items for comment, with noted referrals directed as recommended. The motion passed unanimously.

a. **Agenda Item 2018-17**

Mr. Bruggeman directed the Working Group to agenda item 2018-17: Structured Settlements. Ms. Gann stated that this agenda item is prepared as a nonsubstantive item to consider statutory accounting and reporting guidance for an insurance reporting entity that acquires (directly or indirectly) structured settlement payment rights as a result of a structured settlement factoring transaction. She stated that this item is specific for transactions that only provide a reporting entity the right to receive payments under a structured settlement and does not address situations in which the reporting entity has acquired an insurance product (e.g., life settlement, annuity, etc).
Ms. Gann stated that guidance exists in SSAP No. 21 for structured settlements when the insurer is the owner and payee of an annuity, but guidance does not exist when structured settlements are acquired as investments. She stated that the agenda item proposes revisions to SSAP No. 21 to allow admittance for period-certain structured settlement income streams that have been legally acquired, and nonadmittance for life-contingent structured settlements, and any structured settlement that was not legally acquired under both state and federal law.

With exposure of this item, referrals are proposed to the Blanks (E) Working Group and the Valuation of Securities (E) Task Force to inform them of the exposure and to assess if any changes would be required by those groups. Additionally, for this item, comments are specifically requested on whether the revisions should be considered substantive, with an issue paper developed for historical reference.

b. Agenda Item 2018-18

Mr. Bruggeman directed the Working Group to agenda item 2018-18: Structured Notes. Ms. Gann stated that this agenda item has been drafted to revisit the accounting and reporting of structured notes and other similar investment products. This agenda item is focused on investment products structured to resemble debt instruments, where the investor assumes a risk on principal loss based on an underlying component unrelated to the credit risk of the issuer.

Ms. Gann stated that the agenda item is detailed, but ultimately proposes that structured notes, for which the contractual principal amount to be paid at maturity or the original investment amount is at risk for other than failure of the borrower to pay the contractual amount due, shall be reported as derivatives in scope of SSAP No. 86. The guidance proposes a specific exception for mortgage-referenced government-sponsored enterprises, with those securities proposed to be captured in SSAP No. 43R—Loan-backed and Structured Securities. Other instruments that meet the definition of “bond” and that may be considered a “structured note” under U.S. GAAP terminology, but for which the principal amount or original investment is not at risk for other than credit risk (e.g., U.S. Treasury inflation-indexed securities), will continue to be reported as a bond in scope of SSAP No. 26R.

Ms. Gann stated that the agenda item proposes revisions to four SSAPs:

- **SSAP No. 2—Cash, Cash Equivalents, Drafts and Short-Term Investments**: Revisions clarify that derivative instruments shall not be reported as cash equivalents or short-term instruments regardless of their maturity date, but shall be reported as derivatives.

- **SSAP No. 26R**: Revisions remove securities from the “bond” definition when the contractual amount of the instrument to be paid at maturity is at risk for other than the failure of the borrower to pay the contractual amount due. This guidance identifies that the instrument may be in the form of a debt instrument, but the issuer obligation to return principal is contingent on the performance of an underlying variable (e.g., equity index or performance of an unrelated security). The revisions also delete the structured note disclosure.

- **SSAP No. 43R**: Revisions explicitly capture mortgage-reference securities in scope. This is an explicit exception to the LBSS definition, as the items do not qualify as “loan-backed securities” as the pool of mortgages are not held in trust, and the amounts due under the investment are not backed by the referenced mortgages.

- **SSAP No. 86**: Revisions capture structured notes in scope when there is a risk of principal loss based on the terms of the agreement in addition to default risk.

Ms. Gann stated that that there is a definition in the P&P Manual for “structured note.” Although a referral is not recommended at this time, if the revisions go forward, there will be a subsequent referral requesting the Valuation of Securities (E) Task Force to review and update this definition.

c. Agenda Item 2018-19

Mr. Bruggeman directed the Working Group to agenda item 2018-19: Elimination of Modified Filing Exempt (MFE). Ms. Gann stated that this agenda item was drafted in response to a Valuation of Securities (E) Task Force referral
(Attachment One-H) requesting that the Working Group consider deletion of paragraph 26.b. of SSAP No. 43R and make other necessary changes to delete the MFE guidance from SSAP No. 43R. She noted that with this revision, the final NAIC designation for credit rating provider (CRP) rated securities would not be modified.

Ms. Gann stated that the Task Force will make the ultimate decision on whether to eliminate MFE guidance, and the Task Force’s proposal is also currently exposed, but this item proposes a concurrent exposure to detail the statutory accounting revisions that would be necessary with the elimination. She noted that comments are specifically requested on the effective date as well as whether any specific transition guidance would need to be considered. She noted that a referral was also recommended to the Blanks (E) Working Group to consider any necessary revisions to the annual financial statement instructions.

d. Agenda Item 2018-20

Mr. Bruggeman directed the Working Group to agenda item 2018-20: Debt Forgiveness Between Related Parties. Ms. Gann stated that this agenda item was drafted to clarify statutory accounting guidance when an amount due under a related party transaction involving a parent or stockholder has been forgiven. Particularly, it recommends clarifications regarding the treatment of forgiven debt involving a parent or other stockholder in SSAP No. 15—Debt and Holding Company Obligations and SSAP No. 25—Affiliates and Other Related Parties.

Ms. Gann stated that with exposure, comments are specifically requested on whether an uncollectible amount loaned in advance to a parent should be considered a dividend, instead of a write-off to income, and whether it is clear when an amount is uncollectible or forgiven. Comments are also specifically requested on whether additional guidance for the recording of related party service transactions should be captured.

e. Agenda Item 2018-21

Mr. Bruggeman directed the Working Group to agenda item 2018-21: SSAP No. 72 Distributions. Ms. Gann stated that this agenda item has been drafted to clarify statutory accounting guidance for distributions captured within the scope of SSAP No. 72—Surplus and Quasi-Reorganization. She stated that this agenda item intends to clarify the difference between a dividend and other distribution to a parent or shareholders and incorporate appropriate statutory accounting and reporting guidance. She stated that the proposed revisions clarify that in any event in which unassigned funds are negative or go below zero as a result of a distribution to a parent or stockholder, the distribution (or portion thereof that does not reflect undistributed accumulated earnings in unassigned funds) shall be considered a return of capital. The guidance specifies that a return of capital shall be charged directly to gross paid in and contributed surplus.

f. Agenda Item 2018-22

Mr. Bruggeman directed the Working Group to agenda item 2018-22: Participation Agreement in a Mortgage Loan. Ms. Gann stated that this agenda item was drafted to clarify statutory accounting guidance for a participation agreement in a mortgage loan under SSAP No. 37—Mortgage Loans. The guidance permitting a “participation agreement” was adopted in 2017 and was intended to allow ownership in a single mortgage loan agreement with a sole borrower when the insurer is not named on the original mortgage loan agreement. With a participation agreement, the insurer would acquire the mortgage loan via an assignment or participation agreement between the selling lender and any co-lenders.

Ms. Gann stated that although SSAP No. 37 pertains to mortgages issued to a “sole borrower,” and there is explicit guidance that identifies that investments that reflect involvement in a “mortgage loan fund” are not considered mortgage loans, from questions received, it appears that the “participation agreement” language is being used to incorporate ownership interests in pools/funds of mortgages with the expectation that the investment would be in scope of SSAP No. 37. She stated that the agenda item incorporates minimal revisions to the “participant agreement” language to indicate that a participation agreement must pertain to a single mortgage loan agreement with a sole borrower.
Mr. Bruggeman directed the Working Group to agenda item 2018-24EP: Editorial and Maintenance Update. Ms. Marcotte stated that this agenda item had been prepared to capture editorial revisions to SSAP No. 86, SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities and Appendix A-010 – Minimum Reserve Standards for Individual and Group Health Insurance Contracts (A-010).

h. Agenda Item 2018-25

Mr. Bruggeman directed the Working Group to agenda item 2018-25: ASU 2018-01—Leases, Land Easement Practical Expedient for Transition to Topic 842. Jake Stultz (NAIC) stated that ASU 2018-01 provides an optional practical expedient to not require review of existing or expired land easements that were not previously accounted for as leases under the new U.S. GAAP lease guidance. Mr. Stultz stated that the guidance is proposed to be rejected for statutory accounting, because the operating leases concept is proposed to be retained and revisions have been drafted to reject ASU 2018-01 in SSAP No. 22—Leases, as well as in the proposed substantively revised SSAP No. 22 being considered under agenda item 2016-02.

i. Agenda Item 2018-26

Mr. Bruggeman directed the Working Group to agenda item 2018-26: SCA Loss Tracking – Accounting Guidance. Ms. Gann stated that this agenda item was drafted to clarify the existing accounting guidance that results with a zero or negative equity reporting in SSAP No. 97. She noted that prior agenda item 2018-09: SCA Loss Tracking, adopted during the Spring National Meeting, incorporated new disclosures for these situations, but that questions received have identified the need to clarify the instances that require a negative value to be reported.

j. Agenda Item 2018-27

Mr. Bruggeman directed the Working Group to agenda item 2018-27: SSAP No. 48 Entities’ Loss Tracking. Ms. Gann stated that this agenda item has been drafted to incorporate accounting and reporting guidance for situations in which the reporting entity’s share of losses in SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies results in a negative equity position. She stated that the reporting guidance proposed is similar to the disclosure provisions adopted for subsidiary, controlled or affiliated (SCA) entities in agenda item 2018-09, and the provisions for when negative value that is required to be reported is similar to what is proposed under agenda item 2018-26.

k. Agenda Item 2018-28

Mr. Bruggeman directed the Working Group to agenda item 2018-28: Life and Annuity Liquidity Disclosures. Ms. Marcotte stated that the Financial Stability (EX) Task Force has developed proposed disclosures that expand and add more product type granularity to the existing disclosures on annuity actuarial reserves and deposit-type liabilities by withdrawal characteristics. In addition, a new note is proposed that provides a similar liquidity disclosure for life products. These disclosures are to enhance the regulator’s ability to focus on potential product areas with greater liquidity risk. Ms. Marcotte noted that the existing disclosures are in multiple SSAPs; therefore, revisions are proposed to SSAP No. 51R—Life Contracts, SSAP No. 52—Deposit-Type Contracts and SSAP No. 61R—Life and Health Reinsurance, for year-end 2019 disclosure. She noted that the expanded disclosures would impact existing annual financial statement Note 32. The life disclosures were proposed to be included in a new annual financial statement note.

l. Agenda Item 2018-29

Mr. Bruggeman directed the Working Group to agenda item 2018-29: Consistency Revisions to A-820. Ms. Marcotte stated that this agenda item is to address an issue brought to the attention of NAIC staff by a state actuary who noted a difference in Appendix A-820 – Minimum Life and Annuity Reserve Standards (A-820) from the Standard Valuation Law (#820). The noted difference was that the phrase “good and sufficient reserve” is not in Model #820. In researching this difference, NAIC staff noted that the phrase “good and sufficient reserve” has existed from the first publication of the Accounting Practices and Procedures Manual (AP&P Manual) in 1999. Ms. Marcotte noted that informal staff discussions with NAIC support staff for the Life Actuarial (A) Task Force and a few Task Force members did not note any concerns with removing the phrase. She stated that the agenda item proposes revisions to A-820 to remove the phrase “good and sufficient reserve” to be
more consistent with Model #820 as currently adopted by the NAIC membership. Mr. Bruggeman also directed NAIC staff to notify the Life Actuarial (A) Task Force of the exposure.

4. Considered Maintenance Agenda—Active Listing
   a. Agenda Item 2016-02

   Mr. Bruggeman directed the Working Group to agenda item 2016-02: Leases. Mr. Stultz noted that the agenda item is based on ASU 2016-02—Leases, which is U.S. GAAP’s major rewrite of the treatment for leases. The changes in the U.S. GAAP standard also align better with International Financial Reporting Standards (IFRS) and the biggest changes are regarding the reporting of financing lease treatment. Mr. Stultz stated that in 2017, the Working Group chose to retain operating lease treatment, and directed NAIC staff to further review the guidance and update SSAP No. 22 for any new language or guidance that was appropriate for statutory accounting.

   Mr. Stultz stated that the revisions incorporated after the last exposure pertain to sale-leaseback transactions, disclosure requirements and straight-line lease expense recognition. Additionally, in response to regulator comments, the revisions clarify the definition of assets allowed for lease treatment and sale-leaseback treatment. In accordance with these comments, and which is intended under the existing SSAP No. 22, assets must qualify as property, plant or equipment to be part of a lease. It is not appropriate to sell nonadmitted premium receivables, and then “lease” these receivables back as part of a sale-leaseback agreement. There are also minor revisions to this draft to update the readability of the document. Mr. Stultz stated that the agenda item proposes to expose substantive revisions to SSAP No. 22 and a related issue paper.

   Ms. Weaver made a motion, seconded by Mr. DiMemmo, to expose the issue paper and the substantive revisions to SSAP No. 22. The motion passed unanimously.

   b. Agenda Item 2017-28

   Mr. Bruggeman directed the Working Group to agenda item 2017-28: Reinsurance Credit. Ms. Marcotte stated that on its Nov. 6, 2017, call, the Working Group formed two informal drafting groups; the first group is for P/C issues and the second is for life and health issues. The informal drafting groups include regulators, as well as non-regulators with industry expertise, to allow for detailed discussion on this technical topic to ensure that participants have some consensus on the wording. Mr. Bruggeman noted that the drafting group discussions have been more difficult for life and health because of how Appendix A-791 – Life and Health Reinsurance (A-791) functions. Ms. Marcotte stated that both drafting groups have held several calls and there are two sets of recommendations proposed for exposure.

   Ms. Marcotte stated that the Informal Property and Casualty Reinsurance Drafting Group recommends that the Working Group expose updates to SSAP No. 62R—Property and Casualty Reinsurance to incorporate U.S. GAAP guidance to be more consistent with ASC 994-20, Financial Services – Insurance. She said that the proposed revisions specifically incorporate guidance from FASB Emerging Issues Task Force No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises (EITF 93-6) and its related interpretation EITF D-035, FASB Staff Views on Issue No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises. She stated that SSAP No. 62R already adopts EITF 93-6 with modification; however, it is incorporated by reference rather than explicitly quoted.

   Mr. Marcotte noted that the Informal Property and Casualty Reinsurance Drafting Group members agree that SSAP No. 62R intends to match U.S. GAAP to the extent feasible. Therefore, the drafting group has recommended revisions to SSAP No. 62R guidance and Exhibit A – Implementation Questions and Answers to assist with application of existing guidance, which is consistent with the principles of SSAP No. 62R. She noted that the proposed revisions would assist in addressing the concerns noted in the agenda item including ensuring that credit for reinsurance reported by the cedent is appropriate.

   Ms. Marcotte stated that although the drafting group views the revisions as consistency and implementation updates, because of the extent of revisions, NAIC staff recommend categorizing the SSAP No. 62R revisions as substantive. She noted that the
attachment has several drafting notes to assist with review and understanding the source of changes, which are not planned to be in the final document. She noted that comments are specifically requested on the effective date.

Ms. Marcotte stated that the primary issue under discussion by the Informal Life and Health Reinsurance Drafting Group is how to provide clear pointers from SSAP No. 61R to assist users in determining which contracts are subject to the guidance in A-791. Ms. Marcotte stated that the drafting group members have found it challenging to provide clear guidance that does not conflict with the existing A-791 because of ambiguities regarding the scope of A-791.

She noted that the Informal Life and Health Reinsurance Drafting Group has prepared updates to the question-and-answer guidance in A-791 to assist with further defining the scope of its applicability. She stated that the drafting group will continue to work on revisions to the body of the SSAP No. 61R, but believes feedback will assist with drafting further revisions. Ms. Marcotte stressed that the Informal Life and Health Reinsurance Drafting Group views the life and health revisions as an initial exposure to gain feedback for ongoing work.

Ms. Marcotte stated that the Informal Life and Health Reinsurance Drafting Group has also prepared updated disclosures that are designed to address the Financial Analysis (E) Working Group referral request for additional disclosures, which are similar to some of the existing disclosures in SSAP No. 62R. She noted that the existing SSAP No. 62R disclosures could not be copied into SSAP No. 61R exactly because of variations between product types and A-791. She noted that the exposure requests specific feedback from industry and regulators on whether the proposed disclosures adequately address the referral request and whether additional disclosures are needed.

Ms. Marcotte summarized that the two informal drafting groups are recommending that the Working Group expose substantive revisions to SSAP No. 62R, as well as nonsubstantive revisions to the SSAP No. 61R disclosure and the A-791 questions and answers.

Ms. Brown made a motion, seconded by Mr. Moser, to expose the revisions to SSAP No. 61R, SSAP No. 62R and A-791 as discussed during the meeting. The motion passed unanimously.

NAIC staff were also directed to provide notice of the exposure and request for feedback to the Financial Analysis (E) Working Group. Mr. Bruggeman also acknowledged the drafting group members for their contributions to this project.

5. **Considered Other Matters**

a. **Update on FASB Long-Duration Insurance Contracts Project**

Ms. Gann stated that the Financial Accounting Standards Board (FASB) finalized its discussion on its Long-Term Insurance Contracts project, noting that the adopted ASU is expected Aug. 31. She stated that NAIC staff expect to review the ASU for statutory accounting immediately once released; therefore, there may be an interim exposure of the agenda item.

Mr. Hendler stated that in June 2018, FASB adopted the provisions to be included in the standard, and decided on a Jan. 1, 2021, effective date for public companies. FASB is currently in the process of writing the final ASU. Mr. Hendler stated that the industry and the ACLI had filed several comment letters on the effective date, with almost everyone indicating that more time would be needed to implement the new standard. Although FASB has characterized the standard as a “targeted improvement,” Mr. Hendler stated that there are significant changes captured in the guidance. He stated that the industry must start updating reserves and current assumptions for all products, noting that some companies have several contracts that originated 30–40 years ago. For those companies, they must identify the assumptions and ensure they are updated and reflected in the liabilities. He stated that there will be new provisions for variable annuity guarantees that will require retrospective fair value assessment. He stated that these revisions will take a long time to implement and require system changes, as well as the establishment of new controls. He stated that he does not think FASB will revise the effective date of the standard, but the industry and the ACLI will work with FASB on implementation issues.

Mr. Monahan stated that the ACLI worked closely with FASB staff and members to get some significant elements reflected in the final standard, but FASB proceeded with a 2021 effective date. He stated that with an Aug. 31, 2018, release date, the industry would have two years and four months to implement significant changes. He stated that the ACLI has submitted an
additional letter to FASB noting that this time frame is not feasible for the extent of changes required. He advised that he is still working with FASB and, once the adopted ASU is released, he expects further discussion on the effective date.

Mr. Bruggeman agreed that the retrospective application expected in the ASU will require significant work and time by companies to implement.


Ms. Gann stated that the NAIC is moving forward with use of the VitalSource/Bookshelf product as the mechanism for electronic access to the AP&P Manual for 2019. She stated that the NAIC has used the “Folio View” product for years, but as that product is provided on a USB drive, and is supported by outdated code, there have been several issues for customers that have purchased that product. She noted that with security restrictions on the use of USB drives, some companies are not able to use this product design.

Ms. Gann stated that the VitalSource/Bookshelf product is an online and downloadable product. With the format, customers can download the product to their device to access the content without an internet connection, but also retain the ability to use their ID and password to access the content online. She stated that the NAIC is working to make the product available as early as possible for 2019, but is currently working out contractual and logistical provisions. She stated that the goal is to have the hardcopy and electronic version released around the same time.

Ms. Gann stated that the NAIC may move forward with a “pre-reserving” process for hardcopy versions of the AP&P Manual. She stated that this approach is intended to ensure that the number of hardcopy manuals acquired are sufficient to meet the need, without an excessive number of extra copies. She stated that the demand of the hardcopy has decreased over time, with more users preferring the electronic access. With the process that is being considered, all regulators and non-regulators that desire a hardcopy would “pre-reserve” their copy, with a limited number of extras available. For anyone that does not pre-reserve a copy, requests would be filled as remaining hardcopies remain. Once there are no hardcopies remaining, the customer would be limited to the electronic version.

Ms. Gann stated that it is uncertain whether this approach will be initially used in 2019, but, when implemented, extensive communication will be distributed to ensure proper notification of the change.

c. **Valuation Manual Coordination**

Ms. Marcotte stated that as part of the process of coordination between the AP&P Manual and the *Valuation Manual*, there is planned project to review Appendix A – Excerpts of Model Laws to assess for consistency with model laws and any issues to maintain consistency with the *Valuation Manual*. She stated that this project is expected to include the Life Actuarial (A) Task Force staff, NAIC legal staff and a possible Life Actuarial (A) Task Force subgroup, noting that any proposed revisions to Appendix A will be exposed for public comment.

d. **U.S. GAAP Exposures**

Mr. Stultz stated that NAIC staff have conducted a review of the current FASB exposure, noting that it did not warrant submission of a comment letter during the U.S. GAAP exposure period. He stated that once FASB releases the final ASU, the Working Group will review the guidance under the statutory accounting maintenance process.

e. **Incorrect News Articles Regarding SSAP No. 26R**

Ms. Gann stated that since the adoption of SSAP No. 26R, in 2017, there have been some incorrect news articles detailing the changes reflected in the adoption. She stated that the 2017 revisions focused on the measurement method of SVO-identified bond exchange-traded funds (ETFs) that were included in scope, requiring fair value measurement but allowing systematic value if certain criteria are met.

Ms. Gann stated that the 2017 revisions did not change the extent to which SVO-identified bond ETFs were included in the standard, and that these investments have been in scope of SSAP No. 26R since 2006. She stated that NAIC staff work with
the editors to correct the articles to reflect the accurate information, and stated that anyone with questions on the extent of revisions adopted in 2017, or who identifies an incorrect article, should contact NAIC staff.

f. Credit Losses

Mr. Bruggeman stated that comments have been received on the exposed issue paper for agenda item 2016-20: Credit Losses. He stated that subsequent discussions have occurred with interested parties, and it seems that there were different assessments of the guidance reflected in the exposed issue paper. As such, NAIC staff are working with the industry to ensure a consistent understanding of the proposed modifications before the item is brought back to the Working Group.

Keith Bell (Travelers) stated that after a subsequent discussion with Ms. Gann, the industry prepared a draft outline of what they believe was the intent of the modifications in the issue paper. It is expected that a subsequent discussion with Ms. Gann will occur on the outline, and then interested parties will submit an updated comment letter. Mr. Bell stated that the industry had a different interpretation of the exposed issue paper than what was intended by NAIC staff.

Ms. Gann agreed, and noted that NAIC staff is working to prepare guidance that would not require earlier assessment of credit losses in comparison to U.S. GAAP, but that also does not delay the recognition of losses beyond what would be required for U.S. GAAP. She stated that the intent of the “fair value floor” in the exposed issue paper was intended to result with time frames that converge for investments that are held at amortized cost under statutory accounting, but that are held as available-for-sale under U.S. GAAP. She stated that she will be working with interested parties shortly after the national meeting, and expects subsequent Working Group discussion in the interim or at the Fall National Meeting.

Mr. Bruggeman inquired whether the issue paper is still exposed. Ms. Gann stated that the issue paper is still publicly available, and the comment letters previously received can be posted.

Diane Behrens (Allstate) stated that Allstate does not believe that adopting the expected credit loss model for reinsurance recoverables would ever get the balance sheet right, and does not believe that the expected credit loss model for reinsurance recoverables should be considered for statutory accounting. She stated that there are no hidden credit losses for reinsurance transactions that need to be recognized on day one for these transactions. She stated that Allstate’s comment letter noted opposition to consider the FASB’s model for reinsurance recoverables, identifying that the model adopted by FASB is not appropriate under U.S. GAAP or statutory accounting.

Mr. Bruggeman stated that the Working Group has not reviewed the U.S. GAAP guidance for reinsurance recoverables, but that assessment will consider whether the FASB guidance is needed in accordance with the statutory accounting collateral provisions, and other statutory accounting guidance that currently exists. He stated that this aspect of the credit loss model was delayed to allow consideration after assessment of statutory accounting changes to reinsurance resulting from the “Bilateral Agreement Between the United States of America and the European Union on Prudential Measures Regarding Insurance and Reinsurance” (Covered Agreement).

Ms. Bruggeman stated that Oct. 5 is the public comment deadline for most exposures and the submission of new items.

Having no further business, the Statutory Accounting Principles (E) Working Group adjourned.
Issue: SSAP No. 68 Merger

Check (applicable entity):

- Modification of existing SSAP
- New Issue or SSAP
- Interpretation

P/C | Life | Health
---|---|---
[ ] | [ ] | [x]

Description of Issue: This agenda item has been drafted to clarify statutory accounting guidance for mergers addressed in SSAP No. 68—Business Combinations and Goodwill. Specifically, this agenda item intends to clarify that transactions in which an SCA cancels their equity, resulting with the insurance reporting entity parent directly absorbing the assets and liabilities of the SCA within their financial statements, is a statutory merger.

For example:
- Insurance reporting entity owns 70% of SCA Entity A outstanding common stock
- Insurance reporting entity acquires remaining 30% of SCA Entity A outstanding common stock
- Insurance reporting entity cancels SCA’s common stock thereby dissolving the corporate structure of the SCA and reports the SCAs assets and liabilities directly on the insurance reporting entity’s financial statements.

<table>
<thead>
<tr>
<th>Insurance Reporting Entity Financials</th>
<th>SCA Financials</th>
</tr>
</thead>
<tbody>
<tr>
<td>70% Ownership</td>
<td>Investment in SCA 70</td>
</tr>
<tr>
<td></td>
<td>Cash 70</td>
</tr>
<tr>
<td>100% Ownership</td>
<td>Investment in SCA 30</td>
</tr>
<tr>
<td></td>
<td>Cash 30</td>
</tr>
</tbody>
</table>

The investment in the SCA is reported as a stock investment on D-2-2 and D-6-1.

<table>
<thead>
<tr>
<th>Merge into Parent</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets 180</td>
<td></td>
</tr>
<tr>
<td>Liabilities 80</td>
<td></td>
</tr>
<tr>
<td>Investment in SCA 100</td>
<td></td>
</tr>
</tbody>
</table>

With the “cancellation” of the SCA stock, the parent reporting entity eliminates the reporting of the SCA via a stock ownership, and the assets and liabilities of the SCA are brought directly onto the books of the reporting entity.

The existing guidance in SSAP No. 68 identifies that a merger is accomplished with the issuance of new equity, when only one entity survives. This guidance has been cited as rationale supporting a position that only cancelling equity, without the issuance of new equity, (such as the example above when an SCA is merged directly into the parent) is not a statutory merger subject to the guidance in SSAP No. 68.

Application of the statutory merger guidance in these “absorption” scenarios is considered necessary, as the guidance requires the merged entity to adjust their accounts to reflect statutory bases with an offsetting adjustment to beginning surplus of the earliest period presented. Hence, if the SCA did not employ the statutory basis of
accounting, when the assets and liabilities are initially reported on the parent company’s financials, they must be adjusted to reflect statutory amounts. Additionally, under a merger, the income of the combined entity is to include income of the merged entities for the entire period in which the combination occurs, and the balance sheet and the statement of operations for the two-years presented shall be restated as if the merger had occurred as of January 1 of the prior year. There are also specific disclosures required for statutory mergers.

Existing Authoritative Literature:

**SSAP No. 68—Business Combinations and Goodwill**

**Statutory Mergers**

10. The statutory merger method of accounting is defined as accounting for a business combination in which the original investors in the investee receive equity of the reporting entity for their interest in the investee and only one entity survives. It shall be used for all business combinations accomplished by (a) issuing equity of a newly formed entity for the equity of the merging entities, (b) one entity issuing equity in exchange for the equity of another entity and immediately canceling the equity of that entity, or (c) the exchange of membership interest.

11. Under the statutory merger method, no acquisition shall be recognized because the combination is accomplished without disbursing resources of the constituents. Ownership interest continues and the former statutory bases of accounting shall be retained. However, if one of the merged entities did not employ the statutory basis of accounting, the accounts shall be adjusted to the statutory bases with an offsetting adjustment to beginning surplus of the earliest period presented. The recorded assets, liabilities, and related surplus accounts of the constituents shall be carried forward to the combined corporation at their recorded statutory amounts. The capital accounts of the entities shall be adjusted as necessary to reflect the appropriate par values of the capital stock of the new entity. Adjustments to the capital stock account shall be made to gross paid-in and contributed surplus, to the extent there is a balance in the account.

12. Income of the combined reporting entity shall include income of the constituents for the entire fiscal period in which the combination occurs and the balance sheet and the statement of operations for the two years presented shall be restated, as required by SSAP No. 3—Accounting Changes and Corrections of Errors. A reporting entity that merges with an entity which effectively is a shell company\(^1\) (i.e., the reporting entity has no outstanding underwriting liabilities) shall be exempt from prior year restatement.

**Treatment of Goodwill When Previously Purchased or Merged Entity Ceases to Exist**

13. Goodwill carried by an entity related to a previous business combination shall be charged or credited to surplus immediately in the event that the investee or previous investor that the goodwill relates to ceases to exist (e.g., by merger or dissolution). This guidance is intended to prevent recognition of goodwill when the acquisition, merger or dissolution of the investor or investee would result with the remaining entity reporting goodwill in itself. Internally generated goodwill, or amounts that reflect the goodwill of the reporting entity are not permitted under statutory accounting principles.

15. For business combinations taking the form of a statutory merger, the financial statements shall disclose:

a. The names and brief description of the combined entities;

b. Method of accounting, that is the statutory merger method;

---

\(^1\) When one of the entities is a "shell company," the prior year amounts shall only consist of the "non-shell company." The merger with a shell entity shall be reflected as of January 1 of the current year.
c. Description of the shares of stock issued in the transaction;

d. Details of the results of operations of the previously separate entities for the period before the combination is consummated that are included in the current combined net income, including revenue, net income, and other changes in surplus; and

e. A description of any adjustments recorded directly to surplus for any entity that previously did not prepare statutory statements.

SSAP No. 3—Accounting Changes and Corrections of Errors

Mergers

12. For mergers, prior years’ amounts in the Annual Statements shall be restated as if the merger had occurred as of January 1 of the prior year. Additionally, restatement shall be required for the two most recent years included in the Five Year Historical Summary. The Five Year Historical Summary shall include a footnote indicating that the other three years have not been restated. A reporting entity that merges with an entity which effectively is a shell company\(^2\) (i.e., the reporting entity has no outstanding underwriting liabilities) shall be exempt from prior year restatement.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): None

Information or issues (included in Description of Issue) not previously contemplated by the Working Group: None


Staff Recommendation:

NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose revisions to SSAP No. 68—Business Combinations and Goodwill to clarify that scenarios in which the ownership equity of an SCA is cancelled, with the parent reporting entity directly reporting the SCA assets and liabilities on their financial statements shall be considered, and accounted for, as statutory mergers.

Proposed revisions to SSAP No. 68:

Statutory Mergers

10. The statutory merger method of accounting is defined as accounting for a business combination in which the original investors in the investee receive equity of the reporting entity for their interest in the investee and only one entity survives. It shall be used for all business combinations accomplished by (a) issuing equity of a newly formed entity for the equity of the merging entities, (b) one entity issuing equity in exchange for the equity of another entity and immediately canceling the equity of that entity, (c) cancelling equity of an owned entity, without issuance of new equity, and incorporating the assets and liabilities of the owned entity directly within the reporting entity’s financial statements (e.g., dissolving the SCA entity and absorbing their assets and liabilities) or (cd) the exchange of membership interest.

11. Under the statutory merger method, no acquisition shall be recognized because the combination is accomplished without disbursing resources of the constituents. Ownership interest continues and the former statutory bases of accounting shall be retained. However, if one of the merged

\(^2\) When one of the entities is a “shell company,” the prior year amounts shall only consist of the “non-shell company.” The merger with a shell entity shall be reflected as of January 1 of the current year.
entities did not employ the statutory basis of accounting, the accounts shall be adjusted to the statutory bases with an offsetting adjustment to beginning surplus of the earliest period presented. The recorded assets, liabilities, and related surplus accounts of the constituents shall be carried forward to the combined corporation at their recorded statutory amounts. The capital accounts of the entities shall be adjusted as necessary to reflect the appropriate par values of the capital stock of the new entity. Adjustments to the capital stock account shall be made to gross paid-in and contributed surplus, to the extent there is a balance in the account.

12. Income of the combined reporting entity shall include income of the constituents for the entire fiscal period in which the combination occurs and the balance sheet and the statement of operations for the two years presented shall be restated, as required by SSAP No. 3—Accounting Changes and Corrections of Errors. A reporting entity that merges with an entity which effectively is a shell company\(^3\) (i.e., the reporting entity has no outstanding underwriting liabilities) shall be exempt from prior year restatement.

Treatment of Goodwill When Previously Purchased or Merged Entity Ceases to Exist

13. Goodwill carried by an entity related to a previous business combination shall be charged or credited to surplus immediately in the event that the investee or previous investor that the goodwill relates to ceases to exist (e.g., by merger or dissolution). This guidance is intended to prevent recognition of goodwill when the acquisition, merger or dissolution of the investor or investee would result with the remaining entity reporting goodwill in itself. Internally generated goodwill, or amounts that reflect the goodwill of the reporting entity are not permitted under statutory accounting principles.

Disclosures (Only paragraph 15 shown)

15. For business combinations taking the form of a statutory merger, the financial statements shall disclose:

a. The names and brief description of the combined entities;

b. Method of accounting, that is the statutory merger method;

c. Description of the shares of stock issued or cancelled in the transaction;

d. Details of the results of operations of the previously separate entities for the period before the combination is consummated that are included in the current combined net income, including revenue, net income, and other changes in surplus; and

e. A description of any adjustments recorded directly to surplus for any entity that previously did not prepare statutory statements.

Staff Review Completed by:
Julie Gann, NAIC Staff – June 2018

Status:
On August 4, 2018, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed proposed revisions to SSAP No. 68—Business Combinations and Goodwill, as shown above, to clarify that a scenario in which the stock ownership of an owned entity is cancelled, with the parent entity incorporating the assets and liabilities of the owned entity directly on their financial statements is a statutory merger.

\(^3\) When one of the entities is a "shell company," the prior year amounts shall only consist of the "non-shell company." The merger with a shell entity shall be reflected as of January 1 of the current year.

© 2018 National Association of Insurance Commissioners
Maintenance updates provide revisions to the *Accounting Practices and Procedures Manual*, such as editorial corrections, reference changes and formatting.

<table>
<thead>
<tr>
<th>SSAP/Appendix</th>
<th>Description/Revision¹</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SSAP No. 86—Derivatives</strong></td>
<td>Removes Effective Date Language from SSAP Guidance</td>
</tr>
<tr>
<td><strong>SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities</strong></td>
<td>Remove Paragraph References for Deleted Guidance</td>
</tr>
<tr>
<td><strong>Appendix A-010</strong></td>
<td>Update Paragraph Reference to be Consistent with the Model Law</td>
</tr>
<tr>
<td><strong>Appendix A-010</strong></td>
<td>Update Date to Match Model Law</td>
</tr>
</tbody>
</table>

**Removes Effective Date Language from SSAP Guidance**

The guidance in SSAP No. 86, paragraph 57.j details the Dec. 31, 2017, effective date for the aggregate derivative financing premiums disclosures. With the 2018 adoption of additional individual disclosures in paragraph 57.h.ii. (captured in Schedule DB), the reference for the 2017 effective date for paragraph 57.h. is no longer accurate. Revisions are proposed to remove the effective date from the guidance.

**Remove Paragraph References for Deleted Guidance**

SSAP No. 97, paragraph 49, detailing effective date and transition guidance, references guidance that was incorporated into SSAP No. 97 and then deleted. Proposed revisions remove old paragraph numbers, which are not applicable in the current SSAP, and update the description of the changes to reference the new SSAPs, which describe the changes.

**Update Paragraph Reference to be Consistent with the Model Law**

Update a paragraph reference in *Appendix A-010 Minimum Reserve Standards For Individual And Group Health Insurance Contracts* Exhibit 1, paragraph 1.c.i.(b)(iii). These revisions were adopted in agenda item 2017-09 regarding the 2016 Cancer Claim Cost Valuation Tables (2016 CCCVT). This update is needed because the paragraph numbering in Appendix A-010 is slightly different from Model 10.

**Update Date to Match Model Law**

The language incorporated into *Appendix A-010 Minimum Reserve Standards For Individual And Group Health Insurance Contracts* Exhibit 1, paragraph 1.a.ii., regarding the 2013 Individual Disability Income Valuation Table (2013-IDI) referenced an incorrect date, which was updated to be consistent with changes to the Model 10 previously adopted by the Health Actuarial (B) Task Force, and with the revisions adopted by the Statutory Accounting Principles (E) Working Group in agenda item 2016-17.
1) Proposed Revisions to SSAP No. 86—Derivatives

Note – Paragraph 57.h.i. was adopted in 2017 and was required in the 2017 year-end financials as a narrative (non-data captured) disclosure. In 2018, the SAPWG adopted revisions to add paragraph 57.h.ii. and to incorporate revisions to Schedule DB/data-capturing instructions, to collect all information in paragraph 57.h. electronically. Since paragraph 57.h.ii. was not adopted until 2018, the effective date reference for 2017 is proposed to be deleted.

57. Reporting entities shall disclose the following for all derivative contracts used:

h. For derivative contracts with financing premiums:

i. Disclose the aggregate, non-discounted total premium cost for these contracts and the premium cost due in each of the following four years, and thereafter. Include the aggregate fair value of derivative instruments with financing premiums excluding the impact of the deferred or financing premiums.

ii. For each derivative contract with financing premiums:

(a) Whether premium cost is paid throughout the contract, or at derivative maturity
(b) Next premium cost payment date
(c) Total premium cost
(d) Premium cost paid in prior years
(e) Current year premium cost paid
(f) Future unpaid premium cost
(g) Fair value of derivative, excluding impact of financing premiums
(h) Unrealized gain/loss, excluding impact of financing premiums

i. All derivatives are required to be shown gross on Schedule DB. However, derivatives may be reported net in the financial statements (pages 2 and 3 of the statutory financial statements) in accordance with SSAP No. 64—Offsetting and Netting of Assets and Liabilities (SSAP No. 64) when a valid right to offset exists. Derivatives offset in accordance with SSAP No. 64 and reported net in the financial statement shall follow the disclosure requirements in SSAP No. 64, paragraph 6. (Derivative Assets and Derivative Liabilities reported on the balance sheet shall agree to columns 5 and 6, respectively, after netting, on Schedule DB – Part D – Section 1.)

j. The disclosure requirements of paragraphs 57.a., 57.b., and 57.g. shall be included in the annual statement. Refer to the Preamble for further discussion regarding interim disclosure requirements. The disclosure requirements of paragraphs 57.a. through 57.g. shall be included in the annual audited statutory financial reports. The disclosure requirements in paragraph 57.h. shall be included in statutory financial statements (annual and quarterly) and are initially effective for year-end 2017. Paragraph 62 of the Preamble states that disclosures made within specific schedules or exhibits to the annual statement need not be duplicated in a separate note.
2) Proposed Revisions to SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities

Note – The guidance in this paragraph references SSAP paragraphs that are no longer applicable as the guidance was removed from the SSAP. (For example, “The guidance previously in paragraph 29 of this SSAP…”) Since the guidance is retained for historical purposes in the original issue papers, is noted in SSAP No. 32 and SSAP No. 68 respectfully, and has not been present in SSAP No. 97 since 2010, NAIC staff propose to update the guidance and remove outdated paragraph references from the SSAP.

Effective Date and Transition

49. This statement is effective for reporting periods ending on and after December 31, 2007. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors. The guidance previously in paragraph 29 of this SSAP amended the title and paragraphs 2 and 3 of SSAP No. 32—Preferred Stock (SSAP No. 32). In 2011, this guidance was moved to SSAP No. 32 and deleted from this SSAP. The original guidance included in this standard is retained for historical purposes in Issue Paper No. 118. The guidance previously in paragraph 35 of this SSAP amended paragraphs 4-6 of SSAP No. 68—Business Combinations and Goodwill (SSAP No. 68). In 2011, this guidance was moved to SSAP No. 68 and deleted from this SSAP. The original guidance included in this standard is retained for historical purposes in SSAP No. 88—Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 46. Detail of 2011 amendments that relocated guidance from this statement to SSAP No. 32—Preferred Stock and SSAP No. 68—Business Combinations and Goodwill is provided in those statements respectively. Guidance reflected in paragraph 21, incorporated from INT 03-03: Admissibility of Investments Recorded Based on the Audited GAAP Equity of the Investee when a Qualified Opinion is Provided was originally effective December 7, 2003. Guidance reflected in paragraphs 15-17 incorporated from INT 04-10: Accounting for Subsequent Investments in an Investee after Suspension of Equity Method Loss Recognition was originally effective December 5, 2004. Guidance in paragraph 43 was previously included within INT 08-03: EITF 06-9: Reporting a Change in (or the elimination of) a Previously Existing Difference between the fiscal Year-End of a Parent Company and That of a Consolidated Entity or between the Reporting Period of an Investor and That of an Equity Method Investee and was effective for periods beginning May 31, 2008.

3) Update Paragraph Reference to be Consistent with the Model Law

Update a paragraph reference in Appendix A-010 Minimum Reserve Standards For Individual And Group Health Insurance Contracts Exhibit 1, paragraph 1.c.i.(b)(iii). These revisions were adopted in agenda item 2017-09 regarding the 2016 Cancer Claim Cost Valuation Tables (2016 CCCVT). This update is needed because the paragraph numbering in Appendix A-010 is slightly different from Model 10.

A-010 Exhibit 1 Specific Standards For Morbidity, Interest And Mortality

Morbidity

1. Minimum morbidity standards for valuation of specified individual contract health insurance benefits are as follows:

(Drafting note a and b are omitted to save space)

   c. Cancer Expense Benefits

      i. Contract Reserves:
(b) Contracts issued on or after January 1, 2019:
   (ii) For all other benefits: Assumptions based on company experience, relevant industry experience and actuarial judgement. Such assumptions should be appropriate for valuation which considers margin for adverse experience.
   (iii) For contracts issued on or after January 1, 2018, and before January 1, 2019, a company may elect to use morbidity basis described in paragraphs (i) and (ii). Once a company begins use of the 2016 CCCVT for new issues, it may not revert to the 1985 CCCT.

4) Update Date to Match Model Law

The language incorporated into Appendix A-010 Minimum Reserve Standards For Individual And Group Health Insurance Contracts Exhibit 1, paragraph 1.a.ii., regarding the 2013 Individual Disability Income Valuation Table (2013-IDI) referenced an incorrect date, which was updated to be consistent with changes to the Model 10 previously adopted by the Health Actuarial (B) Task Force, and with the revisions adopted by the Statutory Accounting Principles (E) Working Group in agenda item 2016-17.

A-010 Exhibit 1 Specific Standards For Morbidity, Interest And Mortality

Morbidity

1. Minimum morbidity standards for valuation of specified individual contract health insurance benefits are as follows:
   a. Disability Income Benefits Due to Accident or Sickness
      i. Contract Reserves for Contracts issued before January 1, 2010:
   
         (a) The 1985 Commissioners Individual Disability Tables A (85CIDA); or
         (b) The 1985 Commissioners Individual Disability Tables B (85CIDB).

         (c) Each insurer shall elect, with respect to all individual contracts issued in any one statement year, whether it will use Tables A or Tables B as the minimum standard.
   
      ii. Contract Reserves for Contracts issued on or after January 1, 2020:
           The 2013 IDI Valuation Table with modifiers as described in Actuarial Guideline L. An insurer may begin to use the 2013 IDI Valuation Table with modifiers at a date earlier than January 1, 2020, but not prior to January 1, 2017.

           Within three years of 2020, or the earlier date that an insurer begins to use the 2013 IDI Valuation Table, the insurer may elect to apply that morbidity standard for all policies issued subject to other valuation tables. This may be done if the following conditions are met:
|   | (a.) The insurer must apply the morbidity standard to all inforce policies and incurred claims; |
|   | (b.) The insurer elects or has elected to apply the 2013 IDI Valuation Table to all claims incurred, regardless of incurred date; |
|   | (c.) The insurer maintain adequate policy records on policies issued prior to 2020 that allow the insurer to apply the 2013 IDI Valuation Table appropriately; and |
|   | (d.) Once an insurer elects to calculate reserves for all inforce policies based on the 2013 IDI Valuation Table morbidity standard, all future valuations must be on that basis |

**Status:**
On August 4, 2018, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed editorial maintenance revisions as detailed above.
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: ASU 2018-01—Leases (Topic 842), Land Easement Practical Expedient for Transition to Topic 842

Check (applicable entity):

<table>
<thead>
<tr>
<th>Modification of existing SSAP</th>
<th>P/C</th>
<th>Life</th>
<th>Health</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Issue or SSAP</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interpretation</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Description of Issue:
ASU 2016-02 was released in 2016 and created Topic 842—Leases in the FASB Codification. An issue that was not addressed in ASU 2016-02 was the treatment of land easements (also commonly referred to as rights of way) which represent the right to use, access, or cross another entity’s land for a specified purpose. Statutory accounting currently does not provide guidance for land easements. With the changes to GAAP lease accounting from ASU 2016-02, which includes the creation of Topic 842 of the FASB Codification and requires all leases be treated as financing leases, land easements will need to be assessed as to whether they meet the definition of a lease. If they are considered leases under Topic 842, they would be subject to that guidance, with potential recognition as right-to-use assets by GAAP reporting entities. For statutory accounting, all leases are treated as operating leases; therefore there is no right-to-use asset that will be recorded.

The guidance in ASU 2018-01 provides an optional practical expedient to not require review of existing or expired land easements, which were not previously accounted for as leases, under the new GAAP lease guidance. Pursuant to the guidance in ASU 2018-01, an entity that elects this practical expedient would be required to evaluate new or modified land easements under Topic 842 beginning at the date that the entity adopts Topic 842. Furthermore, an entity that does not elect the practical expedient would be required to evaluate all existing or expired land easements in connection with the adoption of the new lease requirements in Topic 842 to assess whether they meet the definition of a lease.

Existing Authoritative Literature:
Currently, the Accounting Practices and Procedures Manual does not have guidance that specifically covers land easements. Leases are covered in SSAP No. 22—Leases and basic discussion of the nature of assets, and specifically admitted assets, is covered in SSAP No. 4—Assets and Nonadmitted Assets. The FASB Codification includes an example involving land easements in Section 350-30-55-(29-32), and discussion of leases, which is a similar topic to land easements, is in Topic 842.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): FASB issued ASU 2016-02, Leases (Topic 842), which supersedes Topic 840, which contained the prior lease guidance. The Working Group is currently considering this ASU in agenda item 2016-02, with the expectation that SAP guidance will retain the treatment of leases as operating leases by the lessor, but will incorporate some of the new language and guidance from ASU 2016-02, specifically on leveraged leases and sale-leaseback transactions, into a revised SSAP No. 22, which will be SSAP No. 22R—Leases.

Information or issues (included in Description of Issue) not previously contemplated by the Working Group: None

Convergence with International Financial Reporting Standards (IFRS):
The intent of Topic 842 is to make U.S. GAAP lease treatment more closely resemble that of IFRS lease treatment in IFRS 16—Leases. IFRS does not reference land easements.
Staff Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and incorporate revisions to reject ASU 2018-01 in SSAP No. 22—Leases as noted below. The Working Group exposed a revised SSAP No. 22 during 2017, which is planned for an updated exposure at the Summer National Meeting. The revised SSAP No. 22R—Leases will include the statement below in the Relevant Literature section.

SSAP No. 22:

 Relevant Literature
40. This statement rejects FAS 13, as amended and interpreted, except for certain of the guidance on operating leases, sale-leaseback transactions and leveraged leases (i.e., paragraphs 15, 16.(b., c., d.), 19.(a., b.), 23.(b., c.), 36, 37, 39.c. and, 42-47). A complete list of all FASB Statements, Interpretations and Technical Bulletins adopted and rejected in this statement is as follows:

a. Accounting Standards Codification (ASC) 420-10-25 paragraphs 11-13 and ASC 420-10-30 paragraph 8 regarding the recognition of costs to terminate an operating lease before the end of the term and costs that will continue to be incurred under the contract for its remaining term without economic benefit are adopted. Other provisions of ASC 420 are rejected in SSAP No. 24.

b. ASU 2014-05, Service Concession Arrangements (Adopted with modification to only exclude service concession arrangements from the lease definition.)

c. ASU 2017-10, Determining the Customer of the Operation Services (Adopted with modification to clarify the customer in the previously adopted service concession arrangement definition.)

d. ASU 2018-01, Land Easement Practical Expedient for Transition to Topic 842 (Rejected in its entirety.)

Proposed SSAP No. 22R:

81.c. This statement rejects U.S. GAAP guidance for land easements from ASU 2018-01, Land Easement Practical Expedient for Transition to Topic 842. The guidance from ASU 2018-01 is for financing leases, specifically regarding the right-to-use assets and related liabilities for land easements, which is an accounting treatment that is rejected for statutory accounting.

Staff Review Completed by: Jake Stultz – May 2018

Status:
On August 4, 2018, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions, as shown above, to reject ASU 2018-01, Leases—Land Easement Practical Expedient for Transition to Topic 842 in SSAP No. 22—Leases for statutory accounting. It was noted that the rejection of ASU 2018-01 would also be identified in the substantively revised SSAP No. 22 that is being developed in response to ASU 2016-02, Leases.
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Updates to Liquidity Disclosures

Check (applicable entity):
- Modification of existing SSAP
  - P/C: x
  - Life: x
  - Health: x
- New Issue or SSAP
  - P/C: □
  - Life: □
  - Health: □
- Interpretation
  - P/C: □
  - Life: □
  - Health: □

Description of Issue:
The Financial Stability (Ex) Task Force has developed recommended enhancements to the existing disclosures on annuity actuarial reserves and deposit type liabilities by withdrawal characteristics and other annual statement blanks revisions for 2019 reporting. The purpose of the enhanced liquidity disclosures is to enhance the ability of the Task Force to address its role in macro prudential surveillance of the insurance industry. These disclosures are to address liquidity risk in the life insurance industry.

To enhance the ability to focus in on potential product areas with greater liquidity risk, the Task Force has developed disclosure revisions. These recommended revisions add more granularity to the product categories used as columns in various schedules in the statutory annual statement, and establish more granularity in the annuities liquidity note disclosure (breaking out the existing annual statement note 32 presentation by Individual Annuity, Group Annuity (both of which include supplementary contracts with life contingencies), and Deposit-Type Contracts (without life contingencies). Finally, an additional new note is recommended, which provides similar liquidity disclosure for life products.

Existing Authoritative Literature:

SSAP No. 51R—Life Contracts

45. Disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics for the categories of general account, separate account with guarantees, separate account nonguaranteed and the total as follows:

a. Subject to discretionary withdrawal:
   i. With market value adjustment, where withdrawal of funds is payable at all times, or prior to specified maturity dates where such dates are more than one year after the statement date and;
      (a) In a lump sum with adjustments to reflect general changes in interest rates, or asset values since receipt of funds by the insurer;
      (b) In installments over five years or more, with or without a reduction in the interest rate during the installment period;
   ii. At book value less current surrender charge, where the withdrawal of funds is payable at all times, or at any time within one year from the statement date in a lump sum subject to a current fixed surrender charge of 5% or more and it does not contain a meaningful bail out rate as described in paragraph 45.a.v.(d);
   iii. At fair value, where the withdrawal of funds is payable at current fair value of the assets supporting the liabilities, the assets are stated at current fair value, and the liabilities are stated at the current fair value or per unit value of the assets supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk;
   iv. Total with adjustment or at fair value;
v. At book value without adjustment (minimal or no charge or adjustment), where the withdrawal of funds is either payable at all times, or at any time (including a withdrawal on a scheduled payment date) within one year from the statement date and:
   (a) In a lump sum without adjustment;
   (b) In installments over less than five years, with or without a reduction in interest rate during the installment period;
   (c) In a lump sum subject to a fixed surrender charge of less than 5%;
   (d) In a lump sum subject to surrender charge, but such charge is waived if the credited rate falls below a specified "bail out" rate and the "bail out" rate is more than the maximum statutory valuation rate for life insurance policies for more than 20 years for new issues;

b. Not subject to discretionary withdrawal;

c. Total gross;

d. Reinsurance ceded;

e. Total net.

**SSAP No. 52—Deposit-Type Contracts**

19. Disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics for the categories of general account, separate account with guarantees, separate account nonguaranteed and the total as follows:

a. Subject to discretionary withdrawal:
   i. With market value adjustment, where withdrawal of funds is payable at all times, or prior to specified maturity dates where such dates are more than one year after the statement date and;
      (a) In a lump sum with adjustments to reflect general changes in interest rates, or asset values since receipt of funds by the reporting entity; and
      (b) In installments over five years or more, with or without a reduction in the interest rate during the installment period.

ii. At book value less current surrender charge, where the withdrawal of funds is payable at all times, or at any time within one year from the statement date in a lump sum subject to a current fixed surrender charge of 5% or more and it does not contain a meaningful bail out rate as described in paragraph 19.a.v.(d);

iii. At fair value, where the withdrawal of funds is payable at current fair value of the assets supporting the liabilities, the assets are stated at current fair value, and the liabilities are stated at the current fair value or per unit value of the assets minimal or no charge or adjustment), where the withdrawal of funds is either payable at all times, or at any time (including a withdrawal on a scheduled payment date) within one year from the statement date and supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk;

iv. Total with adjustment or at fair value;

v. At book value without adjustment (minimal or no charge or adjustment), where the withdrawal of funds is either payable at all times, or at any time (including a withdrawal on a scheduled payment date) within one year from the statement date and:
   (a) In a lump sum without adjustment;
   (b) In installments over less than five years, with or without a reduction in interest rate during the installment period;
   (c) In a lump sum subject to a fixed surrender charge of less than 5%;
   (d) In a lump sum subject to surrender charge, but such charge is waived if the credited rate falls below a specified "bail out" rate and the “bail out” rate is more than the maximum statutory valuation rate for life insurance policies for more than 20 years for new issues;

b. Not subject to discretionary withdrawal;

c. Total gross;
d. Reinsurance ceded;
e. Total net.

**SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance**

69. Disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics for the categories of general account, separate account with guarantees, separate account nonguaranteed and the total as follows:

a. Subject to discretionary withdrawal:
   i. With market value adjustment, where withdrawal of funds is payable at all times, or prior to specified maturity dates where such dates are more than one year after the statement date and;
      (a) In a lump sum with adjustments to reflect general changes in interest rates, or asset values since receipt of funds by the entity;
      (b) In installments over five years or more, with or without a reduction in the interest rate during the installment period.
   ii. At book value less current surrender charge, where the withdrawal of funds is payable at all times, or at any time within one year from the statement date in a lump sum subject to a current fixed surrender charge of 5% or more and it does not contain a meaningful bail out rate as described in 67.v.(d) below;
   iii. At fair value, where the withdrawal of funds is payable at current market value of the assets supporting the liabilities, the assets are stated at current fair value, and the liabilities are stated at the current fair value or per unit value of the assets supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk;
   iv. Total with adjustment or at fair value;
   v. At book value without adjustment (minimal or no charge or adjustment), where the withdrawal of funds is either payable at all times, or at any time (including a withdrawal on a scheduled payment date) within one year from the statement date and:
      (a) In a lump sum without adjustment;
      (b) In installments over less than five years, with or without a reduction in interest rate during the installment period;
      (c) In a lump sum subject to a fixed surrender charge of less than 5%;
      (d) In a lump sum subject to surrender charge, but such charge is waived if the credited rate falls below a specified “bail out” rate and the “bail out” rate is more than the maximum statutory valuation rate for life insurance policies for more than 20 years for new issues.

b. Not subject to discretionary withdrawal;
c. Total gross;
d. Reinsurance ceded; and
e. Total net.

70. Reconcile the total annuity reserves and deposit fund liabilities amount disclosed to the appropriate sections of the Aggregate Reserve for Life Policies and Contracts Exhibit and the Deposit Funds and Other Liabilities without Life or Disability Contingencies Exhibit, of the Life, Accident & Health Annual Statement and the corresponding lines in the Separate Accounts Statement.

**Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): None**

**Information or issues (included in Description of Issue) not previously contemplated by the Working Group:** None

**Convergence with International Financial Reporting Standards (IFRS):** Not applicable.
Staff Review Completed by:
Robin Marcotte - NAIC Staff

Staff Recommendation:
The revisions referred by the Financial Stability (Ex) Task Force are to improve the life insurance industry liquidity disclosures and assist with regulator monitoring. NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions SSAP No. 51R, SSAP No. 52 and SSAP No. 61R for year-end 2019 disclosure.

SSAP No. 51R—Life Contracts

45. **Disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics for the categories of general account, separate account with guarantees, separate account nonguaranteed as well as the total as follows:** and percentage of the total, include a separate section for Individual Annuities, Group Annuities, and Deposit-Type Contracts (with no life contingencies). Supplementary contracts with life contingencies are reported in the appropriate Annuities section (Individual or Group).

   a. Subject to discretionary withdrawal:

   i. With market value adjustment, where withdrawal of funds is payable at all times, or prior to specified maturity dates where such dates are more than one year after the statement date and;

      (a) In a lump sum with adjustments to reflect general changes in interest rates, or asset values since receipt of funds by the insurer;

      (b) In installments over five years or more, with or without a reduction in the interest rate during the installment period;

   ii. At book value less current surrender charge, where the withdrawal of funds is payable at all times, or at any time within one year from the statement date in a lump sum subject to a current fixed surrender charge of 5% or more and it does not contain a meaningful bail out rate as described in paragraph 45.a.v.(d);

   iii. At fair value, where the withdrawal of funds is payable at current fair value of the assets supporting the liabilities, the assets are stated at current fair value, and the liabilities are stated at the current fair value or per unit value of the assets supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk;

   iv. Total with adjustment or at fair value;

   v. At book value without adjustment (minimal or no charge or adjustment), where the withdrawal of funds is either payable at all times, or at any time (including a withdrawal on a scheduled payment date) within one year from the statement date and:

      (a) In a lump sum without adjustment;

      (b) In installments over less than five years, with or without a reduction in interest rate during the installment period;

      (c) In a lump sum subject to a fixed surrender charge of less than 5%;
In a lump sum subject to surrender charge, but such charge is waived if the credited rate falls below a specified "bail out" rate and the "bail out" rate is more than the maximum statutory valuation rate for life insurance policies for more than 20 years for new issues;

b. Not subject to discretionary withdrawal;

c. Total gross;

d. Reinsurance ceded;

e. Total net.

f. Amount with current surrender charge of 5% or more included in the current year in paragraph 45.a.ii. that will have less than a 5% surrender charge (and thus be reported with the amounts at book value with minimal or not charge or adjustment noted in paragraph 45.a.v.) in the year subsequent to the balance sheet year. (Note that percentage of total is not required for this item.)

46. Disclose the amounts of account value, cash value and reserve for the breakouts of life insurance by withdrawal characteristics, separately for General Account products and Separate Account products, as follows:

a. Subject to discretionary withdrawal, surrender values, or policy loans:
   i. Term Policies with Cash Value
   ii. Universal Life
   iii. Universal Life with Secondary Guarantees
   iv. Indexed Universal Life
   v. Indexed Universal Life with Secondary Guarantees
   vi. Indexed Life
   vii. Other Permanent Cash Value Life Insurance
   viii. Variable Life
   ix. Variable Universal Life
   x. Miscellaneous Reserves

b. Not subject to discretionary withdrawal or no cash value.
   i. Term Policies without Cash Value
   ii. Accidental Death Benefits
   iii. Disability - Active Lives
   iv. Disability - Disabled Lives
   v. Miscellaneous Reserves

 c. Total gross (Direct + Assumed).
d. Reinsurance ceded.
e. Total net (Net: Total gross (paragraph 46.c.) less Reinsurance ceded (paragraph 46.d.)).

The difference between the account value and the cash value is the surrender charge, if any. After the surrender period is over, there is no difference. Some contract types have no account value such as traditional whole life, term, etc. So if there is no account value, leave it blank. UL typically has an account value and a cash surrender value. Just as account values are not reduced for policy loans taken and outstanding, the cash value amount reported in this disclosure should not be reduced for policy loans taken and outstanding. This will ensure the difference between account value and cash value is the actual surrender charge.

47. Reconcile total life insurance reserves amount disclosed to the appropriate sections of the Aggregate Reserves for Life Policies and Contracts Exhibit (Exhibit 5) of the Life, Accident and Health Annual Statement and the corresponding lines in the Separate Accounts Statement. The reconciliation is a single presentation including all amounts from the sections on Individual Life Insurance and Group Life Insurance.

48. Reconcile the total annuity reserves and deposit fund liabilities amount disclosed in the (non-life reserves) from the annual statement - Aggregate Reserve for Life Contracts Exhibit 5 and the and deposit-type contract fund liabilities from the Deposit Type Contracts Exhibit 7 of the Life, Accident & Health Annual Statement and the corresponding lines in the Separate Accounts Statement. The reconciliation is a single presentation including all amounts from the sections on Individual Annuities, Group Annuities and Deposit-Type Contracts.

(All other paragraphs renumbered accordingly.)

SSAP No. 52—Deposit-Type Contracts

19. For the disclosures noted below, disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics for the categories of general account, separate account with guarantees, separate account nonguaranteed and as well as the total, include a separate section for Individual Annuities, Group Annuities, and Deposit-Type Contracts (with no life contingencies). Supplementary contracts with life contingencies are reported in the appropriate Annuities section (Individual or Group).

a. Subject to discretionary withdrawal:

i. With market value adjustment, where withdrawal of funds is payable at all times, or prior to specified maturity dates where such dates are more than one year after the statement date and;

   (a) In a lump sum with adjustments to reflect general changes in interest rates, or asset values since receipt of funds by the reporting entity; and

   (b) In installments over five years or more, with or without a reduction in the interest rate during the installment period.

ii. At book value less current surrender charge, where the withdrawal of funds is payable at all times, or at any time within one year from the statement date in a lump sum subject to a current fixed surrender charge of 5% or more and it does not contain a meaningful bail out rate as described in paragraph 19.a.v.(d);

iii. At fair value, where the withdrawal of funds is payable at current fair value of the assets supporting the liabilities, the assets are stated at current fair value, and the liabilities are stated at the current fair value or per unit value of the assets.
supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk;

iv. Total with adjustment or at fair value;

v. At book value without adjustment (minimal or no charge or adjustment), where the withdrawal of funds is either payable at all times, or at any time (including a withdrawal on a scheduled payment date) within one year from the statement date and:

(a) In a lump sum without adjustment;

(b) In installments over less than five years, with or without a reduction in interest rate during the installment period;

(c) In a lump sum subject to a fixed surrender charge of less than 5%;

(d) In a lump sum subject to surrender charge, but such charge is waived if the credited rate falls below a specified “bail out” rate and the “bail out” rate is more than the maximum statutory valuation rate for life insurance policies for more than 20 years for new issues;

b. Not subject to discretionary withdrawal;

c. Total gross (Direct + Assumed);

d. Reinsurance ceded;

e. Total net (Net: Total gross (paragraph 19.c.) less Reinsurance ceded (paragraph 19.d.)).

f. Amount with current surrender charge of 5% or more included in the current year in paragraph 19.a.ii that will have less than a 5% surrender charge (and thus be reported with the amounts at book value with minimal or not charge or adjustment noted in paragraph 19.a.v.) in the year subsequent to the balance sheet year. (Note that percentage of total is not required for this item.)

20. Reconcile the total annuity reserves and deposit fund liabilities amount disclosed in the (non-life reserves) from the annual statement -Aggregate Reserve for Life Contracts Exhibit 5 and the and deposit-type contract fund liabilities from the Deposit Type Contracts Exhibit 7, of the Life, Accident & Health Annual Statement and the corresponding lines in the Separate Accounts Statement. The reconciliation is a single presentation including all amounts from the sections on Individual Annuities, Group Annuities and Deposit-Type Contracts.

(Drafting Note - Paragraphs 21-22 are omitted as they are not changing. Subsequent paragraphs to be renumbered. Note that existing paragraph 21 (renumbered 22), relates to retained assets and will continue to be excluded from the audited financials as illustrated in paragraph 23 above.)

2223. The disclosures in paragraph 24-22 are not required in the annual audited financial statements. Refer to the Preamble for further discussion regarding disclosure requirements.

**SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance**

69. For the disclosures noted below, disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics for the categories of general account, separate account with guarantees, separate account nonguaranteed as well as and the total as follows: and percentage of the total, include a separate section for Individual Annuities, Group Annuities, and Deposit-Type Contracts.
with no life contingencies). Supplementary contracts with life contingencies are reported in the appropriate Annuities section (Individual or Group).

a. Subject to discretionary withdrawal:
   i. With market value adjustment, where withdrawal of funds is payable at all times, or prior to specified maturity dates where such dates are more than one year after the statement date and:
      (a) In a lump sum with adjustments to reflect general changes in interest rates, or asset values since receipt of funds by the entity;
      (b) In installments over five years or more, with or without a reduction in the interest rate during the installment period.
   ii. At book value less current surrender charge, where the withdrawal of funds is payable at all times, or at any time within one year from the statement date in a lump sum subject to a current fixed surrender charge of 5% or more and it does not contain a meaningful bail out rate as described in paragraph 6769.a.v.(d) below;
   iii. At fair value, where the withdrawal of funds is payable at current market value of the assets supporting the liabilities, the assets are stated at current fair value, and the liabilities are stated at the current fair value or per unit value of the assets supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk;
   iv. Total with adjustment or at fair value;
   v. At book value without adjustment (minimal or no charge or adjustment), where the withdrawal of funds is either payable at all times, or at any time (including a withdrawal on a scheduled payment date) within one year from the statement date and:
      (a) In a lump sum without adjustment;
      (b) In installments over less than five years, with or without a reduction in interest rate during the installment period;
      (c) In a lump sum subject to a fixed surrender charge of less than 5%;
      (d) In a lump sum subject to surrender charge, but such charge is waived if the credited rate falls below a specified "bail out" rate and the "bail out" rate is more than the maximum statutory valuation rate for life insurance policies for more than 20 years for new issues.

b. Not subject to discretionary withdrawal;

c. Total gross (Direct + Assumed);

d. Reinsurance ceded;

e. Total net. (Net: Total gross (paragraph 69.c.) less Reinsurance ceded (paragraph 69.d.).)

f. Amount with current surrender charge of 5% or more included in the current year in paragraph 69.a(ii), that will have less than a 5% surrender charge (and thus be reported with the amounts at book value with minimal or not charge or adjustment noted in paragraph 69.a(iv)).
Reconcile the total annuity reserves and deposit fund liabilities amount disclosed to in the appropriate sections (non-life reserves) from of the annual statement - Aggregate Reserve for Life Policies and Contracts Exhibit 5 and the deposit-type contract fund liabilities from the Deposit Funds and Other Liabilities without Life or Disability Contingencies Type Contracts Exhibit 7 of the Life, Accident & Health Annual Statement and the corresponding lines in the Separate Accounts Statement. The reconciliation is a single presentation including all amounts from the sections on Individual Annuities, Group Annuities and Deposit-Type Contracts.

Reconcile total life insurance reserves amount disclosed to the appropriate sections of the Aggregate Reserves for Life Policies and Contracts Exhibit (Exhibit 5) of the Life, Accident and Health Annual Statement and the corresponding lines in the Separate Accounts Statement. The reconciliation is a single presentation including all amounts from the sections on Individual Life Insurance and Group Life Insurance.

(Remaining paragraphs to be renumbered accordingly)

Status:
On August 4, 2018, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 51—Life Contracts, SSAP No. 52—Deposit-Type Contracts, and SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance, as shown above, to add life liquidity disclosures and expand the variable annuity liquidity disclosures for year-end 2019.
This page intentionally left blank.
Issue: Consistency Revisions to A-820

Check (applicable entity):

<table>
<thead>
<tr>
<th>Modification of existing SSAP</th>
<th>P/C</th>
<th>Life</th>
<th>Health</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Issue or SSAP</td>
<td>[ ]</td>
<td>[ ]</td>
<td>[ ]</td>
</tr>
<tr>
<td>Interpretation</td>
<td>[ ]</td>
<td>[ ]</td>
<td>[ ]</td>
</tr>
</tbody>
</table>

Description of Issue:
This agenda item is to address an issue brought to the attention of NAIC staff by a state actuary who noted a difference in Appendix A-820 Minimum Life and Annuity Reserve Standards (A-820) from the NAIC Standard Valuation Law (Model 820). The difference, which was noted, was that a phrase “good and sufficient reserve” was not in Model 820. In researching this difference, NAIC staff noted that the phrase “good and sufficient reserve” has existed from the first publication of the Accounting Practices and Procedures Manual in 1999.

Because the remaining language in the relevant paragraph in Section 9 of the Standard Valuation Law Model 820, references the phrase “as determined by regulations promulgated by the commissioner”, it is not recommended to reference this language in A-820, as doing so would potentially reference state regulatory variations which would not promote consistent reporting in the application of the Accounting Practices and Procedures Manual. Therefore, the phrase “good and sufficient reserve” is proposed for deletion in Appendix A-820. In discussing this issue with NAIC Life Actuarial (A) Task Force staff, the phrase “good and sufficient” was noted as not necessary to the reading of the intent of Model 820.

When NAIC staff researched to find documentation regarding the use of the phrase “good and sufficient reserve;” it was noted to appear in a September 1991 report of the American Council of Life Insurance (ACLI) and the National Association of Life Companies (NALC), Joint Task Force on Reserves for Certain Life Insurance Contracts With Non-Level Premiums Or Benefits which was submitted to Life And Health Actuarial (A&B) Task Force in 1992.

Existing Authoritative Literature:
Appendix A-820 provides the following (bolding and underlining added for emphasis):

Reserve Calculation—Indeterminate Premium Plans

21. In the case of a plan of life insurance that provides for future premium determination, the amounts of which are to be determined by the insurance company based on then estimates of future experience, or in the case of a plan of life insurance or annuity that is of such a nature that the minimum reserves cannot be determined by the methods described above, the reserves that are held under the plan shall:

   a. Be appropriate in relation to the benefits and the pattern of premiums for that plan; and

   b. Be computed by a method that is consistent with the principles of this Appendix and which produce a **good and sufficient reserve**.

The NAIC Standard Valuation Law Model No. 820 provides the following (bolding and underlining added for emphasis):

Section 9. Reserve Calculation—Indeterminate Premium Plans

In the case of a plan of life insurance that provides for future premium determination, the amounts of
which are to be determined by the insurance company based on then estimates of future experience, or in the case of a plan of life insurance or annuity that is of such a nature that the minimum reserves cannot be determined by the methods described in Sections 5, 5a and 8, the reserves that are held under the plan shall:

A. Be appropriate in relation to the benefits and the pattern of premiums for that plan; and

B. Be computed by a method that is consistent with the principles of this Standard Valuation Law, as determined by regulations promulgated by the commissioner.

Drafting Note: If desired the following paragraph may be added.

“Notwithstanding any other provision in the laws of this State, a policy, contract or certificate providing life insurance under such a plan shall be affirmatively approved by the commissioner before it can be marketed, issued, delivered or used in this State.”

If the previous paragraph is enacted in a State where prior filing and approval of life insurance policy forms has not been previously required by statute, this paragraph would mandate such action for plans requiring approval under Section 9. If the previous paragraph is enacted in a State where approval is deemed under certain circumstances, the deemed provision would be overridden by the terms of this section. In some States specific reference must be made to any statutory provision that is overridden.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): None

Information or issues (included in Description of Issue) not previously contemplated by the Working Group: None


Staff Recommendation:
NAIC staff recommends moving this item to the nonsubstantive active listing and exposing revisions to Appendix A-820 Minimum Life and Annuity Reserve Standards as illustrated below to remove the prior phrase “good and sufficient reserve” to be more consistent with the Model 820 as currently adopted by the NAIC.

Reserve Calculation—Indeterminate Premium Plans

21. In the case of a plan of life insurance that provides for future premium determination, the amounts of which are to be determined by the insurance company based on then estimates of future experience, or in the case of a plan of life insurance or annuity that is of such a nature that the minimum reserves cannot be determined by the methods described above, the reserves that are held under the plan shall:

a. Be appropriate in relation to the benefits and the pattern of premiums for that plan; and

b. Be computed by a method that is consistent with the principles of this Appendix and which produce a good and sufficient reserve.

Staff Review Completed by:
Robin Marcotte - NAIC Staff - July 2018

Status:
On August 4, 2018, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to Appendix A-820—Minimum Life and Annuity Reserve Standards, as shown above, to remove the phrase “good and sufficient reserve” as it is not consistent with the
related NAIC Standard Valuation Law Model 820. In addition, the Working Group directed that the Life Actuarial (A) Task Force be notified of the exposure.
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

**Issue:** SSAP No. 86 – Hedge Effectiveness Documentation

**Check (applicable entity):**

<table>
<thead>
<tr>
<th>Modification of existing SSAP</th>
<th>P/C</th>
<th>Life</th>
<th>Health</th>
</tr>
</thead>
<tbody>
<tr>
<td>x</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New Issue or SSAP</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interpretation</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Description of Issue:** This agenda item has been drafted to consider nonsubstantive changes to *SSAP No. 86—Derivatives*, to consider revised hedge effectiveness documentation provisions incorporated within *ASU 2017-12, Derivatives and Hedging*. (Agenda item 2017-33 will continue to review the overall accounting and reporting changes in this ASU as potential substantive revisions to SSAP No. 86.)

The provisions in the ASU intend to reduce cost and complexity of applying hedge accounting by simplifying the way assessments of hedge effectiveness may be performed. It has been noted that the efficiencies gained from the revisions in the ASU for U.S. GAAP filers will be lost if corresponding provisions are not considered for statutory accounting.

Pursuant to a July 9, 2018 interested parties’ comment letter, the following three elements were requested to be considered by the Statutory Accounting Principles (E) Working Group in a nonsubstantive proposal:

1) Allow companies to perform subsequent assessments of hedge effectiveness qualitatively if certain conditions are met.

2) Allow companies more time to perform the initial quantitative hedge effectiveness assessment.

3) Clarify that companies may apply the “critical terms match” method for a group of forecasted transactions if the transactions occur and the derivatives mature within the same 31-day period or fiscal month, and the other requirements for applying the critical terms match method are satisfied.

The interested parties’ noted that these elements will reduce the costs associated with hedge accounting, while neither changing the underlying accounting, nor creating any additional regulatory risks or concerns.

**Existing Authoritative Literature:**

*SSAP No. 86—Derivatives.* SSAP No. 86 provides the statutory accounting principles for derivative instruments and hedging, income generation and replication transactions using selected concepts from prior GAAP guidance. Generally, the documentation requirements for hedge effectiveness were reflected from U.S. GAAP.

39. At inception of the hedge, documentation must include:

a. A formal documentation of the hedging relationship and the entity’s risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the hedging instrument’s effectiveness in offsetting the exposure to changes in the hedged item’s fair value or variability in cash flows attributable to the hedged risk will be assessed. There must be a reasonable basis for how the entity plans to assess the hedging instrument’s effectiveness;
b. An entity's defined risk management strategy for a particular hedging relationship may exclude certain components of a specific hedging derivative's change in fair value, such as time value, from the assessment of hedge effectiveness, as discussed in paragraph 37 and Exhibit B;

c. Signature of approval, for each instrument, by person(s) authorized, either by the entity's board of directors or a committee authorized by the board, to approve such transactions; and

d. A description of the reporting entity's methodology used to verify that opening transactions do not exceed limitations promulgated by the state of domicile.

40. For all derivatives terminated, expired, or exercised during the year:
   a. Signature of approval, for each instrument, by person(s) authorized, either by the entity's board of directors or a committee authorized by the board, to approve such transactions;
   b. A description, for each instrument, of the nature of the transaction, including:
      i. The date of the transaction;
      ii. A complete and accurate description of the specific derivative, including description of the underlying securities, currencies, rates, indices, commodities, derivatives, or other financial market instruments;
      iii. Number of contracts or notional amount;
      iv. Date of maturity, expiry or settlement;
      v. Strike price, rate or index (termination price for futures contracts);
      vi. Counterparty, or exchange on which the transaction was traded; and
      vii. Consideration paid or received, if any, on termination.
   c. Description of the reporting entity's methodology to verify that derivatives were effective hedges; and
   d. Identification of any derivatives that ceased to be effective as hedges.

41. For derivatives open at quarter-end:
   a. A description of the methodology used to verify the continued effectiveness of hedges;
   b. An identification of any derivatives that have ceased to be effective as hedges;
   c. A description of the reporting entity's methodology to determine fair values of derivatives;
   d. Copy of Master Agreements, if any, where indicated on Schedule DB Part D.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): Agenda item 2017-33 was drafted to consider ASU 2017-12 for statutory accounting. On Aug. 4, 2018, the Statutory Accounting Principles (E) Working Group directed NAIC staff to bifurcate review of ASU 2017-12 to allow for immediate review of nonsubstantive changes from the ASU pertaining to hedge documentation. It was noted that the U.S. GAAP revisions would be effective Jan. 1, 2019, and the efficiencies gained under the revisions would
be lost for insurers if corresponding revisions were not reflected in statutory accounting. Agenda item 2017-33 will continue to review potential substantive revisions to statutory accounting as a result of the ASU.

Information or issues (included in Description of Issue) not previously contemplated by the Working Group: None

Convergence with International Financial Reporting Standards (IFRS): As noted in the ASU, although the language used to describe hedge accounting guidance in the ASU and IFRS 9, Financial Instruments, differs, there are several areas of alignment between the two standards, and it is expected that many common hedge accounting strategies will have similar outcomes related to hedging components of financial instruments and nonfinancial terms and in the measurement of hedged items in fair value hedges of interest rate risk. However, differences still remain between the two standards in the criteria for qualifying for hedge accounting. Additionally, IFRS 9 retained the separate measurement and reporting of hedge ineffectiveness and does not have broad guidance on presentation.

Staff Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose revisions to SSAP No. 86 to incorporate revisions to reflect hedge documentation and assessment efficiencies from ASU 2017-12 in accordance with the recommendation by interested parties. These revisions intend to:

1. Allow companies to perform subsequent assessments of hedge effectiveness qualitatively if certain conditions are met.

2. Allow companies more time to perform the initial quantitative hedge effectiveness assessment.

3. Clarify that companies may apply the “criterial terms match” method for a group of forecasted transactions if the transactions occur and the derivatives mature within the same 31-day period or fiscal month, and the other requirements for applying the criterial terms match method are satisfied.

Staff Review Completed by:
Julie Gann, NAIC Staff – August 4, 2018

Proposed Revisions to SSAP No. 86—Derivatives:

38. At inception of the hedge, documentation must include:
   a. A formal documentation of the hedging relationship and the entity’s risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the hedging instrument’s effectiveness in offsetting the exposure to changes in the hedged item’s fair value or variability in cash flows attributable to the hedged risk will be assessed, including whether an entity will perform subsequent effectiveness assessments on a qualitative basis (per paragraph 42) and how it intends to carry out that qualitative assessment. There must be a reasonable basis for how the entity plans to assess the hedging instrument’s effectiveness;

   b. An entity’s defined risk management strategy for a particular hedging relationship may exclude certain components of a specific hedging derivative’s change in fair value, such as time value, from the assessment of hedge effectiveness, as discussed in paragraph 37 and Exhibit B;

   c. Signature of approval, for each instrument, by person(s) authorized, either by the entity's board of directors or a committee authorized by the board, to approve such transactions; and

   d. A description of the reporting entity’s methodology used to verify that opening transactions do not exceed limitations promulgated by the state of domicile.
39. At inception, if an entity is required to perform an initial prospective assessment of hedge effectiveness on a quantitative basis (using information applicable as of the date of hedge inception), the assessment is considered to be performed concurrently at hedge inception if it completed by the earliest of the following: (815-20-25-3)

   a. The first quarterly hedge effectiveness assessment date.
   b. The date that financial statements that include the hedged transaction are available to be issued.
   c. The date that the hedging instrument and hedged item no longer qualify for hedge accounting.
   d. The date of expiration, sale, termination or exercise of the hedging instrument.
   e. The date of dedesignation of the hedging relationship.
   f. For a cash flow hedge of a forecasted transaction, the date that the forecasted transaction occurs.

New FN – Entities are required to perform an initial prospective assessment unless qualifying for an exception in accordance with ASU 2017-12, paragraph 815-20-25-3.

Staff Note – Although the exceptions from the initial prospective quantitative assessment are not proposed to be captured in the SSAP (these are not necessarily new under ASU 2017-12), for purposes of review of this agenda item, they are noted below. The key revision from ASU providing documentation efficiencies is to allow more time to complete the initial prospective assessment when it is required. NAIC staff notes that the prior U.S. GAAP documentation requirements are presumed to be part of the “FAS 133 framework / technical guidance” adoption reflected in SSAP No. 86. NAIC staff believes the SAP intent is to continue to mirror U.S. GAAP documentation requirements. NAIC staff plans to assess whether more detail from the GAAP documentation requirements would be beneficial if copied into SSAP No. 86 as part of the more substantive project. However, comments are requested on whether this info would be beneficial in the SSAP at this time.

- Overview of when an initial prospective quantitative assessment would not be required under US GAAP:
  - In a cash flow or fair value hedge, the entity applies the short-cut method.
  - In a cash flow or fair value hedge, the entity determines that the critical terms of the hedging instrument and the hedged item match.
  - In a cash flow hedge, the hedging instrument is an option and it meets specific criteria in the ASU.
  - In a cash flow hedge, a private company that is not a financial institution applies the simplified hedge accounting approach.
  - In a cash flow hedge, the entity assesses hedge effectiveness under the change in variable cash flows method permitted in the ASU, with all noted conditions being met.
  - In a cash flow hedge, the entity assesses hedge effectiveness under the hypothetical derivative method permitted in the ASU and all of the criterial terms of the hypothetical derivative and the hedging instrument are the same.
  - In a net investment hedge, the entity assesses hedge effectiveness using a method based on changes in spot exchange rates, and the conditions noted in the ASU are met.
  - In a net investment hedge, the entity assesses hedge effectiveness using a method based on changes in forward exchange rates and the noted conditions in the ASU are met.

39.40. For all derivatives terminated, expired, or exercised during the year:

   a. Signature of approval, for each instrument, by person(s) authorized, either by the entity's board of directors or a committee authorized by the board, to approve such transactions;

   b. A description, for each instrument, of the nature of the transaction, including:
      i. The date of the transaction;
      ii. A complete and accurate description of the specific derivative, including description of the underlying securities, currencies, rates, indices, commodities, derivatives, or other financial market instruments;
iii. Number of contracts or notional amount;
iv. Date of maturity, expiry or settlement;
v. Strike price, rate or index (termination price for futures contracts);
vi. Counterparty, or exchange on which the transaction was traded; and
vii. Consideration paid or received, if any, on termination.
c. Description of the reporting entity’s methodology to verify that derivatives were effective hedges; and
d. Identification of any derivatives that ceased to be effective as hedges.

40.41. For derivatives open at quarter-end:
   a. A description of the methodology used to verify the continued effectiveness of hedges, and whether the entity is using qualitative assessments pursuant to paragraph 42FN;
   b. An identification of any derivatives that have ceased to be effective as hedges;
   c. A description of the reporting entity’s methodology to determine fair values of derivatives;
   d. Copy of Master Agreements, if any, where indicated on Schedule DB Part D.

New Footnote: For purposes of this requirement, this statement adopts the guidance for effectiveness assessment after initial designation reflected in ASU 2017-12, including the concepts and restrictions for use of the short-cut method and the critical terms match method.

40.42. An entity may subsequently qualitatively assess hedge effectiveness, on a hedge-by-hedge basis, if both the conditions in paragraphs 42a and 42b were initially met. When an entity performs subsequent qualitative assessments of hedge effectiveness, it shall verify and document whenever financial statements or earnings are reported and at least every three months that the facts and circumstances related to the hedging relationship have not changed such that it can assert qualitatively that the hedging relationship was and continues to be highly effective. An entity may perform a quantitative assessment in any reporting period to validate whether qualitative assessments remain appropriate. When facts and circumstances change such that an entity no longer can assert qualitatively that the hedging relationship continue to be highly effective, then the entity shall begin performing quantitative assessments. (815-20-35-2A, 2C and 2D abbreviated)

   a. An entity performs an initial quantitative test of hedge effectiveness on a prospective basis (that is, it is not assuming that the hedging relationship is perfectly effective at hedge inception) and the results of that quantitative test demonstrate highly effective offset.
   b. At hedge inception, an entity can reasonably support an expectation of high effectiveness on a qualitative basis in subsequent periods.

Staff Note – Although explicit detail is not planned for the SSAP, the short-cut method and critical terms match method are current methods permitted under U.S. GAAP retained under ASU 2017-12. Under these methods, an entity may qualitatively assume, in very limited circumstances, that a hedging relationship is highly effective and that there is no ineffectiveness to be recognized or measured. Current reference of the critical terms is included in Exhibit B of SSAP No. 86.

Relevant Literature
6059. This statement adopts the framework established by FAS 133, FASB Statement No. 137, Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133, An amendment of FASB Statement No. 133 (FAS 137) and FASB Statement No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities, An amendment of FASB Statement No. 133 (FAS 138), for
fair value and cash flow hedges, including its technical guidance to the extent such guidance is consistent with the statutory accounting approach to derivatives utilized in this statement. This statement adopts the provisions of FAS 133 and 138 related to foreign currency hedges. With the exception of guidance specific to foreign currency hedges and amendments specific to refining the hedging of interest rate risk (under FAS 138, the risk of changes in the benchmark interest rate would be a hedged risk), this statement rejects FAS No. 137 and 138 as well as the various related Emerging Issues Task Force interpretations. This statement adopts paragraphs 4 and 25 of FASB Statement No. 149: Amendment of Statement 133 on Derivative Instruments and Hedging Activities (FAS 149) regarding the definition of an underlying and guidance for assessing hedge effectiveness. All other paragraphs in FAS 149 are rejected as not applicable for statutory accounting. This statement adopts FSP FAS 133-1 and FIN 45-5: Disclosures about Credit Derivatives and Certain Guarantees, An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45 and Clarification of the Effective Date of FASB Statement No. 161 (FSP FAS 133-1 and FIN 45-4) and requires disclosures by sellers of credit derivatives. This statement rejects FSP FIN 39-1, Amendments of FASB Interpretation No. 39, and ASU 2014-03, Derivatives and Hedging – Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps – Simplified Hedge Accounting Approach.

61 This statement adopts certain revisions to ASC 815-20 included in ASU 2017-12. This adoption is limited to specific provisions, and related transition guidance, pertaining to the documentation and assessment of hedge effectiveness and only includes: 1) provisions allowing more time to perform the initial quantitative hedge effectiveness assessment; 2) provisions allowing subsequent assessments of hedge effectiveness to be performed qualitatively if certain conditions are met; and 3) revisions regarding use of the critical terms and shortcut methods for assessing hedge effectiveness. The remaining provisions of ASU 2017-12 will be subsequently assessed for statutory accounting and shall not be considered adopted for statutory accounting until that assessment is complete.

6260. This statement adopts with modification revisions to ASC 815 as reflected within ASU 2016-05, Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships. This guidance is modified to require prospective application, as such it is only applicable to future counterparty changes in derivative instruments, and this guidance cannot be used to adjust derivative transactions previously terminated. This statement adopts revisions to ASC 815-20-25-15 as reflected within ASU 2010-08, Technical Corrections to Various Topics. This statement adopts revisions to ASC 815-10-50-4K as reflected within ASU 2010-11, Derivatives and Hedging (Topic 815), Scope Exception Related to Embedded Credit Derivatives, but rejects all other GAAP revisions from ASU 2010-11 and ASU 2014-16, Derivatives and Hedging, Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share is More Akin to Debt or to Equity and ASU 2016-06, Derivatives and Hedging, Contingent Put and Call Options in Debt Instruments. These GAAP revisions are rejected as embedded derivatives are not separated from the host contract and recognized as derivatives under SSAP No. 86. Revisions are also incorporated to SSAP No. 86 to require disclosures on embedded credit derivatives that expose the holder of a financial instrument to the possibility of being required to make future payments. This disclosure is a modification to the GAAP disclosures specific to statutory accounting as embedded credit derivatives are not separately recognized under statutory accounting. It should be noted that the conclusions reached in this statement are not intended to usurp the rules and regulations put forth by states in their respective investment laws. The contents of this statement are intended to provide accounting guidance on the use of derivatives as allowed by an insurer’s state of domicile. It is not intended to imply that insurers may use derivatives or cash instruments that the insurer’s state of domicile does not allow under the state’s insurance regulatory requirements, e.g., in replication transactions.

6364. This statement adopts revisions to ASC 815-20 as reflected within ASU 2013-10, Derivatives and Hedging, Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a benchmark interest rate for Hedge Accounting Purposes. These revisions define a benchmark interest rate, clarify what can be used in the U.S. for a benchmark interest rate, and eliminate the prior restriction on using different benchmark rates for similar hedges.

Effective Date and Transition

6765. This statement is effective for derivative transaction entered into or modified on or after January 1, 2003. A modification is any revision or change in contractual terms of the derivative. SSAP No. 31 applies to derivative transaction prior to January 1, 2003. Alternatively, an insurer may choose to apply this statement to all derivatives to which the insurer is a party as of January 1, 2003. In either case, the insurer is to disclose the transition approach that is being used. Revisions adopted to paragraph 59 to reject FSP FIN 39-1 is effective January 1,
2013, for companies that have previously reported a position in the balance sheet that was net of counterparty agreements. (Companies that have previously reported derivative instruments and/or related collateral gross shall not be impacted by these revisions.) Revisions adopted in paragraph 15 clarify the reporting for amounts received/paid to adjust variation margin until the derivative contract has ended and are effective January 1, 2018, on a prospective basis, for reporting entities that have previously considered these amounts to reflect settlement or realized gains/losses. (Companies that have previously reported variation margin changes in line with the revisions shall not be impacted by these revisions.) Revisions to incorporate limited provisions from ASU 2017-12 pertaining to the documentation of hedge effectiveness (detailed in paragraph 61) are effective January 1, 2019, with early adoption permitted for year-end 2018. However, if the reporting entity is a U.S. GAAP filer, the reporting entity may only elect early adoption if the entity has also elected early adoption of ASU 2017-12 for year-end 2018.

EXHIBIT B – ASSESSMENT OF HEDGING EFFECTIVENESS

The following is based on paragraphs 62-70 of FAS 133 to offer additional guidance on assessing hedging effectiveness. The intent of such is to remain consistent with FAS 133 U.S. GAAP with respect to assessing hedge effectiveness, including guidance in ASU 2017-12 that outlines when an entity may perform subsequent assessments of hedge effectiveness qualitatively.

1. This statement requires that an entity define at the time it designates a hedging relationship the method it will use to assess the hedge’s effectiveness in achieving offsetting changes in fair value or offsetting cash flows attributable to the risk being hedged. It also requires that an entity use that defined method consistently throughout the hedge period to assess at inception of the hedge and on an ongoing basis whether it expects the hedging relationship to be highly effective in achieving offset. If the entity identifies an improved method and wants to apply that method prospectively, it must discontinue the existing hedging relationship and designate the relationship anew using the improved method. Although this statement suggests a method for assessing whether a hedge is expected to be highly effective or measuring hedge ineffectiveness, the appropriateness of a given method of assessing hedge effectiveness can depend on the nature of the risk being hedged and the type of hedging instrument used. Ordinarily, however, an entity should assess effectiveness for similar hedges in a similar manner; use of different methods for similar hedges should be justified.

2. In defining how hedge effectiveness will be assessed, an entity must specify whether it will include in that assessment all of the gain or loss on a hedging instrument. As discussed in paragraph 33, this statement permits (but does not require) an entity to exclude all or a part of the hedging instrument’s time value from the assessment of hedge effectiveness, as follows:

   a. If the effectiveness of a hedge with an option contract is assessed based on changes in the option’s intrinsic value, the change in the time value of the contract would be excluded from the assessment of hedge effectiveness.

   b. If the effectiveness of a hedge with an option contract is assessed based on changes in the option’s minimum value, that is, its intrinsic value plus the effect of discounting, the change in the volatility value of the contract would be excluded from the assessment of hedge effectiveness.

   c. If the effectiveness of a hedge with a forward or futures contract is assessed based on changes in fair value attributable to changes in spot prices, the change in the fair value of the contract related to the changes in the difference between the spot price and the forward or futures price would be excluded from the assessment of hedge effectiveness.

In each circumstance above, changes in the excluded component would be included in unrealized gains or losses. As noted in paragraph 1 of this Exhibit, the effectiveness of similar hedges generally should be assessed similarly; that includes whether a component of the gain or loss on a derivative is excluded in assessing effectiveness. No other components of a gain or loss on the designated hedging instrument may be excluded from the assessment of hedge effectiveness.

3. In assessing the effectiveness of a cash flow hedge, an entity generally will need to consider the time value of money if significant in the circumstances. Considering the effect of the time value of money is especially important if the hedging instrument involves periodic cash settlements. An example of a situation in which an
entity likely would reflect the time value of money is a tailing strategy with futures contracts. When using a tailing strategy, an entity adjusts the size or contract amount of futures contracts used in a hedge so that earnings (or expense) from reinvestment (or funding) of daily settlement gains (or losses) on the futures do not distort the results of the hedge. To assess offset of expected cash flows when a tailing strategy has been used, an entity could reflect the time value of money, perhaps by comparing the present value of the hedged forecasted cash flow with the results of the hedging instrument.

4. **Whether a hedging relationship qualifies as highly effective sometimes will be easy to assess.** If the critical terms of the hedging instrument and of the entire hedged item (asset or liability) (as opposed to selected cash flows) or hedged forecasted transaction are the same, the entity could conclude that changes in fair value or cash flows attributable to the risk being hedged are expected to completely offset at inception and on an ongoing basis. For example, an entity may assume that a hedge of a forecasted purchase of a commodity with a forward contract will be highly perfectly effective if:

   a. The forward contract is for purchase of the same quantity of the same commodity at the same time and location as the hedged forecasted purchase.

   b. The fair value of the forward contract at inception is zero.

   c. Either the change in the discount or premium on the forward contract is excluded from the assessment of effectiveness and included directly in unrealized gains and losses pursuant to paragraph 22B or the change in expected cash flows on the forecasted transaction is based on the forward price for the commodity.

5. **In a cash flow hedge of a group of forecasted transactions, an entity may assume that the timing in which the hedged transactions are expected to occur and the maturity date of the hedging instrument match in accordance with paragraph if those forecasted transactions occur and the derivative matures within the same 31-day period or fiscal month.** (815-20-25-84A)

56. However, assessing hedge effectiveness can be more complex. For example, hedge effectiveness would be reduced by the following circumstances, among others:

   a. A difference between the basis of the hedging instrument and the hedged item or hedged transaction (such as a Deutsche mark-based hedging instrument and Dutch guilder-based hedged item), to the extent that those bases do not move in tandem

   b. Differences in critical terms of the hedging instrument and hedged item or hedged transaction, such as differences in notional amounts, maturities, quantity, location, or delivery dates.

Hedge effectiveness also would be reduced if part of the change in the fair value of a derivative is attributable to a change in the counterparty’s creditworthiness.

67. A hedge that meets the effectiveness test specified in paragraphs 19.b. and 20.b. (that is, both at inception and on an ongoing basis, the entity expects the hedge to be highly effective at achieving offsetting changes in fair values or cash flows) also must meet the other hedge accounting criteria to qualify for hedge accounting. If the hedge initially qualifies for hedge accounting, the entity would continue to assess whether the hedge meets the effectiveness test. If the hedge fails the effectiveness test at any time (that is, if the entity does not expect the hedge to be highly effective at achieving offsetting changes in fair values or cash flows), the hedge ceases to qualify for hedge accounting. The discussions of measuring hedge effectiveness in the examples in the remainder of this Exhibit assume that the hedge satisfied all of the criteria for hedge accounting at inception.

**Status:**
On August 4, 2018, the Statutory Accounting Principles (E) Working Group, via evote, moved this item to the active listing, categorized as nonsubstantive, and exposed revisions, as shown above, to incorporate revisions to reflect hedge documentation and assessment efficiencies from ASU 2017-12. This item was exposed with a shortened comment period ending Sept. 14, 2018.
Issue: Extension of Ninety-Day Rule for the Impact of Hurricane Florence and Hurricane Michael

Check (applicable entity):

<table>
<thead>
<tr>
<th>Modification of existing SSAP</th>
<th>P/C</th>
<th>Life</th>
<th>Health</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Issue or SSAP</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interpretation</td>
<td>☑</td>
<td>☑</td>
<td>☑</td>
</tr>
</tbody>
</table>

Description of Issue:
Hurricane Florence, Hurricane Michael and related tropical storms and flooding have resulted in damage to lives and property. The damage is still being assessed but is estimated to exceed $20 billion. This agenda item recommends an interpretation to extend temporarily the 90-day rule for uncollected premiums to insurers for policies, and agents collecting for policies, directly impacted by Hurricane Florence, Hurricane Michael and related tropical storms and flooding. The proposed extension is for an additional 60 days so that the total number of days to nonadmission is 150 days. This recommendation is consistent with prior extensions for nationally significant catastrophic events such as in INT 17-01: Extension of Ninety-Day Rule for the Impact of Hurricane Harvey, Hurricane Irma and Hurricane Maria, INT 13-01: Extension of Ninety-Day Rule for the Impact of Hurricane/Superstorm Sandy; and INT 05-04: Extension of Ninety-day Rule for the Impact of Hurricane Katrina, Hurricane Rita and Hurricane Wilma.

Existing Authoritative Literature:
SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers, paragraph 9 provides for nonadmission of premium and agents balances amounts in excess of 90 days overdue. Paragraphs 10 and 11 provide impairment guidance:

Impairment
9. Nonadmitted amounts are determined as follows:
   a. Uncollected Premium—To the extent that there is no related unearned premium, any uncollected premium balances which are over ninety days due shall be nonadmitted. If an installment premium is over ninety days due, the amount over ninety days due plus all future installments that have been recorded on that policy shall be nonadmitted;
   b. Bills Receivable—Bills receivable shall be nonadmitted if either of the following conditions are present:
      i. If any installment is past due, the entire bills receivable balance from that policy is nonadmitted; or
      ii. If the bills receivable balance due exceeds the unearned premium on the policy for which the note was accepted, the amount in excess of the unearned premium is nonadmitted.
   c. Agents' Balances—The uncollected agent's receivable on a policy by policy basis which is over ninety days due shall be nonadmitted regardless of any unearned premium;
      i. If amounts are both payable to and receivable from an agent on the same underlying policy, and the contractual agreements between the agent and the reporting entity permit offsetting, the nonadmitted portion of amounts due from that agent shall not be greater than the net balance due, by agent;
ii. If reconciling items between a reporting entity's account and an agent's account are over ninety days due, the amounts shall be nonadmitted.

10. After calculation of nonadmitted amounts, an evaluation shall be made of the remaining admitted assets in accordance with SSAP No. 5R–Liabilities, Contingencies and Impairments of Assets (SSAP No. 5R), to determine if there is impairment. If, in accordance with SSAP No. 5R, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made. If it is reasonably possible a portion of the balance is uncollectible and is therefore not written off, disclosure requirements outlined in SSAP No. 5R shall be followed.

11. Amounts classified as nonadmitted assets collected subsequent to the date of the statutory financial statements shall not be used to adjust the nonadmitted asset otherwise calculated.

The policy state on Maintenance of Statutory Accounting Principles requires:

11. In rare circumstances, the Working Group may adopt an interpretation which creates new SAP or conflicts with existing SSAPs. Historically, these interpretations temporarily modified statutory accounting principles and/or specific disclosures were developed in response to nationally significant events (e.g., Hurricane Sandy, September 11, 2001). In order to adopt an interpretation that creates new SAP or conflicts with existing SSAPs, the Working Group must have 67% of its members voting (10 out of 15 members) with a supermajority (7 out of 10, 8 out of 11 or 12, 9 out of 13, 10 out of 14, or 11 out of 15) supporting adoption. These interpretations can be adopted, overturned, amended or deferred only by a two-thirds majority of the Task Force membership.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): None

Information or issues (included in Description of Issue) not previously contemplated by the Working Group: None


Staff Review Completed by: Jake Stultz—NAIC Staff, October 2018

Staff Recommendation: Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose a tentative interpretation to allow for an optional temporary 60-day extension of the normal 90-day rule in paragraph 9 of SSAP No. 6 for policies impacted by Hurricane Florence, Hurricane Michael and related tropical storms and flooding. The extension would extend the nonadmission guidance for premium receivables for directly impacted policies or agents by 60 days for a total of 150 days (90 days plus the 60-day extension) not to extend past March 6, 2019. This temporary relaxation of the 90-day rule for directly impacted policies is similar to the extensions that have been granted for other major national disasters in prior interpretations.

The proposed extension temporarily overrides SSAP No. 6, paragraph 9 for affected policies, therefore the policy statement in Appendix F (see authoritative literature) requires 2/3rd (two-thirds) of the Working Group members to be present and voting and a supermajority of the Working Group members present to vote in support of the interpretation before it can be finalized.

Due to the short-term nature of the applicability of this extension, which expires March 6, 2019, this interpretation will be publicly posted on the Statutory Accounting Principles (E) Working Group’s website. This interpretation is proposed to be automatically nullified on March 7, 2019 and will be included as a nullified INT in Appendix H – Superseded SSAPs and Nullified Interpretations in the “as of March 2019” Accounting Practices and Procedures Manual.
Status:
On October 26, 2018, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as nonsubstantive and expose a tentative Interpretation 18-04: Extension of Ninety-Day Rule for the Impact of Hurricane Florence and Hurricane Michael to allow for an optional temporary 60-day extension of the normal 90-day rule in paragraph 9 of SSAP No. 6 for policies impacted by Hurricane Florence, Hurricane Michael and related tropical storms and flooding. The extension would extend the nonadmission guidance for premium receivables for directly impacted policies or agents by 60 days for a total of 150 days (90 days plus the 60-day extension) not to extend past March 6, 2019. This temporary relaxation of the 90-day rule for directly impacted policies is similar to the extensions that have been granted for other major national disasters in prior interpretations.

Due to the short-term nature of the applicability of this extension, which expires March 6, 2019, this interpretation will be publicly posted on the Statutory Accounting Principles (E) Working Group’s website. This interpretation is proposed to be automatically nullified on March 7, 2019 and will be included as a nullified INT in Appendix H – Superseded SSAPs and Nullified Interpretations in the “as of March 2019” Accounting Practices and Procedures Manual.
This page intentionally left blank.
Interpretation of the Statutory Accounting Principles Working Group

INT 18-04: Extension of Ninety-Day Rule for the Impact of Hurricane Florence and Hurricane Michael

INT 18-04 Dates Discussed

Email Vote to Expose October 26, 2018

INT 18-04 References

SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers (SSAP No. 6)

INT 18-04 Issue

1. Hurricane Florence and Hurricane Michael and their aftermath have resulted in loss of life and property, the extent to which is currently not known. The Federal Emergency Management Agency (FEMA) lists Alabama, Florida, Georgia, North Carolina, South Carolina, and Virginia as having emergency declarations because of hurricane and tropical storm or related flooding. This interpretation is intended to cover storm impacted policies in areas, which a state of emergency was declared. State regulators and insurers are taking action to provide policyholders affected by this disaster with the support and understanding that is deserved.

2. Should a 60-day extension of the 90-day rule for uncollected premiums be temporarily granted to insurers for policies in U.S. jurisdictions where a state of emergency was declared which were affected by the hurricane, tropical storm or related flooding?

INT 18-04 Discussion

3. The Working Group reached a tentative consensus for a one-time optional extension of the ninety-day rule for uncollected premium balances, bills receivable for premiums and amounts due from agents and policyholders directly impacted by Hurricane Florence, Hurricane Michael, tropical storm Florence and tropical storm Michael or the related flooding, as follows:

   a. For policies in effect as of the declaration of a state of emergency by either the states, U.S. territories or federal government, as described in paragraph 1, insurers with policyholders in areas impacted by Hurricane Florence, Hurricane Michael, tropical storm Florence and tropical storm Michael or the related flooding may wait 150 days (90 days per existing guidance, plus a 60-day extension), not to extend beyond March 6, 2019, before nonadmitting premiums receivable from those directly impacted policyholders as required per SSAP No. 6, paragraph 9.

   b. Existing impairment analysis remains in effect for these affected policies.

4. The Working Group noted that a 60-day extension is consistent with previous temporary extensions that were granted for other nationally significant catastrophes including INT 17-01: Extension of Ninety-Day Rule for the Impact of Hurricane Harvey, Hurricane Irma and Hurricane Maria, INT 13-01: Extension of Ninety-Day Rule for the Impact of Hurricane/Superstorm Sandy; and INT 05-04: Extension of Ninety-day Rule for the Impact of Hurricane Katrina, Hurricane Rita and Hurricane Wilma.
5. Due to the short-term nature of the applicability of this extension, which expires March 7, 2019, this interpretation will be publicly posted on the Statutory Accounting Principles (E) Working Group’s website. This interpretation will be automatically nullified on March 7, 2019 and will be included as a nullified INT in Appendix H – Superseded SSAPs and Nullified Interpretations in the “as of March 2019” Accounting Practices and Procedures Manual.

INT 18-04 Status

6. Further discussion is planned.
Exposure Draft

SSAP NO. 108 — DERIVATIVES HEDGING VARIABLE ANNUITY GUARANTEES

Hearing Date: 2018 Fall National Meeting or Interim Conference Call
Location: 2018 Fall National Meeting or Interim Conference Call
Deadline for Written Notice of Intent to Speak: October 5, 2018
Deadline for Receipt of Written Comments: October 5, 2018

Notice of Public Hearing and Request for Written Comments

Basis for hearings. The Statutory Accounting Principles Working Group (SAPWG) will hold a public hearing to obtain information from and views of interested individuals and organizations about the standards proposed in this Exposure Draft. The SAPWG will conduct the hearing in accordance with the National Association of Insurance Commissioners (NAIC) policy statement on open meetings. An individual or organization desiring to speak must notify the NAIC in writing by October 5, 2018. Speakers will be notified as to the date, location, and other details of the hearings.

Oral presentation requirements. The intended speaker must submit a position paper, a detailed outline of a proposed presentation or comment letter addressing the standards proposed in the Exposure Draft by October 5, 2018. Individuals or organizations whose submission is not received by that date will only be granted permission to present at the discretion of the SAPWG chair. All submissions should be addressed to the NAIC staff at the address listed below.

Format of the hearings. Speakers will be allotted up to 10 minutes for their presentations to be followed by a period for answering questions from the SAPWG. Speakers should use their allotted time to provide information in addition to their already submitted written comments as those comments will have been read and analyzed by the SAPWG. Those submissions will be included in the public record and will be available at the hearings for inspection.

Copies. Exposure Drafts can be obtained on the Internet at the NAIC Home Page (http://www.naic.org). The documents can be downloaded using Microsoft Word.

Written comments. Participation at a public hearing is not a prerequisite to submitting written comments on this Exposure Draft. Written comments are given the same consideration as public hearing testimony.

The Statutory Accounting Principles Statement of Concepts was adopted by the Accounting Practices & Procedures (EX4) Task Force on September 20, 1994, in order to provide a foundation for the evaluation of alternative accounting treatments. All issues considered by the SAPWG will be evaluated in conjunction with the objectives of statutory reporting and the concepts set forth in the Statutory Accounting Principles Statement of Concepts. Whenever possible, establish a relationship between your comments and the principles defining statutory accounting.

The exposure period is not meant to measure support for, or opposition to, a particular accounting treatment but rather to accumulate an analysis of the issues from other perspectives and persuasive comments supporting them. Therefore, form letters and objections without valid support for their conclusions are not helpful in the deliberations of the working group. Comments should not simply register your agreement or disagreement without a detailed explanation, a description of the impact of the proposed guidelines, or possible alternative recommendations for accomplishing the regulatory objective.

Any individual or organization may send written comments addressed to the Working Group to the attention of Julie Gann at jgann@naic.org, Robin Marcotte at rmarcotte@naic.org, Fatima Sediqzad at fsediqzad@naic.org and Jake Stultz at jstultz@naic.org no later than October 5, 2018, 2018. Electronic submission is preferred. Julie Gann is the NAIC Staff that is the project lead for this topic.

National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500, Kansas City, MO 64106-2197
(816) 842-3600
Statement of Statutory Accounting Principles No. 108

Derivatives Hedging Variable Annuity Guarantees

STATUS

Type of Issue ...................................... Common Area
Issued.............................................. TBD
Effective Date ....................... TBD
Affects ............................................... None
Affected by ......................................... No other pronouncements
Interpreted by ................................ None
Relevant Appendix A Guidance ....... None

SCOPE OF STATEMENT ......................................................................................................................................... 3
SUMMARY CONCLUSION ...................................................................................................................................... 3
Terms / Concepts (for purposes of this Statement).............................................................................................. 3
Special Accounting Provision .............................................................................................................................. 4
Assessing Hedge Effectiveness ............................................................................................................................ 6
Measurement / Recognition of Gains and Losses of Outstanding (Open) Instruments ........................................... 7
Measurement / Recognition of Realized Gains or Losses of Expired Derivatives .................................................. 10
Derivative Income ................................................................................................................................................. 11
Disclosures ............................................................................................................................................................ 11
Effective Date and Transition ................................................................................................................................. 12
REFERENCES .......................................................................................................................................................... 13
Relevant Issue Papers ............................................................................................................................................. 13
This paged intentionally left blank.
Derivatives Hedging Variable Annuity Guarantees

SCOPE OF STATEMENT

1. Current statutory accounting guidance for derivatives qualifying for hedging effectiveness is in SSAP No. 86—Derivatives. Pursuant to the direction from the Financial Condition (E) Committee, this Statement allows special accounting treatment for limited derivatives hedging variable annuity guarantee benefits subject to fluctuations as a result of interest rate sensitivity. The provisions within this Statement are separate and distinct from the guidance in SSAP No. 86, as the items subject to the scope of this guidance, and the provisions within, would not qualify for hedge effectiveness under SSAP No. 86. The provisions provided within this Statement are only permitted if all of the components of the Statement are met, and shall not be inferred as an acceptable statutory accounting approach for derivative transactions that do not meet the stated qualifications or that are not specifically addressed within this guidance.

SUMMARY CONCLUSION

2. This statement establishes statutory accounting principles to address certain, limited derivative transactions hedging variable annuity guarantees subject to fluctuations as a result of interest rate sensitivity. Eligibility for the special accounting provision within this standard is strictly limited to variable annuity contracts and other contracts involving certain guaranteed benefits similar to those offered with variable annuities that are reserved for in accordance with Valuation Manual 21: Requirements for Principal-Based Reserves for Variable Annuities (VM-21)1 Actuarial Guideline XLIII, CARVM for Variable Annuities (AG 43). The statutory accounting guidance within this statement is considered a special accounting provision, only permitted if all the components in the standard are met, and shall not be inferred as an acceptable statutory accounting approach for situations that do not meet the stated qualifications or that are not specifically addressed within this guidance.

Terms / Concepts (for purposes of this Statement)

3. The following terms reflect concepts specific to this Statement. (This listing only details the key concepts. Specific guidelines are reflected throughout the guidance.)

   a. Derivative Instrument: Means an agreement, option, instrument or series or combination thereof: (1) To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or (2) That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.

   b. Dynamic Hedging Approach: A dynamic hedging strategy allows for the portfolio of derivatives comprising the hedging instrument to be rebalanced in accordance with changes to the hedged item in order to adhere to the specified, documented hedging strategy.

   c. Hedged item: The hedged item shall consist of declared guarantee benefits on a pool, or portion thereof, of variable annuity contracts exposed to interest rate risk. The hedged item may relate to an open or flexible portfolio (e.g., group of variable annuity contracts with different characteristics and liability durations) that allows for addition of newly issued contracts, subtraction of surrenders and fluctuations in balances. The portfolio of

---

1 Actuarial Guideline XLIII, CARVM for Variable Annuities (AG 43) shall apply in states that have not adopted the Valuation Manual.
variable annuity contracts may consist of an entire book of business or declared components thereof.

d. Hedging Instrument: The hedging instrument shall reflect a specified derivative, or a portfolio of specified derivatives, that hedges the interest rate sensitivity of the designated hedged item. The hedging instrument may reflect a dynamic hedging strategy in which a portfolio of derivatives comprising the hedging instrument is rebalanced in accordance with changes to the hedged item.

Special Accounting Provision

4. The special accounting provision within this Statement permits reporting entities to utilize a form of “macro-hedging” in which a portfolio of variable annuity policies, which could include the entire book of business or subsections thereof, are jointly designated as the host contracts containing the hedged item, in a fair value hedge\(^2\), pursuant to a Clearly Defined Hedging Strategy (throughout this issue paper also referred to as “CDHS” or “hedging strategy”). This is considered a macro-hedge, as the designated hedged item (rate sensitive guarantee benefits) may be attached to a portfolio of variable annuity contracts with different characteristics and liability durations. Under this special accounting provision, the portfolio of contracts giving rise to the hedged item is not required to be static, but can be revised to remove policies and/or include new policies to allow for continuous risk management (hedging) of the variable annuity guarantees in accordance with the specific risks being hedged and the hedge objectives of the specified, documented hedging strategy. In designating the hedged item, reporting entities are permitted to exclude specific components of the variable annuity contracts, but such exclusions must apply collectively to all policies included within the portfolio. For example, reporting entities may elect to only hedge the interest rate risk of rider cash flows, and if making this election, would define the hedged item as the “fair value of rider claims net of rider fees” for the portfolio of policies designated as giving rise to the hedged item.

5. This special accounting provision permits reporting entities to utilize a specified derivative, or a portfolio of specified derivatives, as the hedging instrument within a fair value hedge to hedge the interest rate sensitively, or a specific percentage\(^3\) of the interest rate sensitivity, of the designated hedged item. The hedging instrument may reflect a dynamic hedging strategy in which a portfolio of derivatives comprising the hedging instrument is rebalanced in accordance with changes to the hedged item in order to adhere to the specified, documented hedging strategy. Although the hedging instruments must address interest rate risk, this guidance does not preclude use of derivative instruments that may offset risks other than interest rate risk from being designated as the hedging instruments. For derivative instruments that are affected by multiple risk factors, including interest rate risk, reporting entities shall apply this special accounting treatment to the change in fair value due to interest rate risk. Reporting entities shall bifurcate the change in fair value due to the various risk factors - e.g., fair value volatility due to interest rates (rho), and other risk factors, such as equity level (delta) or volatility (vega). Pursuant to paragraphs 10 and 13, fair value fluctuations not attributed to the hedged risk, including fair value changes from excluded open components, shall be recognized as unrealized gains or losses.

6. With the provisions in this standard to allow for flexibility in the hedged item (changes to variable annuity contracts within a portfolio) coupled with a dynamic hedging approach (rebalancing of derivative hedging instruments), there is a greater risk of misrepresentation of successful risk

---

\(^2\) As detailed in paragraph 10, these hedges are required to be highly effective in achieving offsetting changes in fair value attributed to the hedged risk between the derivative hedging instruments and the hedged item (AG 12 liability) during the period that the hedge is designated.

\(^3\) In identifying the hedged risk, reporting entities must identify whether they are hedging the full, or a portion of (e.g., 40%), the interest rate sensitivity.
management and achievement of a highly effective hedging relationship. Although this risk cannot be eliminated, the following provisions intend to ensure governance of the program and provide sufficient tools to allow for regulator review:

a. Prior to implementing a hedging program for application within scope of this standard, the reporting entity must obtain explicit approval from the domiciliary state commissioner allowing use of this special accounting provision. The domiciliary state commissioner may subsequently disallow use of this special accounting provision at their discretion. Although this guidance does not restrict the state domiciliary commissioner on when to prohibit future use, disallowance should be considered upon finding that the reporting entity’s documentation, controls, measurement, prior execution of strategy or historical results are not adequate to support future use.

b. Actuarial certifications of AG 43–VM-21 reserves, consistent with Actuarial Guideline 43VM-21 requirements, which explicitly include the following:
   i. Certification as to whether the hedging strategy is incorporated within the establishment of AG 43VM-21 reserves, and the impact of the hedging strategy within the AG 43VM-21 Conditional Tail Expectation Amount.
   ii. Certification by a financial officer of the company (CFO, treasurer, CIO, or designated person with authority over the actual trading of assets and derivatives) that the hedging strategy meets the definition of a Clearly Defined Hedging Strategy within AG 43VM-21 and that the Clearly Defined Hedging Strategy is the hedging strategy being used by the company in its actual day-to-day risk mitigation efforts. This provision does not require reporting entities to use a hedging strategy in determining AG 43VM-21 reserves, nor does it require entities to use the special accounting provision within this standard. However, it does require reporting entities that use the special accounting provisions within this standard to certify that the hedging strategy within scope of this standard is a Clearly Defined Hedging Strategy and is reflected in the establishment of AG 43VM-21 reserves.

7. As identified in paragraph 2, eligibility for the special accounting provision within this standard is strictly limited to variable annuity contracts and other contracts involving certain guaranteed benefits similar to those offered with variable annuities that are reserved for in accordance with AG 43VM-21. This special accounting provision requires the reporting entity to engage in highly effective fair value hedges that follow a Clearly Defined Hedging Strategy, as defined in AG 43VM-21, meeting all required provisions of AG 43VM-21 allowing the reporting entity to reduce the amount of the Conditional Tail Expectation (CTE) Amount. In order to qualify as a Clearly Defined Hedging Strategy (which may be dynamic, static, or a combination thereof), the strategy must meet the principles outlined in AG 43VM-21, be in place (implemented) for at least three months⁴, and shall at a minimum, identify:

---

⁴ As detailed in AG 43VM-21, before a new or revised hedging strategy can be used to reduce the amount of the Conditional Tail Expectation (CTE) otherwise calculated, the hedging strategy should be in place (effectively implemented) for at least three months. As detailed in AG 43VM-21, the reporting entity may meet the time requirement by having evaluated the effective implementation of the hedging strategy for at least three months without actually having executed the trades indicated by the hedging strategy (e.g., mock testing or by having effectively implemented the strategy with similar annuity products for at least three months.)
a. Specific risks being hedged,
b. Hedge objectives,
c. Risks not being hedged,
d. Financial instruments that will be used to hedge the risks,
e. Hedge trading rules, including permitted tolerances from hedging objectives,
f. Metric(s) used for measuring hedging effectiveness,
g. Criteria that will be used to measure effectiveness,
h. Frequency of measuring hedging effectiveness,
i. Conditions under which hedging will not take place, and
j. The individuals responsible for implementing the hedging strategy.

8. While an initially documented hedging strategy may subsequently change, any change in hedging strategy, which includes a change in hedge target, shall be documented, with notification to the domiciliary state commissioner, and include an effective date of the change in strategy. Reporting entities that elect to change a documented hedging strategy prior to the end of the three-month minimum implementation timeframe shall identify the hedging strategy, and all hedging instruments executed under the strategy, as ineffective. The three-month timeframe begins with the stated effective date of the hedging strategy regardless if any hedging instruments have been executed under the hedging strategy. Changes in a documented hedging strategy that occur after the three-month implementation timeframe do not necessitate an ineffective determination as long as hedged items and hedging instruments under the revised/new strategy continue to meet the requirements of a highly effective fair value hedge. Reporting entities are permitted to have more than one hedging strategy implemented, but all implemented strategies must qualify as a component of a Clearly Defined Hedging Strategy pursuant to paragraph 7.

Assessing Hedge Effectiveness

9. The provisions within this standard require the entity to use a specific method, as detailed in paragraph 10, to assess hedge effectiveness at inception and on an ongoing basis. At a minimum, hedge effectiveness assessment is required whenever financial statements are reported, at least every three months. Documentation requires prospective and retrospective hedge effectiveness assessments, with ongoing assessment consistent with the originally documented risk management strategy.

10. This standard requires a single measure for assessing whether the hedging strategy is highly effective, and in measuring hedge ineffectiveness. Both at inception, and on an ongoing basis, the hedging relationship must be highly effective in achieving offsetting changes in fair value attributed to the hedged risk during the period that the hedge is designated. In order to meet this requirement, reporting entities electing to use this special accounting provision must calculate the fair value of the hedged item (declared guarantee benefits exposed to interest rate risk) at inception and on an ongoing basis, and compare the

---

5 The specific risk being hedged shall include a measure of the hedge coverage (e.g., percentage of interest rate sensitivity being hedged).
6 For situations in which there has been a change in hedging strategy pursuant to paragraph 8, when conducting retrospective hedge effectiveness assessments, reporting entities shall assess effectiveness based on the hedge target that was actually in effect during the retrospective time periods.
cumulative fair value change of the hedged item to the cumulative fair value change of the hedging instruments in assessing whether the relationship is highly effective on a cumulative basis. This comparison is specific to the designated hedged risks and exposures, therefore, if only a portion of the interest rate risk is hedged or if the designated hedge only include specific components of the variable annuity policies (e.g., riders), for determining hedge effectiveness, the fair value comparisons is limited to those designated items. If an entity’s defined risk management strategy for a particular hedging relationship excludes specific components of the hedging derivative from the assessment of hedge effectiveness, the excluded open components shall be reported at fair value with gains or losses recognized as unrealized gains or losses.

11. The term “highly effective” describes a fair value hedging relationship where the change in fair value of the derivative instrument is within 80 to 125 percent of the opposite change in fair value of the hedged item attributed to the hedged risk. It shall also apply when an R-squared of .80 or higher is achieved when using a regression analysis technique.

**Measurement / Recognition of Gains and Losses of Outstanding (Open) Instruments**

12. All designated hedging instruments (all derivatives, including those reflected in portfolios) shall be reported in the financial statements at fair value.

13. Fair value fluctuations in the measurement of outstanding (non-expired) derivatives within a highly effective hedging strategy shall be reflected as follows:

   a. Fair value fluctuations in the hedging instruments attributable to the hedged risk that offset the current period change in the designated portion of the AG 43VM-21 reserve liability (e.g., guarantee benefits) shall be recognized as a realized gain or loss.

   b. Fair value fluctuations in the hedging instruments attributable to the hedged risk that do not offset the current period change in the designated portion of the AG 43VM-21 reserve liability shall be recognized as deferred assets (admitted) and deferred liabilities. The ability to recognize a deferred asset and deferred liability is limited to only the portion of the fair value fluctuation in the hedging instruments that is attributed to the hedged risk and does not immediately offset changes in the designated portion of the AG 43VM-21 reserve liability.

---

7 Hedge effectiveness is determined by comparing fair value fluctuations between the hedging instruments and the hedged item. However, in determining recognition in the financial statements, the fair value fluctuation of the hedging instruments is compared to the change in the reported value of the designated portion of the AG 43VM-21 liability. The designated portion of the AG 43VM-21 liability is not reported at fair value in the statutory financial statements, as such, the offset reported as realized gains and losses is the portion of the fair value change in hedging instruments offset by the change in the reported value of the designated portion of the AG 43VM-21 reserve. In accordance with the documented hedging strategy, reporting entities shall compare the fair value fluctuations to the change in the designated portion of the reserve liability, after considering recognized derivative returns (including recognized derivative income), when determining the recognition of fair value fluctuations.

8 Recognizing the fair value change for open derivative positions that offset the AG 43VM-21 change as a realized gain/loss (instead of an unrealized gain or loss) directly offsets the AG 43VM-21 reserve change in the income statement.

9 The change in fair value of the hedging instruments and hedged item is limited to changes driven by market factors. For example, periodic recognition of a cost owed to acquire the derivative from a counterparty (financing cost) shall not be captured as a change in the derivative instrument’s fair value. The fair value of the instrument shall be determined based on the underlying derivative without inclusion of acquisition costs (or other such contractual elements that may exist with the counterparty) that do not change based on the underlying derivative interests or market factors.
c. An amount equal to the net deferred asset and deferred liability (net amount from all hedging strategies / programs captured within this guidance) shall be allocated from unassigned funds to special surplus. **Upon domestic regulator request, reporting entities shall provide estimations of RBC as if the special accounting provisions had not been applied. This estimation shall reflect the removal of deferred assets or deferred liabilities, and reflect the impact to unassigned funds as if the derivative gains and losses had been recognized.**

d. As detailed in **paragraph 10**, fair value fluctuations in the hedging instruments that are not attributable to the hedged risk, shall be recognized as unrealized gains or unrealized losses.

e. Reporting entities shall utilize the following calculation for establishing the deferred asset (also illustrated in Appendix A) unless a different method has been approved by the domiciliary state commissioner:

i. Calculate the fair value gain or loss in the hedged item attributable to the hedged risk.

ii. Express the quantity calculated in paragraph 13.e.i. as a percentage of the change in the full-contract fair value (i.e., with all product cash flows) attributed to interest rate movements.

iii. Calculate the AG-43VM-21 liability change attributed to the hedged risk as the quantity calculated in paragraph 13.e.ii. multiplied by the AG-43VM-21 liability change attributable to interest rate.

iv. Establish the deferred asset or deferred liability in the amount of the fair value loss or (gain) of the designated hedging instruments attributed to the hedged risk less the AG-43VM-21 liability decrease or (increase) attributed to the hedged risk as calculated in paragraph 13.e.iii.

v. Allocate an amount equal to the net deferred asset and deferred liability (net amount from all hedging strategies / programs captured within this guidance) to special surplus.

14. Deferred assets and deferred liabilities recognized under **paragraph 13.b.** shall be amortized using a straight-line method into realized gains or realized losses over a finite amortization period. The amortization timeframe shall equal the Macaulay duration of the guarantee benefit cash flows based on the AG-43VM-21 Standard Scenario, but shall not exceed a period of 10 years.

a. Future recognition of deferred assets or liabilities (fair value fluctuations attributed to the hedged risk that are not offset by the reserve liability change) do not extend the amortization timeframe for previously recognized deferred assets or deferred liabilities. Reporting entities are required to separately track, with a schedule to show the initial deferred amount and amortization schedule, of the deferred assets and deferred liabilities recognized and outstanding at each reporting date.

b. The amount reported on the financial statement at each reporting date shall reflect the net amount (net as either a deferred asset or deferred liability) for each hedging strategy captured within scope of this guidance. (Reporting entities that have more than one hedging strategy could have both deferred assets and deferred liabilities in the financial statements based on the net position of the separate hedging strategies.)
Reporting entities are permitted to amortize a greater portion of the deferred assets and/or deferred liabilities into realized gains or realized losses at any time in advance of the scheduled amortization period.

i. If electing to accelerate amortization, reporting entities are required to accelerate amortization equally between deferred assets and deferred liabilities within a single hedging strategy. For example, a reporting entity is not permitted to accelerate amortization of the deferred liabilities (recognizing the gains from fair value changes) and not accelerate amortization of the deferred assets (continuing to defer losses from fair value changes). If a reporting entity only has a single hedging strategy which only reflects deferred assets or deferred liabilities, the reporting entity is permitted to accelerate amortization without restrictions.

ii. If a reporting entity has more than one hedging strategy, and the strategies have offsetting net positions (both deferred assets and deferred liabilities are recognized in the financial statements), a reporting entity’s election to accelerate amortization must be applied equally to programs with offsetting net positions. (For example, a decision to accelerate amortization of a program with a net deferred liability must be applied equally to a program with a deferred asset that best corresponds to the deferred liability.) In these situations, the guidance in paragraph 14.c.i is also applicable, whereas, the accelerated amortization must also apply equally to the deferred assets and deferred liabilities within each individual hedging program. If a reporting entity with more than one hedging strategy only has net deferred assets or net deferred liabilities recognized, the reporting entity is permitted to accelerate amortization to a single program in a manner consistent with the guidelines in paragraphs 14.c.i.

15. For outstanding (non-expired) derivative instruments that were removed from a highly effective hedging strategy (rebalanced), subsequent gains and losses from fair value fluctuations shall not impact the previously recognized deferred assets or deferred liabilities. The deferred assets and deferred liabilities for these derivative instruments shall be “locked” and amortized under the remaining schedule unless the reporting entity elects to terminate or accelerate amortization. Subsequent to the removal from a highly effective strategy, all fair value fluctuations from the outstanding derivative instruments would be subject to the guidance in SSAP No. 86, and recognized as unrealized gains and/or unrealized losses. If the derivative is re-designated as part of a highly effective hedging strategy qualifying under this standard, subsequent fair value fluctuations (after the re-designation) may be accounted for under the special accounting proviso herein stated.

16. For outstanding (non-expired) derivative instruments in a hedging strategy that no longer qualifies within scope of this standard (e.g., AG 43VM-21 requirements are not met) or is no longer a highly effective hedge, any non-amortized deferred assets or deferred liabilities shall be amortized to unrealized gains or unrealized losses over the remaining amortization timeframe, not to exceed five-years. If the deferred assets / deferred liabilities have a remaining amortization period that is less than the shortened timeframe, amortization shall continue over the remaining period. If the remaining amortization period is greater than 5-years at the time of the program no longer qualifies, or is no longer highly effective, the amortization schedule shall be revised to require full amortization within the shortened 5-year timeframe. If elected by the reporting entity, deferred assets and deferred liabilities may be immediately recognized as unrealized gains and/or unrealized losses or have accelerated amortization.

10 The intent of this guidance is to ensure that the ability to accelerate amortization does not result with elections that simply result in favorable financial statement presentation.
(less than 5-years) as unrealized gains and/or unrealized losses. (An election to immediate eliminate or accelerate amortization must follow the provisions in paragraph 14.c.) All future fair value fluctuations for these derivative instruments would be subject to the guidance in SSAP No. 86, and shall be recognized as unrealized gains or unrealized losses unless the instrument is subsequently designated as part of a highly effective hedging strategy within scope of this statement. If the derivative is re-designated as part of a highly effective hedging strategy qualifying under this standard, subsequent fair value fluctuations (after the re-designation) may be accounted for under the special accounting provision detailed in this statement.

17. Reporting entities may elect to terminate use of this special accounting provision at any time. In those instances, if the derivative instruments are outstanding, all deferred assets and deferred liabilities shall be amortized to unrealized gains or unrealized losses over the remaining amortization timeframe, not to exceed five-years. If the deferred assets / deferred liabilities have an amortization period that is less than the shortened 5-year timeframe, amortization shall continue over the established period. If the remaining amortization period is greater than 5-years at the time of termination, the amortization schedule shall be revised to require full amortization within the shortened 5-year timeframe. If elected by the reporting entity, deferred assets and deferred liabilities may be immediately eliminated or have accelerated amortization (less than 5-years) with recognition as unrealized gains and/or unrealized losses. (An election to immediate eliminate or accelerate amortization must follow the provisions in paragraph 14.c.) Once the special accounting provision is terminated, unless re-designated by the reporting entity, subsequent accounting of the derivatives in a hedging strategy that would be captured within this statement shall follow the fair value accounting approach in SSAP No. 86.

Measurement / Recognition of Realized Gains or Losses of Expired Derivatives

18. With the ability to rebalance the hedging instrument, this guidance allows for individual derivative instruments to expire and/or be removed from the portfolio of the hedging instrument, and not immediately trigger an assessment that the overall hedging strategy is no longer highly effective. Furthermore, special allowances are included to consider the tenure differences between a hedging instrument and AG 43VM-21 liability duration. These allowances permit expired derivative instruments that were part of a highly effective hedging strategy at the time of expiration to continue amortizing the deferred gains and deferred losses over the previously established amortization timeframe even if the overall hedging strategy is subsequently terminated or subsequently identified as no longer qualifying as a highly effective hedge.

19. Pursuant to the provisions in paragraph 14.c., reporting entities are permitted to amortize a greater portion of the deferred assets and/or deferred liabilities from expired derivatives into realized gains or realized losses in advance of the scheduled amortization period.

20. Consistent with the guidance in paragraph 17, reporting entities may elect to terminate use of this special accounting provision at any time. In those instances, if the derivative instruments have expired, all deferred assets and deferred liabilities shall be amortized to realized gains or realized losses over the remaining amortization timeframe, not to exceed 5-years. If the deferred assets / deferred liabilities had an amortization period that was less than the shortened timeframe, amortization shall continue over the established period. If the amortization period was greater than 5-years at the time of termination, the amortization schedule would be revised to require full amortization within the shortened timeframe. If

---

11 Macro-hedges and the ability to rebalance hedging instruments are not provisions permitted within “effective” hedges in scope of SSAP No. 86. As such, hedging strategies with these components accounted for under SSAP No. 86 shall follow the fair value accounting approach detailed in that standard.

12 Throughout this standard the use of the word “expire” is intended to capture all instances in which the derivative is no longer outstanding. It includes maturities, terminations, sales, and/or other closing transactions of a derivative.
elected by the reporting entity, the deferred assets and deferred liabilities may be immediately eliminated, or have accelerated amortization, with recognition as realized gains and/or realized losses. An election to immediate eliminate or accelerate amortization (less than 5 years) must follow the provisions in paragraph 14.c.)

**Derivative Income**

21. Derivative income shall be recognized when earned.

22. Pursuant to the documented hedging strategy as a fair value hedge, derivative income shall be considered as part of the overall hedging strategy and included in the assessments on whether the strategy is highly effective.

**Disclosures**

*(Staff Note – Staff recommends a new schedule to capture the disclosure information.)*

23. A reporting entity that has any outstanding derivatives accounted for under this special accounting provision, or that has unamortized deferred assets and/or deferred liabilities (representing previously unrecognized qualifying fair value fluctuations) from expired derivatives under the special accounting provision shall disclose the following within the financial statements:

a. Discussion of hedged item (portfolio of variable annuity policies), including information on the guarantees sensitive to interest rate risk, along with information on the designated hedging instruments being used to hedge the risk. Discussion of the hedging instruments shall identify whether a hedging instrument is a single instrument or portfolio, as well as information on the hedging strategy (including whether there have been changes in strategy from the prior reporting period, along with detailed information on the changes), and assessment of hedging effectiveness and compliance with the “Clearly Defined Hedging Strategy” of AG 43VM-21. Identification shall occur on whether the hedged item is intended to be fully hedged under the hedging strategy, or if the strategy is only focused on a portion of the liability characteristics or a portion of the interest rate sensitivity. Hedging strategies shall be identified as highly effective or not highly effective. If the strategy for a particular hedging relationship excludes a specific component of the gain or loss, or related cash flows, from the assessment of hedge effectiveness, details on the excluded components shall be disclosed.

b. Aggregate disclosure of the original cost and fair value of hedging instruments (including all instruments within a portfolio), including any net investment income, realized and unrealized gains and losses during the reporting period. Additionally, disclose the fair value of the hedged item, the change in fair value from the prior reporting period, and the portion of the fair value change attributed to the hedged risk (designated portion of interest rate sensitivity).

c. Schedule showing the aggregate fair value change from the prior reporting period for the designated components for all hedging instruments, with identification of the fair value change reflected in realized gains, realized losses, deferred assets, and deferred liabilities. This schedule shall also show the current period amortization, including any accelerated amortization elected by the reporting entity, and the future scheduled amortization of the deferred assets and deferred liabilities. This schedule shall identify the fair value of the excluded components of the hedging instruments, and the fair value change for those components reflected in unrealized gain and unrealized loss.
d. For hedging strategies no longer identified as highly effective previously captured within scope of this standard, information on the determination of ineffectiveness, including variations from prior assessments resulting in the change from classification as a highly effective hedge. This disclosure shall also include:

i. Identification of outstanding hedging instruments previously captured within scope of this standard and subsequently identified as no longer part of a highly effective hedging strategy. This disclosure shall identify the date in which the domiciliary state was notified that the hedging strategy had been identified by the reporting entity as no longer highly effective.

ii. Deferred assets and deferred liabilities previously recognized when the program was highly effective, with a schedule that shows the amortization that would have occurred if the program had remained highly effective, the amount of original amortization as well as a schedule that details the amortization that will occur as the program is no longer highly effective (maximum five-year timeframe).

iii. Disclosure on whether the reporting entity is electing to accelerate amortization (in advance of the remaining scheduled amortization or the maximum five-year timeframe), along with amounts immediately recognized to unrealized gains / losses, and how the election impacts the scheduled amortization.

e. For situations in which the reporting entity has elected to terminate the hedging strategy and/or discontinue the special accounting provisions permitted within this SSAP, the reporting entity shall disclose the key elements in the reporting’s entity’s decision to terminate, identifying changes in the reporting entity’s objectives or perspectives from initial application. This disclosure shall also include:

i. Identification of outstanding hedging instruments previously captured within scope of this standard and the accounting impact as a result of the termination / discontinuation. (Open derivative transactions no longer captured within the special accounting provision would be subject to the accounting and reporting guidance within SSAP No. 86.) This disclosure shall identify the date in which the domiciliary state was notified that the hedging strategy or the election to use the special accounting provision in this SSAP had been terminated.

ii. Deferred assets and deferred liabilities previously recognized under the hedging strategy and/or program, with a schedule that shows the amortization that would have occurred if the strategy and/or program had remained highly effective, as well as a schedule that details the amortization that will occur with the termination of the strategy and/or program (maximum five-year timeframe).

iii. Disclosure on whether the reporting entity is electing to accelerate amortization (in advance of the remaining scheduled amortization or the maximum five-year timeframe), along with amounts immediately recognized to unrealized gains / losses, and the resulting impact to the scheduled amortization.

Effective Date and Transition

24. This statement is effective ____. The guidance in this SSAP is required to be applied on a prospective basis for qualifying hedge programs in place on or after the effective date. This prospective application prohibits deferred asset and deferred liability recognition from fair value fluctuations. 
previously recognized as unrealized gains or losses that occurred prior to the effective date of the guidance.

25. Reporting entities that have previously received permitted or prescribed practices for qualifying hedge programs, resulting with the recognition of deferred assets/deferred liabilities from unrecognized fair value fluctuations, shall work with their domiciliary state regulator to determine the appropriate method in transitioning from previously approved permitted practices. The reporting entity shall include disclosure of the transition approach approved by the domiciliary state in their financial statements in the first year of application. After the effective date of this Statement, domiciliary state provisions that differ from this Statement must be disclosed as a permitted or prescribed practice pursuant to SSAP No. 1. may elect one of the following approaches with initial application of this guidance:

REFERENCES

RELEVANT ISSUE PAPERS

- Issue Paper No. 1XX—Special Accounting Treatment for Limited Derivatives
Appendix A - Calculation of Deferred Asset or Deferred Liability – Option 1: Fair Value

Under the special accounting provisions within this issue paper, as detailed in paragraph 13.e., fair value fluctuations in the hedging instruments attributable to the hedged risk that do not offset the current period change in the hedged item (the change in the AG-43VM-21 reserve liability) can be recognized as deferred assets (admitted) and deferred liabilities.

The ability to recognize a deferred asset and deferred liability is limited to only the portion of the fair value fluctuation in the hedging instruments that is attributed to the hedged risk and does not immediately offset changes in the hedged item. As detailed in the standard, the hedged risk may be designated as a specific component of the hedged item. For example, if the variable annuity reserve benefits are matched to bonds, the hedged risk could only be the portion of interest rate risk remaining after the natural hedge based on the asset-liability matching.

Unless a different method has been approved by the domiciliary state commissioner, reporting entities shall utilize the following calculation (detailed in paragraph 13) for establishing the deferred asset:

13.e.i Calculate the fair value gain or loss in the hedged item attributable to the hedged risk (Step 1);
13.e.ii Express the fair value gain or loss calculated (Step 1) as a percentage of the change in the full-contract fair value (i.e., with all product cash flows) attributed to interest rate movements (Step 2).
13.e.iii Calculate the AG-43VM-21 liability change attributed to the hedged risk as the quantity calculated in Step 2 multiplied by the AG-43VM-21 liability change attributable to interest rate (Step 3).
13.e.iv Establish the deferred asset or deferred liability in the amount of the fair value loss (gain) of the designated hedging instruments attributed to the hedged risk less the AG-43VM-21 liability decrease or (increase) attributed to the hedged risk as calculated in Step 3.
13.e.v. Allocate an amount equal to the net deferred asset and deferred liability (net amount from all hedging strategies / programs captured within this guidance) to special surplus.

To illustrate the above calculation:

Clearly Defined Hedging Strategy (CDHS) characteristics

<table>
<thead>
<tr>
<th>Hedged item</th>
<th>Rider claims less rider fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedged risk</td>
<td>50% of the rho (first-order IR level sensitivity)</td>
</tr>
</tbody>
</table>

Calculation of the deferred asset or liability

Note: positive values = increase in liability

| Fair value gain (loss) in hedged item attributable to interest rate movement | (500) |
| 13.e.i. - Fair value gain (loss) in hedged item attributable to hedged risk | (250) |

Hence, if the insurer were hedging per the CDHS perfectly, then the insurer should see a 250 fair value loss in the designated IR hedge instruments. To determine how much of that loss should be deferred:
Fair value gain (loss) in full-contract cash flows attributable to IR movement \( (700) \)

13.e.ii - Quantity calculated in 14.b.i. as a % of the \( (700) \) above \( 36\% \)

| AG-43VM-21 liability increase (decrease) from beginning of period to end of period | 400 |
| AG-43VM-21 liability increase (decrease) attributable to interest rate movements | (100) |

13.e.iii - AG-43VM-21 liability increase (decrease) attributable to the hedged risk \( (36) \)

In this example, even though the AG-43VM-21 liability increased by 400 during the reporting period, interest rate movements actually contributed to a 100 decrease. The hedged risk (50% of the interest rate sensitivity of rider cash flows) accounts for 36% of this, or $36 of the liability decrease. As such, $36 of the fair value loss on the interest rate hedge instruments should be reflected immediately and the remainder deferred via a deferred asset equal in amount to \( 250 - 36 = 214 \).

13.e.iv – Deferred asset (14.b.i less 14.b.iii) attributable to hedged risk \( (214) \)

(This is shown as a negative – to be consistent with the decrease in AG-43VM-21 liability – but represents a deferred asset. Deferred assets reflect fair value losses.)
This page intentionally left blank.
Notice of Public Hearing and Request for Written Comments

**Basis for hearings.** The Statutory Accounting Principles Working Group (SAPWG) will hold a public hearing to obtain information from and views of interested individuals and organizations about the standards proposed in this Exposure Draft. The SAPWG will conduct the hearing in accordance with the National Association of Insurance Commissioners (NAIC) policy statement on open meetings. An individual or organization desiring to speak must notify the NAIC in writing by **October 5, 2018**. Speakers will be notified as to the date, location, and other details of the hearings.

**Oral presentation requirements.** The intended speaker must submit a position paper, a detailed outline of a proposed presentation or comment letter addressing the standards proposed in the Exposure Draft by **October 5, 2018**. Individuals or organizations whose submission is not received by that date will only be granted permission to present at the discretion of the SAPWG chair. All submissions should be addressed to the NAIC staff at the address listed below.

**Format of the hearings.** Speakers will be allotted up to 10 minutes for their presentations to be followed by a period for answering questions from the SAPWG. Speakers should use their allotted time to provide information in addition to their already submitted written comments as those comments will have been read and analyzed by the SAPWG. Those submissions will be included in the public record and will be available at the hearings for inspection.

**Copies.** Exposure Drafts can be obtained on the Internet at the NAIC Home Page (http://www.naic.org). The documents can be downloaded using Microsoft Word.

**Written comments.** Participation at a public hearing is not a prerequisite to submitting written comments on this Exposure Draft. Written comments are given the same consideration as public hearing testimony.

The Statutory Accounting Principles Statement of Concepts was adopted by the Accounting Practices & Procedures (EX4) Task Force on September 20, 1994, in order to provide a foundation for the evaluation of alternative accounting treatments. All issues considered by the SAPWG will be evaluated in conjunction with the objectives of statutory reporting and the concepts set forth in the Statutory Accounting Principles Statement of Concepts. Whenever possible, establish a relationship between your comments and the principles defining statutory accounting.

The exposure period is not meant to measure support for, or opposition to, a particular accounting treatment but rather to accumulate an analysis of the issues from other perspectives and persuasive comments supporting them. Therefore, form letters and objections without valid support for their conclusions are not helpful in the deliberations of the working group. Comments should not simply register your agreement or disagreement without a detailed explanation, a description of the impact of the proposed guidelines, or possible alternative recommendations for accomplishing the regulatory objective.

Any individual or organization may send written comments addressed to the Working Group to the attention of Julie Gann at igann@naic.org, Robin Marcotte at rmarcotte@naic.org, Fatima Sediqzad at fsediqzad@naic.org and Jake Stultz at jstultz@naic.org no later than **October 5, 2018**. Electronic submission is preferred. Julie Gann is the NAIC Staff that is the project lead for this topic.

National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500, Kansas City, MO 64106-2197
(816) 842-3600
Statutory Issue Paper No. 15X

Special Accounting Treatment for Limited Derivatives

STATUS
Exposure Draft – August 4, 2018

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for derivatives qualifying for hedging effectiveness is in SSAP No. 86—Derivatives. Based upon a recommendation from the Variable Annuities Issues (E) Working Group, the Financial Condition (E) Committee issued the following 2017 charge to the Statutory Accounting Principles (E) Working Group:

   Develop specific statutory accounting guidance for certain limited derivative contracts hedging variable annuity guarantees, subject to fluctuations as a result of interest rate sensitivity, reserved for in accordance with Actuarial Guideline XLIII—CARVM for Variable Annuities (AG 43). This guidance shall place an emphasis on reducing non-economic surplus volatility for these specific hedges in situations where strong risk-management is in place, with safeguards to ensure appropriate financial statement presentation and disclosures, sufficient transparency, and regulatory oversight. This charge shall be a high priority, with the earliest effective date feasible that allows for adequate development of guidance and related reporting schedules.

2. Pursuant to the direction from the Financial Condition (E) Committee, this issue paper has been drafted to detail substantive statutory accounting revisions to allow special accounting treatment for limited derivatives hedging variable annuity guarantee benefits subject to fluctuations as a result of interest rate sensitivity. The provisions within this issue paper are proposed to be separate and distinct from the guidance in SSAP No. 86, as the items subject to the scope of this guidance, and the provisions within, would not qualify for hedge effectiveness under SSAP No. 86. Allowances provided within this issue paper are only permitted if all of the components of the issue paper are met, and shall not be inferred as an acceptable statutory accounting approach for derivative transactions that do not meet the stated qualifications or that are not specifically addressed within this guidance.

3. The guidance within this issue paper is anticipated to be included as a new SSAP applicable to the limited derivative situations addressed within. Upon adoption of the issue paper, the Working Group will conclude on the location of this guidance within statutory accounting.

SUMMARY CONCLUSION – PROPOSED NEW SSAP GUIDANCE:

4. This statement establishes statutory accounting principles to address certain, limited derivative transactions hedging variable annuity guarantees subject to fluctuations as a result of interest rate sensitivity. Eligibility for the special accounting provision within this standard is strictly limited to variable annuity contracts and other contracts involving certain guaranteed benefits similar to those offered with variable annuities that are reserved for in accordance with Valuation Manual 21: Requirements for Principal-Based Reserves for Variable Annuities (VM-21)1 Actuarial Guideline XLIII, CARVM for Variable Annuities (AG 43). The statutory accounting guidance within this statement is considered a special accounting provision, only permitted if all the components in the standard are met,

---

1 Actuarial Guideline XLIII, CARVM for Variable Annuities (AG 43) shall apply in states that have not adopted the Valuation Manual.
and shall not be inferred as an acceptable statutory accounting approach for situations that do not meet the stated qualifications or that are not specifically addressed within this guidance.

Terms / Concepts (for purposes of this Statement)

5. The following terms reflect concepts specific to this Statement. (This listing only details the key concepts. Specific guidelines are reflected throughout the guidance.)

   a. Derivative Instrument: Means an agreement, option, instrument or series or combination thereof: (1) To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or (2) That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.

   b. Dynamic Hedging Approach: A dynamic hedging strategy allows for the portfolio of derivatives comprising the hedging instrument to be rebalanced in accordance with changes to the hedged item in order to adhere to the specified, documented hedging strategy.

   c. Hedged item: The hedged item shall consist of declared guarantee benefits on a pool, or portion thereof, of variable annuity contracts exposed to interest rate risk. The hedged item may relate to an open or flexible portfolio (e.g., group of variable annuity contracts with different characteristics and liability durations) that allows for addition of newly issued contracts, subtraction of surrenders and fluctuations in balances. The portfolio of variable annuity contracts may consist of an entire book of business or declared components thereof.

   d. Hedging Instrument: The hedging instrument shall reflect a specified derivative, or a portfolio of specified derivatives, that hedges the interest rate sensitivity of the designated hedged item. The hedging instrument may reflect a dynamic hedging strategy in which a portfolio of derivatives comprising the hedging instrument is rebalanced in accordance with changes to the hedged item.

Special Accounting Provision

6. The special accounting provision within this Statement permits reporting entities to utilize a form of “macro-hedging” in which a portfolio of variable annuity policies, which could include the entire book of business or subsections thereof, are jointly designated as the host contracts containing the hedged item, in a fair value hedge\(^2\), pursuant to a Clearly Defined Hedging Strategy (throughout this issue paper also referred to as “CDHS” or “hedging strategy”). This is considered a macro-hedge, as the designated hedged item (rate sensitive guarantee benefits) may be attached to a portfolio of variable annuity contracts with different characteristics and liability durations. Under this special accounting provision, the portfolio of contracts giving rise to the hedged item is not required to be static, but can be revised to remove policies and/or include new policies to allow for continuous risk management (hedging) of the variable annuity guarantees in accordance with the specific risks being hedged and the hedge objectives of the specified, documented hedging strategy. In designating the hedged item, reporting entities are permitted to exclude specific components of the variable annuity contracts, but such exclusions must apply collectively to all policies included within the portfolio. For example, reporting entities may elect to only

\(^2\) As detailed in paragraph 12, these hedges are required to be highly effective in achieving offsetting changes in fair value attributed to the hedged risk between the derivative hedging instruments and the hedged item (AG 12 liability) during the period that the hedge is designated.
hedge the interest rate risk of rider cash flows, and if making this election, would define the hedged item as the “fair value of rider claims net of rider fees” for the portfolio of policies designated as giving rise to the hedged item.

7. This special accounting provision permits reporting entities to utilize a specified derivative, or a portfolio of specified derivatives, as the hedging instrument within a fair value hedge to hedge the interest rate sensitively, or a specific percentage\(^3\) of the interest rate sensitivity, of the designated hedged item. The hedging instrument may reflect a dynamic hedging strategy in which a portfolio of derivatives comprising the hedging instrument is rebalanced in accordance with changes to the hedged item in order to adhere to the specified, documented hedging strategy. Although the hedging instruments must address interest rate risk, this guidance does not preclude use of derivative instruments that may offset risks other than interest rate risk from being designated as the hedging instruments. For derivative instruments that are affected by multiple risk factors, including interest rate risk, reporting entities shall apply this special accounting treatment to the change in fair value due to interest rate risk. Reporting entities shall bifurcate the change in fair value due to the various risk factors - e.g., fair value volatility due to interest rates (rho), and other risk factors, such as equity level (delta) or volatility (vega). Pursuant to paragraphs 12 and 15, fair value fluctuations not attributed to the hedged risk, including fair value changes from excluded open components, shall be recognized as unrealized gains or losses.

8. With the provisions in this standard to allow for flexibility in the hedged item (changes to variable annuity contracts within a portfolio) coupled with a dynamic hedging approach (rebalancing of derivative hedging instruments), there is a greater risk of misrepresentation of successful risk management and achievement of a highly effective hedging relationship. Although this risk cannot be eliminated, the following provisions intend to ensure governance of the program and provide sufficient tools to allow for regulator review:

a. Prior to implementing a hedging program for application within scope of this standard, the reporting entity must obtain explicit approval from the domiciliary state commissioner allowing use of this special accounting provision. The domiciliary state commissioner may subsequently disallow use of this special accounting provision at their discretion. Although this guidance does not restrict the state domiciliary commissioner on when to prohibit future use, disallowance should be considered upon finding that the reporting entity’s documentation, controls, measurement, prior execution of strategy or historical results are not adequate to support future use.

b. Actuarial certifications of AG-43-VM-21reserves, consistent with Actuarial Guideline 43VM-21 requirements, which explicitly include the following:

i. Certification as to whether the hedging strategy is incorporated within the establishment of AG-43VM-21 reserves, and the impact of the hedging strategy within the AG-43VM-21 Conditional Tail Expectation Amount.

ii. Certification by a financial officer of the company (CFO, treasurer, CIO, or designated person with authority over the actual trading of assets and derivatives) that the hedging strategy meets the definition of a Clearly Defined Hedging Strategy within AG-43VM-21 and that the Clearly Defined Hedging Strategy is the hedging strategy being used by the company in its actual day-to-day risk mitigation efforts. This provision does not require reporting entities to use a hedging strategy in determining AG-43VM-21 reserves, nor does it require entities to use the special accounting provision within this standard. However, it

\(^3\) In identifying the hedged risk, reporting entities must identify whether they are hedging the full, or a portion of (e.g., 40%), the interest rate sensitivity.
does require reporting entities that use the special accounting provisions within this standard to certify that the hedging strategy within scope of this standard is a Clearly Defined Hedging Strategy and is reflected in the establishment of AG 43VM-21 reserves.

9. As identified in paragraph 4, eligibility for the special accounting provision within this standard is strictly limited to variable annuity contracts and other contracts involving certain guaranteed benefits similar to those offered with variable annuities that are reserved for in accordance with AG 43VM-21. This special accounting provision requires the reporting entity to engage in highly effective fair value hedges that follow a Clearly Defined Hedging Strategy, as defined in AG 43VM-21, allowing the reporting entity to reduce the amount of the Conditional Tail Expectation (CTE) Amount. In order to qualify as a Clearly Defined Hedging Strategy (which may be dynamic, static, or a combination thereof), the strategy must meet the principles outlined in AG 43VM-21, be in place (implemented) for at least three months\(^4\), and shall at a minimum, identify:

\begin{enumerate}
\item Specific risks being hedged\(^5\),
\item Hedge objectives,
\item Risks not being hedged,
\item Financial instruments that will be used to hedge the risks,
\item Hedge trading rules, including permitted tolerances from hedging objectives,
\item Metric(s) used for measuring hedging effectiveness,
\item Criteria that will be used to measure effectiveness,
\item Frequency of measuring hedging effectiveness,
\item Conditions under which hedging will not take place, and
\item The individuals responsible for implementing the hedging strategy.
\end{enumerate}

10. While an initially documented hedging strategy may subsequently change, any change in hedging strategy, which includes a change in hedge target, shall be documented, with notification to the domiciliary state commissioner, and include an effective date of the change in strategy. Reporting entities that elect to change a documented hedging strategy prior to the end of the three-month minimum implementation timeframe shall identify the hedging strategy, and all hedging instruments executed under the strategy, as ineffective. The three-month timeframe begins with the stated effective date of the hedging strategy regardless if any hedging instruments have been executed under the hedging strategy. Changes in a documented hedging strategy that occur after the three-month implementation timeframe do not necessitate an ineffective determination as long as hedged items and hedging instruments under the revised/new strategy continue to meet the requirements of a highly effective fair value hedge. Reporting

---

\(^4\) As detailed in AG 43VM-21, before a new or revised hedging strategy can be used to reduce the amount of the Conditional Tail Expectation (CTE) otherwise calculated, the hedging strategy should be in place (effectively implemented) for at least three months. As detailed in AG 43VM-21, the reporting entity may meet the time requirement by having evaluated the effective implementation of the hedging strategy for at least three months without actually having executed the trades indicated by the hedging strategy (e.g., mock testing or by having effectively implemented the strategy with similar annuity products for at least three months.)

\(^5\) The specific risk being hedged shall include a measure of the hedge coverage (e.g., percentage of interest rate sensitivity being hedged).
entities are permitted to have more than one hedging strategy implemented, but all implemented strategies must qualify as a component of a Clearly Defined Hedging Strategy pursuant to paragraph 9.

Assessing Hedge Effectiveness

11. The provisions within this standard require the entity to use a specific method, as detailed in paragraph 12, to assess hedge effectiveness at inception and on an ongoing basis. At a minimum, hedge effectiveness assessment is required whenever financial statements are reported, at least every three months. Documentation requires prospective and retrospective\(^6\) hedge effectiveness assessments, with ongoing assessment consistent with the originally documented risk management strategy.

12. This standard requires a single measure for assessing whether the hedging strategy is highly effective, and in measuring hedge ineffectiveness. Both at inception, and on an ongoing basis, the hedging relationship must be highly effective in achieving offsetting changes in fair value attributed to the hedged risk during the period that the hedge is designated. \(\textbf{In order to meet this requirement, reporting entities electing to use this special accounting provision must calculate the fair value of the hedged item (declared guarantee benefits exposed to interest rate risk) at inception and on an ongoing basis, and compare the cumulative fair value change of the hedged item to the cumulative fair value change of the hedging instruments in assessing whether the relationship is highly effective on a cumulative basis.}\)

This comparison is specific to the designated hedged risks and exposures, therefore, if only a portion of the interest rate risk is hedged or if the designated hedge only include specific components of the variable annuity policies (e.g., riders), for determining hedge effectiveness, the fair value comparisons is limited to those designated items. If an entity’s defined risk management strategy for a particular hedging relationship excludes specific components of the hedging derivative from the assessment of hedge effectiveness, the excluded open components shall be reported at fair value with gains or losses recognized as unrealized gains or losses.

13. The term “highly effective” describes a fair value hedging relationship where the change in fair value of the derivative instrument is within 80 to 125 percent of the opposite change in fair value of the hedged item attributed to the hedged risk. It shall also apply when an R-squared of .80 or higher is achieved when using a regression analysis technique.

Measurement / Recognition of Gains and Losses of Outstanding (Open) Instruments

14. All designated hedging instruments (all derivatives, including those reflected in portfolios) shall be reported in the financial statements at fair value.

15. Fair value fluctuations in the measurement of outstanding (non-expired) derivatives within a highly effective hedging strategy shall be reflected as follows:

   a. Fair value fluctuations in the hedging instruments attributable to the hedged risk that offset the current period change in the designated portion of the AG 43VM-21 reserve liability (e.g., guarantee benefits)\(^7\) shall be recognized as a realized\(^6\) gain or loss.

\(^6\) For situations in which there has been a change in hedging strategy pursuant to paragraph 10, when conducting retrospective hedge effectiveness assessments, reporting entities shall assess effectiveness based on the hedge target that was actually in effect during the retrospective time periods.

\(^7\) Hedge effectiveness is determined by comparing fair value fluctuations between the hedging instruments and the hedged item. However, in determining recognition in the financial statements, the fair value fluctuation of the hedging instruments is compared to the change in the reported value of the designated portion of the AG 43VM-21 liability. The designated portion of the AG 43VM-21 liability is not reported at fair value in the statutory financial statements, as such, the offset reported as realized gains and losses is the portion of the fair value change in hedging instruments offset by the change in the reported value of the
b. Fair value fluctuations in the hedging instruments attributable to the hedged risk⁹ that do not offset the current period change in the designated portion of the AG 43VM-21 reserve liability (e.g., guarantee benefits) shall be recognized as deferred assets (admitted) and deferred liabilities. The ability to recognize a deferred asset and deferred liability is limited to only the portion of the fair value fluctuation in the hedging instruments that is attributed to the hedged risk and does not immediately offset changes in the designated portion of the AG 43VM-21 reserve liability.

c. An amount equal to the net deferred asset and deferred liability (net amount from all hedging strategies / programs captured within this guidance) shall be allocated from unassigned funds to special surplus. Upon domestic regulator request, reporting entities shall provide estimations of RBC as if the special accounting provisions had not been applied. This estimation shall reflect the removal of deferred assets or deferred liabilities, and reflect the impact to unassigned funds as if the derivative gains and losses had been recognized.

d. As detailed in paragraph 12, fair value fluctuations in the hedging instruments that are not attributable to the hedged risk, shall be recognized as unrealized gains or unrealized losses.

e. Reporting entities shall utilize the following calculation for establishing the deferred asset (also illustrated in Appendix A) unless a different method has been approved by the domiciliary state commissioner:

i. Calculate the fair value gain or loss in the hedged item attributable to the hedged risk.

ii. Express the quantity calculated in paragraph 15.e.i. as a percentage of the change in the full-contract fair value (i.e., with all product cash flows) attributed to interest rate movements.

iii. Calculate the AG 43VM-21 liability change attributed to the hedged risk as the quantity calculated in paragraph 15.e.ii. multiplied by the AG 43VM-21 liability change attributable to interest rate.

iv. Establish the deferred asset or deferred liability in the amount of the fair value loss or (gain) of the designated hedging instruments attributed to the hedged risk less the AG 43VM-21 liability decrease or (increase) attributed to the hedged risk as calculated in paragraph 15.e.iii.

designated portion of the AG 43VM-21 reserve. In accordance with the documented hedging strategy, reporting entities shall compare the fair value fluctuations to the change in the designated portion of the reserve liability, after considering recognized derivative returns (including recognized derivative income), when determining the recognition of fair value fluctuations.

⁸ Recognizing the fair value change for open derivative positions that offset the AG 43VM-21 change as a realized gain/loss (instead of an unrealized gain or loss) directly offsets the AG 43VM-21 reserve change in the income statement.

⁹ The change in fair value of the hedging instruments and hedged item is limited to changes driven by market factors. For example, periodic recognition of a cost owed to acquire the derivative from a counterparty (financing cost) shall not be captured as a change in the derivative instrument’s fair value. The fair value of the instrument shall be determined based on the underlying derivative without inclusion of acquisition costs (or other such contractual elements that may exist with the counterparty) that do not change based on the underlying derivative interests or market factors.
Allocate an amount equal to the net deferred asset and deferred liability (net amount from all hedging strategies / programs captured within this guidance) to special surplus.

16. Deferred assets and deferred liabilities recognized under paragraph 15.b. shall be amortized using a straight-line method into realized gains or realized losses over a finite amortization period. The amortization timeframe shall equal the Macaulay duration of the guarantee benefit cash flows based on the AG-43VM-21 Standard Scenario, but shall not exceed a period of 10 years.

   a. Future recognition of deferred assets or liabilities (fair value fluctuations attributed to the hedged risk that are not offset by the reserve liability change) do not extend the amortization timeframe for previously recognized deferred assets or deferred liabilities. Reporting entities are required to separately track, with a schedule to show the initial deferred amount and amortization schedule, of the deferred assets and deferred liabilities recognized and outstanding at each reporting date.

   b. The amount reported on the financial statement at each reporting date shall reflect the net amount (net as either a deferred asset or deferred liability) for each hedging strategy captured within scope of this guidance. (Reporting entities that have more than one hedging strategy could have both deferred assets and deferred liabilities in the financial statements based on the net position of the separate hedging strategies.)

   c. Reporting entities are permitted to amortize a greater portion of the deferred assets and/or deferred liabilities into realized gains or realized losses at any time in advance of the scheduled amortization period.

      i. If electing to accelerate amortization, reporting entities are required to accelerate amortization equally between deferred assets and deferred liabilities within a single hedging strategy. For example, a reporting entity is not permitted to accelerate amortization of the deferred liabilities (recognizing the gains from fair value changes) and not accelerate amortization of the deferred assets (continuing to defer losses from fair value changes). If a reporting entity only has a single hedging strategy which only reflects deferred assets or deferred liabilities, the reporting entity is permitted to accelerate amortization without restrictions.

      ii. If a reporting entity has more than one hedging strategy, and the strategies have offsetting net positions (both deferred assets and deferred liabilities are recognized in the financial statements), a reporting entity’s election to accelerate amortization must be applied equally to programs with offsetting net positions. (For example, a decision to accelerate amortization of a program with a net deferred liability must be applied equally to a program with a deferred asset that best corresponds to the deferred liability.) In these situations, the guidance in paragraph 16.c.i is also applicable, whereas, the accelerated amortization must also apply equally to the deferred assets and deferred liabilities within each individual hedging program. If a reporting entity with more than one hedging strategy only has net deferred assets or net deferred liabilities recognized, the reporting entity is permitted to accelerate amortization to a single program in a manner consistent with the guidelines in paragraphs 16.c.i.

---

10 The intent of this guidance is to ensure that the ability to accelerate amortization does not result with elections that simply result in favorable financial statement presentation.
17. For outstanding (non-expired) derivative instruments that were removed from a highly effective hedging strategy (rebalanced), subsequent gains and losses from fair value fluctuations shall not impact the previously recognized deferred assets or deferred liabilities. The deferred assets and deferred liabilities for these derivative instruments shall be “locked” and amortized under the remaining schedule unless the reporting entity elects to terminate or accelerate amortization. Subsequent to the removal from a highly effective strategy, all fair value fluctuations from the outstanding derivative instruments would be subject to the guidance in SSAP No. 86, and recognized as unrealized gains and/or unrealized losses. If the derivative is re-designated as part of a highly effective hedging strategy qualifying under this standard, subsequent fair value fluctuations (after the re-designation) may be accounted for under the special accounting provision detailed in this statement.

18. For outstanding (non-expired) derivative instruments in a hedging strategy that no longer qualifies within scope of this standard (e.g., AG-43VM-21 requirements are not met) or is no longer a highly effective hedge, any non-amortized deferred assets or deferred liabilities shall be amortized to unrealized gains or unrealized losses over the remaining amortization timeframe, not to exceed five-years. If the deferred assets / deferred liabilities have a remaining amortization period that is less than the shortened timeframe, amortization shall continue over the remaining period. If the remaining amortization period is greater than 5-years at the time of the program no longer qualifies, or is no longer highly effective, the amortization schedule shall be revised to require full amortization within the shortened 5-year timeframe. If elected by the reporting entity, deferred assets and deferred liabilities may be immediately recognized as unrealized gains and/or unrealized losses or have accelerated amortization (less than 5-years) as unrealized gains and/or unrealized losses. (An election to immediate eliminate or accelerate amortization must follow the provisions in paragraph 16.c.) All future fair value fluctuations for these derivative instruments would be subject to the guidance in SSAP No. 86, and shall be recognized as unrealized gains or unrealized losses unless the instrument is subsequently designated as part of a highly effective hedging strategy within scope of this statement. If the derivative is re-designated as part of a highly effective hedging strategy qualifying under this standard, subsequent fair value fluctuations (after the re-designation) may be accounted for under the special accounting provision detailed in this statement.

19. Reporting entities may elect to terminate use of this special accounting provision at any time. In those instances, if the derivative instruments are outstanding, all deferred assets and deferred liabilities shall be amortized to unrealized gains or unrealized losses over the remaining amortization timeframe, not to exceed five-years. If the deferred assets / deferred liabilities have an amortization period that is less than the shortened 5-year timeframe, amortization shall continue over the established period. If the remaining amortization period is greater than 5-years at the time of termination, the amortization schedule shall be revised to require full amortization within the shortened 5-year timeframe. If elected by the reporting entity, deferred assets and deferred liabilities may be immediately eliminated or have accelerated amortization (less than 5-years) with recognition as unrealized gains and/or unrealized losses. (An election to immediate eliminate or accelerate amortization must follow the provisions in paragraph 16.c.) Once the special accounting provision is terminated, unless re-designated by the reporting entity, subsequent accounting of the derivatives in a hedging strategy that would be captured within this statement shall follow the fair value accounting approach in SSAP No. 86.11

Measurement / Recognition of Realized Gains or Losses of Expired Derivatives

20. With the ability to rebalance the hedging instrument, this guidance allows for individual derivative instruments to expire and/or be removed from the portfolio of the hedging instrument, and not

---

11 Macro-hedges and the ability to rebalance hedging instruments are not provisions permitted within “effective” hedges in scope of SSAP No. 86. As such, hedging strategies with these components accounted for under SSAP No. 86 shall follow the fair value accounting approach detailed in that standard.
immediately trigger an assessment that the overall hedging strategy is no longer highly effective. Furthermore, special allowances are included to consider the tenure differences between a hedging instrument and AG 43VM-21 liability duration. These allowances permit expired derivative instruments that were part of a highly effective hedging strategy at the time of expiration to continue amortizing the deferred gains and deferred losses over the previously established amortization timeframe even if the overall hedging strategy is subsequently terminated or subsequently identified as no longer qualifying as a highly effective hedge.

21. Pursuant to the provisions in paragraph 16.c., reporting entities are permitted to amortize a greater portion of the deferred assets and/or deferred liabilities from expired derivatives into realized gains or realized losses in advance of the scheduled amortization period.

22. Consistent with the guidance in paragraph 19, reporting entities may elect to terminate use of this special accounting provision at any time. In those instances, if the derivative instruments have expired, all deferred assets and deferred liabilities shall be amortized to realized gains or realized losses over the remaining amortization timeframe, not to exceed 5-years. If the deferred assets/deferred liabilities had an amortization period that was less than the shortened timeframe, amortization shall continue over the established period. If the amortization period was greater than 5-years at the time of termination, the amortization schedule would be revised to require full amortization within the shortened timeframe. If elected by the reporting entity, the deferred assets and deferred liabilities may be immediately eliminated, or have accelerated amortization, with recognition as realized gains and/or realized losses. An election to immediate eliminate or accelerate amortization (less than 5 years) must follow the provisions in paragraph 16.c.

Derivative Income

23. Derivative income shall be recognized when earned.

24. Pursuant to the documented hedging strategy as a fair value hedge, derivative income shall be considered as part of the overall hedging strategy and included in the assessments on whether the strategy is highly effective.

Disclosures

(Staff Note – Staff recommends a new schedule to capture the disclosure information.)

25. A reporting entity that has any outstanding derivatives accounted for under this special accounting provision, or that has unamortized deferred assets and/or deferred liabilities (representing previously unrecognized qualifying fair value fluctuations) from expired derivatives under the special accounting provision shall disclose the following within the financial statements:

a. Discussion of hedged item (portfolio of variable annuity policies), including information on the guarantees sensitive to interest rate risk, along with information on the designated hedging instruments being used to hedge the risk. Discussion of the hedging instruments shall identify whether a hedging instrument is a single instrument or portfolio, as well as information on the hedging strategy (including whether there have been changes in strategy from the prior reporting period, along with detailed information on the changes), and assessment of hedging effectiveness and compliance with the “Clearly Defined Hedging Strategy” of AG 43VM-21. Identification shall occur on whether the hedged item is intended to be fully hedged under the hedging strategy, or if the strategy is only

12 Throughout this standard the use of the word “expire” is intended to capture all instances in which the derivative is no longer outstanding. It includes maturities, terminations, sales, and/or other closing transactions of a derivative.
focused on a portion of the liability characteristics or a portion of the interest rate sensitivity. Hedging strategies shall be identified as highly effective or not highly effective. If the strategy for a particular hedging relationship excludes a specific component of the gain or loss, or related cash flows, from the assessment of hedge effectiveness, details on the excluded components shall be disclosed.

b. Aggregate disclosure of the original cost and fair value of hedging instruments (including all instruments within a portfolio), including any net investment income, realized and unrealized gains and losses during the reporting period. Additionally, disclose the fair value of the hedged item, the change in fair value from the prior reporting period, and the portion of the fair value change attributed to the hedged risk—(designated portion of interest rate sensitivity).

c. Schedule showing the aggregate fair value change from the prior reporting period for the designated components for all hedging instruments, with identification of the fair value change reflected in realized gains, realized losses, deferred assets, and deferred liabilities. This schedule shall also show the current period amortization, including any accelerated amortization elected by the reporting entity, and the future scheduled amortization of the deferred assets and deferred liabilities. This schedule shall identify the fair value of the excluded components of the hedging instruments, and the fair value change for those components reflected in unrealized gain and unrealized loss.

d. For hedging strategies no longer identified as highly effective previously captured within scope of this standard, information on the determination of ineffectiveness, including variations from prior assessments resulting in the change from classification as a highly effective hedge. This disclosure shall also include:

i. Identification of outstanding hedging instruments previously captured within scope of this standard and subsequently identified as no longer part of a highly effective hedging strategy. This disclosure shall identify the date in which the domiciliary state was notified that the hedging strategy had been identified by the reporting entity as no longer highly effective.

ii. Deferred assets and deferred liabilities previously recognized when the program was highly effective, with a schedule that shows the amortization that would have occurred if the program had remained highly effective, the amount of original amortization as well as a schedule that details the amortization that will occur as the program is no longer highly effective (maximum five-year timeframe).

iii. Disclosure on whether the reporting entity is electing to accelerate amortization (in advance of the remaining scheduled amortization or the maximum five-year timeframe), along with amounts immediately recognized to unrealized gains / losses, and how the election impacts the scheduled amortization.

e. For situations in which the reporting entity has elected to terminate the hedging strategy and/or discontinue the special accounting provisions permitted within this SSAP, the reporting entity shall disclose the key elements in the reporting’s entity’ decision to terminate, identifying changes in the reporting entity’s objectives or perspectives from initial application. This disclosure shall also include:
Special Accounting Treatment for Limited Derivatives

15X-11

i. Identification of outstanding hedging instruments previously captured within scope of this standard and the accounting impact as a result of the termination / discontinuation. (Open derivative transactions no longer captured within the special accounting provision would be subject to the accounting and reporting guidance within SSAP No. 86.) This disclosure shall identify the date in which the domiciliary state was notified that the hedging strategy or the election to use the special accounting provision in this SSAP had been terminated.

ii. Deferred assets and deferred liabilities previously recognized under the hedging strategy and/or program, with a schedule that shows the amortization that would have occurred if the strategy and/or program had remained highly effective, as well as a schedule that details the amortization that will occur with the termination of the strategy and/or program (maximum five-year timeframe).

iii. Disclosure on whether the reporting entity is electing to accelerate amortization (in advance of the remaining scheduled amortization or the maximum five-year timeframe), along with amounts immediately recognized to unrealized gains / losses, and the resulting impact to the scheduled amortization.

Effective Date and Transition

26. This statement is effective 13. The guidance in this SSAP is required to be applied on a prospective basis for qualifying hedge programs in place on or after the effective date. This prospective application prohibits deferred asset and deferred liability recognition from fair value fluctuations previously recognized as unrealized gains or losses that occurred prior to the effective date of the guidance.

27. Reporting entities that have previously received permitted or prescribed practices for qualifying hedge programs, resulting with the recognition of deferred assets/deferred liabilities from unrecognized fair value fluctuations, shall work with their domiciliary state regulator to determine the appropriate method in transitioning from previously approved permitted practices. The reporting entity shall include disclosure of the transition approach approved by the domiciliary state in their financial statements in the first year of application. After the effective date of this Statement, domiciliary state provisions that differ from this Statement must be disclosed as a permitted or prescribed practice pursuant to SSAP No. 1. may elect one of the following approaches with initial application of this guidance:

28. Staff Note: The following reflects NAIC staff suggestions after considering comments received and are contingent on Working Group review and discussion:

a. Continue application of the prior program. This election will require approval by the state of domicile as a permitted or prescribed practice, with SSAP No. 1 disclosure.

b. Adjust the prior program to comply with the provisions within this standard. This election will require adjustments to the previously recognized deferred assets or deferred liabilities so that they adhere to the provisions within this standard. This election will

13 After adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (See Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC.
require the reporting entity to capture an additional disclosure identifying the deferred assets and deferred liabilities recognized as of the effective date, as well as a schedule of amortization for those items. This disclosure shall continue separately from the other disclosures required under this standard until the deferred assets/liabilities recognized at initial application have been fully amortized. If the reporting entity fully adjusts the prior permitted/prescribed program to reflect the provisions within this standard, this election will not be considered a permitted or prescribed practice. If the adjusted program (and resulting deferred assets / deferred liabilities) do not adhere to the provisions within this standard, the program would continue to be considered a permitted or prescribed practice and require SSAP No. 1 disclosure.

c. Discontinue the prior program. This election would require the reporting entity to eliminate the effects of the prior permitted or prescribed program. (For example, any deferred assets or deferred liabilities recognized under the prior program would be fully eliminated with recognition to gains and losses accordingly.) After discontinuation, the reporting entity may elect to apply the provisions within this statement on a prospective basis for qualifying hedging programs in place on or after the effective date of the guidance (which could include re-designation of previously discontinued hedges).

Proposed new General Interrogatories:
These would not be in the final SSAP. These revisions will be referred to the Blanks (E) Working Group.

26.1 Does the reporting entity have any hedging transactions reported on Schedule DB?

26.2 If yes, has a comprehensive description of the hedging program been made available to the domiciliary state? If no, attach a description with this statement.

26.3 Does the reporting entity utilize derivatives to hedge variable annuity guarantees subject to fluctuations as a result of interest rate sensitivity?

26.4 If so, does the reporting entity utilize:

   Special Accounting Provision in SSAP No. XXX

   Permitted Accounting Practice

   Other Accounting Guidance

26.5 If the reporting entity utilizes the special accounting provision in SSAP No. XXX, the reporting entity shall attest to the following:

   Reporting entity has obtained explicit approval from the domiciliary state.

   Hedging strategy subject to the special accounting provisions is consistent with the requirements of Actuarial Guideline 43.

   Actuarial certification has been obtained which indicates that the hedging strategy is incorporated within the establishment of Actuarial Guideline 43 reserves, and provides the impact of the hedging strategy within the Actuarial Guideline Conditional Tail Expectation Amount.

   Financial Officer Certification has been obtained which indicates that the hedging strategy meets the definition of a Clearly Defined Hedging Strategy
within Actuarial Guideline 43 and that the Clearly Defined Hedging Strategy is the hedging strategy being used by the company in its actual day-to-day risk mitigation efforts.
Appendix A – Calculation of Deferred Asset or Deferred Liability — Option 1: Fair Value

Under the special accounting provisions within this issue paper, as detailed in paragraph 15.e., fair value fluctuations in the hedging instruments attributable to the hedged risk that do not offset the current period change in the hedged item (the change in the AG43VM-21 reserve liability) can be recognized as deferred assets (admitted) and deferred liabilities.

The ability to recognize a deferred asset and deferred liability is limited to only the portion of the fair value fluctuation in the hedging instruments that is attributed to the hedged risk and does not immediately offset changes in the hedged item. As detailed in the standard, the hedged risk may be designated as a specific component of the hedged item. For example, if the variable annuity reserve benefits are matched to bonds, the hedged risk could only be the portion of interest rate risk remaining after the natural hedge based on the asset-liability matching.

Unless a different method has been approved by the domiciliary state commissioner, reporting entities shall utilize the following calculation (detailed in paragraph 15) for establishing the deferred asset:

15.e.i Calculate the fair value gain or loss in the hedged item attributable to the hedged risk (Step 1);

15.e.ii Express the fair value gain or loss calculated (Step 1) as a percentage of the change in the full-contract fair value (i.e., with all product cash flows) attributed to interest rate movements (Step 2).

15.e.iii Calculate the AG43VM-21 liability change attributed to the hedged risk as the quantity calculated in Step 2 multiplied by the AG43VM-21 liability change attributable to interest rate (Step 3).

15.e.iv Establish the deferred asset or deferred liability in the amount of the fair value loss or (gain) of the designated hedging instruments attributed to the hedged risk less the AG43VM-21 liability decrease or (increase) attributed to the hedged risk as calculated in Step 3.

15.e.v Allocate an amount equal to the net deferred asset and deferred liability (net amount from all hedging strategies / programs captured within this guidance) to special surplus.

To illustrate the above calculation:

**Clearly Defined Hedging Strategy (CDHS) characteristics**

<table>
<thead>
<tr>
<th>Hedged item</th>
<th>Rider claims less rider fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedged risk</td>
<td>50% of the rho (first-order IR level sensitivity)</td>
</tr>
</tbody>
</table>

**Calculation of the deferred asset or liability**

*Note: positive values = increase in liability*

<table>
<thead>
<tr>
<th>Fair value gain (loss) in hedged item attributable to interest rate movement</th>
<th>(500)</th>
</tr>
</thead>
<tbody>
<tr>
<td>15.e.i. - Fair value gain (loss) in hedged item attributable to hedged risk</td>
<td>(250)</td>
</tr>
</tbody>
</table>

Hence, if the insurer were hedging per the CDHS perfectly, then the insurer should see a 250 fair value loss in the designated IR hedge instruments. To determine how much of that loss should be deferred:
Fair value gain (loss) in full-contract cash flows attributable to IR movement (700)
15.e.ii - Quantity calculated in 14.b.i. as a % of the (700) above 36%

AG-43VM-21 liability increase (decrease) from beginning of period to end of period 400
AG-43VM-21 liability increase (decrease) attributable to interest rate movements (100)

15.e.iii - AG-43VM-21 liability increase (decrease) attributable to the hedged risk (36)

In this example, even though the AG-43VM-21 liability increased by 400 during the reporting period, interest rate movements actually contributed to a 100 decrease. The hedged risk (50% of the interest rate sensitivity of rider cash flows) accounts for 36% of this, or $36 of the liability decrease. As such, $36 of the fair value loss on the interest rate hedge instruments should be reflected immediately and the remainder deferred via a deferred asset equal in amount to 250 – 36 = 214.

15.e.iv – Deferred asset (14.b.i less 14.b.iii) attributable to hedged risk (214)
(This is shown as a negative – to be consistent with the decrease in AG-43VM-21 liability – but represents a deferred asset. Deferred assets reflect fair value losses.)
Staff Note: Pursuant to comments received from state regulators, the approach utilizing fair value changes in calculating the deferred asset or deferred liability shall be required. These comments did not support the ACLI proposed option to utilize Rho in lieu of the actual fair value changes.

Appendix A—Calculation of Deferred Asset or Deferred Liability—Option 2: Rho

Under the special accounting provisions within this issue paper, as detailed in paragraph 15.e., fair value fluctuations in the hedging instruments attributable to the hedged risk that do not offset the current period change in the hedged item (AG 43 reserve liability) can be recognized as deferred assets (admitted) and deferred liabilities.

The ability to recognize a deferred asset and deferred liability is limited to only the portion of the fair value fluctuation in the hedging instruments that is attributed to the hedged risk and does not immediately offset changes in the hedged item. As detailed in the standard, the hedged risk may be designated as a specific component of the hedged item. For example, if the variable annuity reserve benefits are matched to bonds, the hedged risk could only be the portion of interest rate risk remaining after the natural hedge based on the asset-liability matching.

Unless a different method has been approved by the domiciliary state commissioner, reporting entities shall utilize the following calculation (detailed in paragraph 15) for establishing the deferred asset:

(Staff Note—This option is not currently detailed in paragraph 15, but would replace the guidance in those paragraphs if this option is selected.)

15.e.i Calculate the Rho of the hedged item. Rho is the expected dollar change in fair value for a 1 basis point decrease in rates, measured at the beginning of the reporting period. Fair value calculations should project a settlement of lifetime benefit claims at the SPIA reserve requirement (i.e., discounting of claims, from the time the AV is depleted until the last benefit payment, using the SPIA discount rate determined with the rates in the scenario at the time of AV depletion). (Step 1);

15.e.ii Express the Rho of the hedged item (Step 1) as a percentage of the rate risk exposure excluding the designated hedge (Step 2). The rate risk exposure excluding the designating hedge is defined as the Rho of the full-contract fair value (i.e., with all product cash flows) less the Rho of the assets in the general account dedicated to the line of business (i.e., fixed income assets modeled in the AG43 and C3P2 liability calculations). The percentage calculated in step 2 is the proportion of risk mitigated by the designated hedge, referenced above.

15.e.iii Calculate the AG 43 liability change attributed to the hedged risk as the quantity calculated in Step 2 multiplied by the AG 43 liability change attributable to interest rate (Step 3).

15.e.iv Establish the deferred asset or deferred liability in the amount of the fair value loss or (gain) of the designated hedging instruments attributed to the hedged risk less the AG 43 liability decrease or (increase) attributed to the hedged risk as calculated in Step 3.

15.e.v Allocate an amount equal to the net deferred asset and deferred liability (net amount from all hedging strategies / programs captured within this guidance) to special surplus.

To illustrate the above calculation:
Clearly Defined Hedging Strategy (CDHS) characteristics

<table>
<thead>
<tr>
<th>Hedged item</th>
<th>50% Rider claims less rider fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedged risk</td>
<td>Interest rate risk</td>
</tr>
</tbody>
</table>

Calculation of the deferred asset or liability

Note: positive values = increase in liability

<table>
<thead>
<tr>
<th></th>
<th>Beginning of period Rho</th>
<th>Rate change in the period</th>
<th>FV G/(L) during the period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedged Item</td>
<td>(10)</td>
<td></td>
<td>(250)</td>
</tr>
<tr>
<td>Designated Hedge Instruments</td>
<td>(10)</td>
<td>+ 25 bps</td>
<td>(250)</td>
</tr>
<tr>
<td>General Account Fixed Income Assets</td>
<td>(6)</td>
<td></td>
<td>(150)</td>
</tr>
<tr>
<td>Full Contract Fair Value</td>
<td>(28)</td>
<td></td>
<td>(700)</td>
</tr>
</tbody>
</table>

In this example, the insurer was hedges per the CDHS perfectly, and sees a 250 fair value loss in the designated IR hedge instruments. To determine how much of that loss should be deferred:

15.b.i — Rho of the hedged item     (10)
15.b.ii — Rate risk excluding the designated hedge | (28) — (6) | (22)
15.b.iii — Proportion of risk mitigated by the designated hedge | 45%

AG 43 liability increase (decrease) from beginning of period to end of period | 400
AG 43 liability increase (decrease) attributable to interest rate movements | (100)
15.b.iii — AG 43 liability increase (decrease) attributable to the hedged risk | (45)

In this example, even though the AG 43 liability increased by 400 during the reporting period, interest rate movements actually contributed to a 100 decrease. The hedged risk (The interest rate sensitivity of 50% of rider cash flows) accounts for 45% of this, or $45 of the liability decrease. As such, $45 of the fair value loss on the interest rate hedge instruments should be reflected immediately and the remainder deferred via a deferred asset equal in amount to 250 — 45 = 205.

15.b.iv — Deferred asset (14.b.i less 14.b.iii) attributable to hedged risk | (205)

(This is shown as a negative — to be consistent with the decrease in AG 43 liability — but represents a deferred asset. Deferred assets reflect fair value losses.)
DISCUSSION

29.28. The provisions within this issue paper are significantly different from what is currently allowed under SAP, U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). The concept of allowing “effective hedge” accounting treatment for macro-hedges is currently not endorsed by any of the noted accounting standards. Provisions within this issue paper have been drafted with the intent to encourage risk-management transactions by insurers for limited, qualifying transactions in order to reduce non-economic surplus volatility and ensure appropriate financial statement presentation with sufficient transparency for regulator review.

Application of SSAP No. 86 Guidance

30.29. The concepts within scope of this issue paper, particularly the allowance for macro-hedges and dynamic (rebalancing) hedging instruments are not permitted within SSAP No. 86. Although limited comments have been received indicating that macro-hedge transactions using a dynamic (rebalancing) approach for variable annuity guarantees could occur under the current concepts of SSAP No. 86, the Statutory Accounting Principles (E) Working Group does not agree with this interpretation. The Working Group agrees that separate guidance is needed to address these limited derivative situations to comply with the Financial Condition (E) Committee charge.

31.30. Hedge effectiveness determinations under SSAP No. 86 require use of derivative instruments in hedging transactions that meet the criteria in SSAP No. 86. The application of the guidance in SSAP No. 86, as well as existing hedge effectiveness guidance under U.S. GAAP and IFRS, is contrary to the concept of a dynamic hedging as the existing guidance is designed primarily for static exposures in which it is necessary to identify a specific hedged item and hedging instrument, and designate them as linked in an individual hedging relationship.

32.31. Existing SSAP No. 86 guidance for fair value hedges does allow for similar assets or similar liabilities to be aggregated and hedged as a portfolio. With the fair value hedge portfolio guidance, a particular risk exposure is required to be designated, and the portfolio of similar assets or similar liabilities must share the risk exposure for which they are designated as being hedged. As detailed within paragraph SSAP No. 86, paragraph 23.e, “the change in fair value attributed to the hedged risk for each individual item in a hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributed to the hedged risk”. This guidance is adopted explicitly from U.S. GAAP. The FASB has specifically indicated that the “proportional” requirement was to be interpreted strictly, but did not require the term to reflect “identical” items. To illustrate, under a FASB example, percentage decreases within a range of 9 to 11 percent could be considered proportionate if that interest rate change reduced the fair value of the portfolio by 10 percent.

33.32. SSAP No. 86 does not include guidance permitting cash flow hedges involving portfolios. SSAP No. 86 guidance is explicit that the hedging relationship shall be highly effective in achieving offsetting cash flows attributable to a particular risk during the term of the hedge. The guidance identifies that this exposure may be associated with an existing recognized asset or liability, or as a forecasted transaction.

34.33. With regards to forecasted transactions, SSAP No. 86 allows single transactions and groups of individual transactions to be the hedged transaction. If the hedged transaction is a group of individual transactions, the transactions must share in the same risk exposure for which they are designated as being hedged. The guidance for forecasted transactions does allow more than one risk to be hedged (for

---

14 A forecasted transaction is a transaction expected to occur for which there is no firm commitment. Because no transaction or event has yet occurred and the transaction or event - when it occurs - will be at the prevailing market price, a forecasted transaction does not give an entity any present rights to future benefits or a present obligation for future sacrifices. For transactions detailed within this issue paper, the hedged items are recognized liabilities (AG-43VM-21 reserves); therefore the guidance for derivative forecasted transactions does not appear applicable for derivatives within scope of this issue paper.
example, the risk of changes in cash flows can be related to purchase/sales price, interest rate risk, foreign currency change risk, or default risk), however, the occurrence of the forecasted transaction (e.g., purchase/sale, cash inflow/outflow) must be probable. (SSAP No. 86 identifies that the term probable requires a significantly greater likelihood of occurrence than the phrase more likely than not.) Once a forecasted transaction is no longer probable, hedge accounting is to immediately cease and any deferred gains or losses are to be recognized immediately. Once a pattern occurs of forecasted transactions not being probable, the entity’s ability to accurately predict forecasted transactions is questioned and the entity is no longer permitted to use hedge accounting in the future for similar forecasted transactions.

35.34. Furthermore, existing guidance in SSAP No. 86 is drafted to reflect derivative transactions hedging invested assets. Although the scope of SSAP No. 86 does not limit the guidance to assets (or excludes hedges of liabilities), the specific provisions within the standard do not provide guidance for hedging liabilities. As noted within this issue paper, the new guidance will be specific to derivative transactions hedging the AG 43VM-21 liability.

36.35. The concepts reflected in the March 2016 original agenda item as the “Initial Staff Proposal for Discussion” (subsequently referred to as the “original agenda item”) proposed use of a “closed” portfolio concept. As detailed within the guidance in this issue paper, the requirement of a closed portfolio has been revised to allow use of a flexible portfolio as the hedged item, providing the ability to continuously adjust the hedged item to remove policies and/or include new policies to effectively manage risk. Use of an open portfolio further differentiates the hedging programs allowed within this issue paper from what is permitted as effective hedges under SSAP No. 86, U.S. GAAP and IFRS. This issue paper reflects the conclusion that the accounting provisions within are separate and distinct from the provisions within SSAP No. 86 and should not be inferred to any derivative transaction that does not explicitly qualify within the scope of this issue paper.

Hedge Strategy

37.36. The guidance within this issue paper requires reporting entities to engage in highly effective fair value hedges that follow a Clearly Defined Hedging Strategy (CDHS or “hedging strategy”) as defined in AG 43VM-21. The documentation required under a CDHS includes:

a. The specific risks being hedged,
b. The hedge objectives,
c. The risks not being hedged,
d. The financial instruments that will be used to hedge the risks,
e. The hedge trading rules, including the permitted tolerances from hedging objectives,
f. The metric(s) for measuring effectiveness,
g. The criteria that will be used to measure effectiveness,
h. The frequency of measuring hedging effectiveness,
i. The condition under which hedging will not take place, and
j. The person or persons responsible for implementing the hedging strategy.
38.37. While the hedging strategy may change over time, this issue paper requires each hedging strategy to be implemented for a minimum of three months, with notification to the domiciliary state when there is a change in hedging strategy. The provisions in AG 43VM-21 also require the hedging strategy to be effectively implemented for at least three months. As detailed in AG 43VM-21, reporting entities can meet the time requirement by having evaluated the effective implementation of the hedging strategy for at least three months without actually having executed any trades indicated by the hedging strategy (e.g., mock testing or by having effectively implemented the strategy with similar annuity products for at least three months). For purposes of this issue paper, the three month time-frame is the required timeframe before a change can occur in the documented hedging strategy without an inherent determination that the hedging strategies, and the derivatives within, were not highly effective (ineffective).

39.38. Any change in the hedging strategy shall be clearly documented and include an effective date of the change in strategy. Determination of whether the hedging instruments were highly effective shall be made in accordance with the hedging strategy in place at the time of assessment.

40.39. Comments initially received identified that most companies identify a target rate sensitivity and purchase interest rate derivatives that will hedge exposure to this target. These comments noted that the target can change with changes in risk appetite and suggested a monthly reset to reflect changes in risk appetite. These comments indicated that regardless of changes in the risk appetite that may occur throughout each month, the hedging strategy would be locked at the beginning of each month. Per these comments, the monthly reset of the overall hedging strategy would not trigger ineffectiveness as long as subsequent cash flows were considered effective under the updated hedging strategy. These comments suggested that reporting entities should be required to specify the operational practices in setting or determining hedging strategies to allow for these changes. After considering these comments, the Working Group disagreed with the request to allow for a “monthly” reset of the hedge program, noting that such an element would be too permissive in determining effectiveness, particularly when coupled with provisions that allow flexible portfolios and dynamic hedges.

41.40. Subsequent to the initial comments, additional comments were received noting the need to differentiate between changes in hedge targets and changes in an entity’s hedging strategy. These comments identified that a “hedging strategy” is the collection of multiple elements, including risks being hedged, objectives, hedging instruments used and effectiveness measurements. Within a hedging strategy, the comments indicated that it may be necessary and appropriate to adjust the hedge target in response to changing market conditions, liability changes and other factors.

42.41. For the special accounting provisions in this issue paper, provisions have not been established to allow for a monthly reset of hedging strategies, or for changes in hedge targets to be considered separately from a change in hedge strategy. Instead, hedging strategies (including the hedge targets in those strategies) are required to be implemented for at least three months. As detailed within the issue paper, reporting entities are allowed to engage in a dynamic hedging strategy in which the hedging instruments may be rebalanced to accommodate changes in the hedged item (which reflects a flexible portfolio of variable annuity contracts) to adhere to a specified, documented derivative strategy. With these provisions, it seems unnecessary, and overly permissive, to incorporate provisions that allow monthly revisions and/or changes in the hedge target that are not considered changes to the hedging strategy. A three-month hedge strategy implementation timeframe still allows for timely revisions throughout a year if a company’s risk appetite was to change and is consistent with AG 43VM-21 provisions. In situations in which the hedging strategy must be revised to reflect a revised risk appetite before the three-month implementation timeframe is over, the hedge should be terminated, and deemed ineffective, with subsequent establishment of a new hedging strategy to reflect the updated risk appetite and parameters for assessing hedge effectiveness.

Hedge Designation - Fair Value Hedge Addressing Variability Attributed to Interest Rate Risk

© 2018 National Association of Insurance Commissioners 15X-20
43.42. The guidance within this issue paper limits the hedge designation to a fair value hedge that addresses variable annuity guarantees sensitive to interest rate risk. Although variable annuity guarantees can be sensitive to other market factors, the guidance in this issue paper is only limited to interest rate risk. This issue paper acknowledges that the initial interest rate risk limitation was a scoping consideration (and not a result from a review of other risk factors) and should not preclude subsequent consideration, if supported by the Working Group, of other risks. Unless, and until, subsequent consideration of other risks are considered for inclusion within this guidance, hedges addressing other risks are subject to the guidance in SSAP No. 86.

44.43. The requirement for a fair value hedge is specific within the proposed guidance and requires assessment on whether the derivative instrument hedges changes in the fair value of hedged item (AG 43VM-21 liability or specific portion thereof) attributable to interest rate risk. In determining effectiveness, the hedging relationship shall be highly effective in offsetting changes in the fair value attributable to the hedge risk during the period in which the hedge is designated. The term highly effective describes a fair value hedging relationship where the change in fair value of the derivative hedging instrument is within 80 to 125 percent of the opposite change in the fair value of the hedged item attributable to the hedged risk. It shall also apply when an R-squared of 0.80 or higher is achieved when using a regression analysis technique.

45.44. The use of a fair value hedge detailed within this issue paper is intended to allow for hedging relationships that consider all relevant contractual cash flows in calculating the change in fair value, or if in accordance with the documented risk management hedging strategy, a designated portion of the relevant contractual cash flows from the hedged item. This is inconsistent with existing guidance in SSAP No. 86 (as well as derivative guidance under U.S. GAAP) in which all contractual cash flows of the entire hedged item must be used in calculating the change in the hedged item’s fair value attributed to changes in the benchmark interest rate. However, as noted by comments received, designating a portion of the cash flows as the hedged item is crucial; otherwise effectiveness may be compromised as fair value changes in cash flows from designated instruments may be more or less than the fair value changes in cash flows from the hedged item. Revisions in the designated portion of cash flows intended to be hedged in accordance with the documented risk management hedging strategy, a designated portion of cash flows related to that specified portion must be considered in calculating the change in the hedged item’s fair value attributed to changes in the benchmark interest rate being hedged to determine hedge effectiveness. Pursuant to the provisions within this issue paper, in addition to the designated portion of a specified liability, specific contractual cash flows of that explicit portion are also permitted to be designated.

46.45. Under SSAP No. 86 and U.S. GAAP, hedge designations are required to be static and are not permitted to be revised over the hedge term. With the provisions in this issue paper, changes are not permitted unless, and until, the reporting entity documents a new hedging strategy. Unless there is a change in hedging strategy, subsequent assessments of effectiveness shall be consistent with the originally documented risk management strategy, and the designated portion of cash flows, for the hedged item. Fair value gains or losses on the derivative instrument that do not offset the change in the fair value of the hedged item attributable to the hedged risk, as detailed within the hedging strategy, are considered ineffective elements of the hedge, and depending on the degree of ineffectiveness could trigger assessment that the entire hedge is ineffective.

15 The change in fair value of the hedging instruments and hedged item is limited to changes driven by market factors. For example, periodic recognition of a cost owed to acquire the derivative from a counterparty (financing cost) shall not be captured as a change in the derivative instrument’s fair value. The fair value of the instrument shall be determined based on the underlying derivative without inclusion of acquisition costs (or other such contractual elements that may exist with the counterparty) that do not change based on the underlying derivative interests or market factors.
47.46. Despite comments initially received supporting use of a cash flow hedge approach, the general nature of the hedging strategies employed for these variable annuity contracts are more representative of a fair value hedge. However, as the hedged item (AG-43VM-21 reserve) is not reported at fair value, these hedging strategies do not qualify as a fair value hedge. Based on information received, reporting entities already calculate the fair value for the AG-43VM-21 reserve and use the fair value changes in the hedged item and hedging instruments to determine hedge effectiveness. Rather than pursue the cash flow hedge designation, this issue paper has been prepared to follow the method that is intuitively applied, although the standard requirements to qualify for a fair value hedge are not met. (As the hedged item is recognized at an amount other than fair value (AG-43VM-21 reserve calculation), changes in the fair value of the hedged item do not immediately adjust the reported amount for the AG-43VM-21 reserve for the fair value change, and are not recognized currently in earnings.)

Hedged Item - Flexible Portfolio or Closed Portfolio

48.47. The guidance within this issue paper proposes use of a flexible portfolio as the hedged item, reflecting the possibility to include variable annuity contracts with different characteristics and different liability durations (macro-hedge). The designated portfolio would not be required to be static in a closed portfolio, but could be revised to remove policies and/or include new policies to allow for continuous risk management of the variable annuity guarantee reserves.

49.48. The use of a flexible portfolio approach, rather than a closed portfolio approach, reflects consideration of industry comments regarding the current aggregate approach for risk-management strategies. Furthermore, consideration was given to comments indicating that the required use of a closed portfolio approach would be operationally burdensome in accordance with documentation requirements and assessments of hedge effectiveness. Key elements noted by industry included:

a. Open or flexible portfolio is imperative as the liability changes on a daily basis with changes to inforce business and capital market factors. Requiring the redesignation of a hedge relationship due to any change in the hedged item is operationally burdensome as new hedge documentation and assessments of effectiveness would be required frequently.

b. A portfolio approach based on guarantee duration could result in an exorbitant amount of hedge relationships that become difficult to maintain. Sensitivity and risk profile can vary from policy to policy and within a policy by performance of the separate account underlying it. Combining policies by duration at inception of the hedge relationship is arbitrary.

c. Multiple portfolio approach is challenging as most risk management strategies hedge at an aggregate level to capture the diversification inherent in the business. Additionally, a closed portfolio approach would require segmentation of the AG-43VM-21 calculation. As AG-43VM-21 was designed to be an aggregate projection of liabilities and assets of all variable annuity policies in force, the AG-43VM-21 calculation includes inherent diversification. The sum of a segmented AG-43VM-21 does not necessarily equal the calculation at an aggregate level and could result in entities holding greater reserves than necessary by a material amount.

50.49. The IASB also has a project to consider a new accounting model for dynamic risk management. This project was driven from difficulties associated with applying existing hedge accounting requirements to a dynamically managed portfolio with continuous frequent changes in the risk positions that are hedged. Within this IASB project, the IASB identifies that under current hedge accounting guidelines, open portfolios are in effect forced into closed portfolios for hedge accounting purposes, and this practice makes it difficult to reflect dynamic risk management in the financial statements.
Moving towards a flexible portfolio approach is intended to better reflect the key features of dynamic risk management. As detailed in the IASB discussion paper and the related April 2014 IFRS in Focus (Deloitte), when derivatives are used to hedge risks which are not measured on the same basis (i.e., hedged item and hedging instruments both measured and reported at fair value with fair value fluctuations recognized as unrealized gains or losses), volatility arises, despite the risk management objective of reducing economic volatility. Hedge accounting helps to reduce this volatility; however, hedge accounting is not well suited to the hedging of dynamic portfolios. Hedge accounting requires the specific designation of hedged items and hedging instruments and requires specific mechanics and effectiveness testing to be performed. Such requirements are better suited to individual hedges or hedges of static groups of items (closed portfolios) rather than hedges of portfolios that are constantly changing with new exposures added and old exposures removed (open or dynamic portfolios) and where the portfolio of hedging derivatives is also frequently changing.

Consistent with issues identified by the IASB, the use of closed portfolios, following the general hedge accounting model, gives rise to various issues, including:

a. Treating open portfolios as a series of closed portfolio hedges inevitably leads to profit or loss volatility from hedge ineffectiveness that is inconsistent with the economic position and reflective of the dynamic risk management applied.

b. As the portfolio of hedged items and hedging instruments change, hedge accounting leads to frequent de-designations and re-designations which give rise to operational difficulties regarding tracking and amortization of hedge adjustments.

In the original agenda item, use of a closed portfolio approach was suggested as an ever-changing portfolio of variable annuity contracts would be difficult for regulators to actively review and assess for hedge effectiveness compliance. Additionally, there was concern that allowing for a variable portfolio, particularly if coupled with a flexible hedging instrument, could allow for companies to “control” the hedge effectiveness by adjusting both the hedged item and the hedging instruments. Although these concerns still exist, provisions within the issue paper have been included to incorporate a higher degree of review and approval for these derivative transactions. Particularly, provisions have been incorporated to require explicit approval from the domiciliary state prior to implementing a hedging program within scope of this guidance, and the guidance requires certifications from both an actuary and a financial officer of the company on the use and impact of the hedging strategy on AG 43VM-21 reserves.

In reviewing the comments from industry, as well as the discussion elements supporting the IASB project, a closed portfolio approach may not be successful in encouraging further risk-management transactions by insurers. The operational burden in applying the concepts of closed portfolios would likely limit the general application of the special accounting provisions being considered, further perpetuating concerns that existing accounting guidance may hinder insurers from engaging in appropriate risk-management activities.

Hedging Instrument - Dynamic Hedging Strategy (Rebalancing)

The provisions within this issue paper permits reporting entities to utilize a specified derivative, or a portfolio of specified derivatives, as the hedging instrument. The portfolio of derivatives is allowed to be rebalanced in accordance with changes in the hedged item to adhere to a specified derivative strategy. The ability to rebalance derivatives designated as the hedging instrument is supported from comments identifying that dynamic hedging is a prevalent industry practice and widely accepted as an appropriate risk management technique. Commenters noted that a dynamic hedging strategy rebalances derivative

16 Deloitte: IFRS in Focus - IASB Issues Macro Hedging Discussion Paper, April 2014
portfolios to result in targeted market sensitivity and is not a result of a flawed hedge. Irrespective of one open or multiple closed hedged items, a dynamic instrument is fundamental in applying adequate risk management measures for variable annuities as the sensitivity changes over time and life of the policies. Comments indicated that designating one static pool at inception could result in significant hedge accounting and economic ineffectiveness, and highlighted that the instruments used to hedge a liability with a changing risk profile must be flexible.

56.55. Although some commenters indicated that the guidance in SSAP No. 86 supports the concept of dynamic hedging (rebalancing of hedging instruments), NAIC staff does not believe that interpretation is consistent with the intent of SSAP No. 86, nor is that interpretation consistent with derivative guidance under U.S. GAAP or IFRS. Pursuant to U.S. GAAP derivative guidance, separate financial instruments shall not be combined, and evaluated as a unit, unless two more derivative instruments in combination are jointly designated as the hedging instrument. As previously noted, guidance in SSAP No. 86, as well as U.S. GAAP and IFRS, are designed primarily for static exposures in which it is necessary to identify a specific hedged item and hedging instrument (including a unit of combined instruments), and designate them as linked in an individual hedging relationship.

Hedging Criteria – Assessment of Effectiveness

57.56. Although the provisions within this issue paper incorporate new concepts for what is allowed as the hedged item and the hedging instrument, and incorporates a specific approach to determine hedge effectiveness, the concept of whether a fair value hedge is effective – and whether the hedging relationship achieves offsetting changes in fair value – is consistent with concepts established in SSAP No. 86 (as well as U.S. GAAP and IFRS) for assessing effectiveness. Key provisions include:

a. Use of a specified method that will be used to assess hedge effectiveness at inception and on an ongoing basis, requiring hedge effectiveness assessment whenever financial statements are reported, with a minimum requirement of every three months. As detailed in the issue paper, in order to determine hedge effectiveness reporting entities must calculate the fair value of the hedged item (portion of AG 43VM-21 reserve liability) at inception and on an ongoing basis, and compare the current period fair value change of the hedged item to the current period fair value change of the hedging instruments. This comparison is specific to the designated hedged risks and exposures, therefore, if only a portion of the interest rate risk is hedged or if the designated hedge only include specific components of the variable annuity policies (e.g., riders), for determining hedge effectiveness, the fair value comparisons is limited to those designated items. The change in fair value of the hedging instruments and hedged item is limited to changes driven by market factors. For example, periodic recognition of a cost owed to acquire the derivative from a counterparty (financing cost) shall not be captured as a change in the derivative instrument’s fair value. The fair value of the instrument shall be determined based on the underlying derivative without inclusion of acquisition costs (or other such contractual elements that may exist with the counterparty) that do not change based on the underlying derivative interests or market factors.

b. Documentation is required for both prospective and retrospective effectiveness assessment, with ongoing assessment consistent with the documented risk management strategy in effect at the time of assessment. (Changes from the original hedging strategy are permitted in accordance with this issue paper.)

c. A highly effective hedging relationship is one where the change in fair value is within 80 to 125 percent of the opposite change in fair value of the hedged item attributed to the...
hedged risk. A highly effective hedge also exists when an R-squared of .80 or higher is achieved when using a regression analysis.

58-57. Unlike the guidance in SSAP No. 86 (as well as U.S. GAAP), the guidance within this issue paper does not allow reporting entities to determine how they will assess hedge effectiveness. Rather, this issue paper specifies a particular approach for assessing whether the hedging strategy is highly effective, and in measuring hedge effectiveness. The hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributed to the hedged risk between the hedged item and the hedging instrument during the period that the hedge is designated. With the dynamic / rebalancing approach detailed within this issue paper, an individual hedging instrument is considered to be part of the effective hedge if the entire portfolio of hedging instruments achieves offsetting changes in fair value during the period in accordance with the hedging strategy. Rebalancing individual hedging instruments within a portfolio does not result with an ineffective assessment as long as the entire hedging instrument (portfolio) continues to meet the hedge effectiveness requirements under the documented hedging strategy.

59-58. As a continued GAAP to SAP difference, the requirements in this issue paper do not require reporting entities to separately report in the financial statements the ineffective portion of a highly-effective hedging transaction. For U.S. GAAP filers, in all instances, the actual measurement of cash flow hedge ineffectiveness is to be recognized in earnings each reporting period. The recognition of ineffectiveness is based on whether exact offset of cash flows is not achieved. This issue paper does not require measurement or disclosure of any ineffective part of the hedge.

Measurement of Open / Outstanding Derivative Instruments Hedging Criteria

60-59. This issue paper requires all derivative hedging instruments to be reported at fair value. Derivative instruments combined in a portfolio are also required to be separately reported at fair value. Although this is a measurement change from derivatives in effective hedges under SSAP No. 86, the fair value measurement approach is consistent with U.S. GAAP and IFRS. The FASB has identified that fair value is the only relevant measurement attribute for derivatives. Furthermore, the FASB has specifically identified that amortized cost is not a relevant measurement because the historical cost of a derivative is often zero, yet a derivative can be settled or sold at any time for an amount equivalent to its fair value. The FASB reasoning supporting “held to maturity” instruments being held at amortized cost was noted as not suitable for derivatives.

61-60. The requirement to use fair value under this special accounting provision is a change from SSAP No. 86 for derivatives that qualify as effective hedges. This change is appropriate under this accounting guidance for the following reasons:

a. Fair value fluctuations in hedging instruments attributable to the hedged risk that offset changes in the AG-43VM-21 liability shall be recognized as realized gains and losses. These offsets result in a neutral financial statement impact, with the financial statements reflecting the impact of the effective hedge. This offset is only possible under a fair value measurement method in which fair value fluctuations are reflected in the financial statements. Under an amortized cost measurement method, fair value fluctuations are not recognized in the financial statements. Although the fair value change in an open derivative instrument would normally be considered an unrealized change, to avoid a statutory accounting disconnect in recognition between derivative changes and the changes in the AG-43VM-21 reserve, offsetting fair value changes will be recognized as realized changes. This is also consistent with U.S. GAAP, as offsetting changes in hedged items and hedging instruments are concurrently recognized in earnings.
b. Provisions are established to allow for the recognition of a “deferred asset” or “deferred liability” for the portion of the fair value fluctuations of the derivative instrument, attributed to the hedged risk, that do not immediately offset the changes in the AG 43VM-21 liability. The recognition of these gains/losses as balance sheet items negates the surplus volatility from the non-offsetting fair value fluctuations. (As discussed in paragraph 60.a. offsetting positions to the changes in the AG 43VM-21 liability are recognized as realized gains and losses.) As previously discussed, the change in fair value of the hedging instruments is limited to changes driven by market factors. This issue paper does not allow deferred derivative acquisition costs (financing costs), or other such contractual costs with the derivative counterparty that are not impacted by underlying derivative interests, or market changes, to impact the fair value of the derivative instrument when determining the offset to the AG 43VM-21 reserve or the resulting deferred asset or deferred liability.

c. Use of fair value will result with consistent measurement methods for derivatives between SAP and U.S. GAAP. Additionally, the reporting of fair value and the development of the deferred assets and deferred liabilities will clearly present derivative positions under this special accounting provision. This is particularly important for instances in which gains and losses from expired derivatives are not immediately reflected in the financial statements, but are scheduled for amortization.

62-61. The provisions within this issue paper permitting recognition of a “deferred asset” and a “deferred liability” to reflect the non-offsetting portion of fair value fluctuations attributed to the hedged risk is inconsistent with U.S. GAAP derivative guidance, as well as the general definitions for what constitutes an asset or liability under both SAP and U.S. GAAP. Gains and losses resulting from changes in the fair value of derivatives are not separate assets or liabilities because they have none of the essential characteristics of assets or liabilities. As noted by the FASB, the act of designating a derivative as a hedging instrument does not convert a subsequent loss or gain into an asset of a liability. A loss is not an asset because there is no future benefit associated with it. The loss cannot be exchanged for cash, a financial asset, or a nonfinancial asset used to produce something of value, or used to settle liabilities. Similarly, a gain is not a liability because no obligation exists to sacrifice assets in the future.

63-62. The reporting of derivative gains and losses from effective hedges as assets or liabilities is not new under statutory accounting. Currently, in SSAP No. 86, upon the sale, maturity, or other closing transaction of a derivative, which is an effective hedge, any gain or loss on the transaction will adjust the basis (or proceeds) of the hedged item(s) individually or in the aggregate. This “adjustment to the basis of the hedged item” is, in effect, the recognition of derivative losses or gains as assets or liabilities. Although these provisions exist in SSAP No. 86, the impact is not easily identifiable in the assets or liabilities reported on the financial statements. With the exception of impairment assessments for the hedged item (pursuant to the SSAP in which the hedged item falls), increases in an asset basis of a hedged item as a result of derivative losses are not restricted, nor are they explicitly nonadmitted.

64-63. SSAP No. 86 also provides an alternative treatment, whereas if the item being hedged is subject to IMR, the gain or loss on the terminated hedging derivative may be realized and subject to IMR. This alternative approach also reflects the recognition of a balance sheet impact (increase or decrease in liabilities) for realized gains and losses that do not meet the definition of assets or liabilities. For IMR items, losses recognized from derivative instruments reduce the IMR liability, whereas gains from derivative instruments increase the IMR liability. With the provisions established for IMR, safeguards are in place to prevent recognition of a contra-liability (or asset) for realized losses that exceed realized gains. If realized losses exceed the IMR liability, resulting with a negative liability balance, the IMR liability is required to be shown as zero. A negative liability for IMR is not permitted to be reflected in the financial statements.
Although statutory accounting does not generally support the recognition of balance sheet items that do not meet the definitions of assets or liabilities, the guidance proposed in this issue paper is supported for the following reasons:

a. The process to recognize the fair value of derivative instruments, coupled with the recognition of “deferred assets” and “deferred liabilities” (reflecting non-offsetting gains and losses attributed to the hedged risk), provides a comprehensive view of the derivative impact in the balance sheet. With this approach, the derivative is reported at fair value, but the non-economic volatility from market fluctuations (the fair value change) does not impact the entity’s solvency presentation.

i. For example, a derivative acquired at zero cost currently in a liability position from fair value fluctuations will be reported as a derivative liability in the financial statements. The unrealized loss from fair value fluctuations attributed to the hedged risk, which were not recognized as they did not offset AG 43VM-21 reserve changes, will be shown as a deferred asset. This deferred asset would be admitted, although it does not meet the definition of an asset, or the concept of an admitted asset under SSAP No. 4, as it does not reflect a probable future benefit or something that would be available for policyholder benefits. However, by reporting both the derivative liability and the deferred asset, non-economic volatility in the financial statements is mitigated, while improving presentation as the derivative obligation (derivative liability) will be presented in the financial statements. In addition, under the narrow scope of this issue paper, it is important to consider accounting that captures what is relevant and a faithful representation of the business model of variable annuity life insurers, who as indicated elsewhere within this issue paper, utilize dynamic hedging as a risk management technique that if determined to be highly effective under the requirements of this statement, reduces risk, and helps the industry as a whole to better serve the marketplace. Under current guidance, using an amortized cost approach, the derivative would be reported at zero, and would not be adjusted for fair value fluctuations, therefore the liability position of the derivative would not be shown in the financial statements.

b. Recognizing derivatives at fair value is consistent with the U.S. GAAP guidance for reporting derivatives, therefore eliminating the GAAP or SAP difference on the reporting of these investments.

c. The recognition of “deferred assets” and “deferred liabilities” and the separate amortization of these balances, outside of IMR, prevents the application of this special accounting provision from diluting or impacting the recognition of IMR. Pursuant to SSAP No. 7, IMR defers recognition of realized capital gains and losses resulting from changes in the general level of interest rates. As the recognition of deferred assets and deferred liabilities proposed within this issue paper would traditionally reflect unrealized gains or losses, (and then realized gains and losses once the derivative instrument expired), using a separate amortization process of these items, and not commingling these items with IMR, retains the original intent of IMR. Under the proposed guidance within this issue paper, the recognition of gain/loss will occur with amortization of the deferred assets / deferred liabilities, and will not be subject to further deferral to IMR.

d. With the recognition of deferred assets and deferred liabilities, this issue paper requires reporting entities to allocate to special surplus an amount equal to the net deferred asset/liability recognized under this special accounting guidance. This allocation
highlights the overall financial statement impact of the deferred assets/liabilities in the financial statements, and in some states, may reduce the likelihood of dividends being paid as a result of an increase in “assets” that actually represent unrecognized losses. This reporting also provides enhanced transparency to the magnitude of these transactions and overall financial statement impact, and assists in determining if a need exists for the state to hire an outside specialist to assess the overall program.

66.65. The guidance in this issue paper is focused on the accounting guidance for the derivative instruments that hedges an AG-43VM-21 liability, not the impact that a Clearly Defined Hedging Strategy under the provisions of AG-43VM-21 can have on the recognized AG-43VM-21 liability. One question that arose during the development of this issue paper was whether there was any double counting of the impact of the hedge that would be recorded under this proposed issue paper and what would be recorded as part of the AG-43VM-21 liability. It was determined this was not a material issue as the amount of credit given to a hedge (the asset to the company under this proposed accounting) under AG-43VM-21 is significantly muted by the mechanics and in fact may work to the detriment of the company in AG-43VM-21 but is not considered to be material.

Amortization of Deferred Assets and Deferred Liabilities – Effective Hedging Programs

67.66. This issue paper requires that deferred assets and deferred liabilities from non-expired derivative contracts be amortized using a straight-line method into realized gains and losses over a finite amortization period. The amortization period shall equal the Macaulay duration of the guarantee benefit cash flows based on the AG-43VM-21 Standard Scenario, but shall not exceed a period of 10-years. The Macaulay duration provides a weighted average length of time of the guarantee cash flows and appropriately varies by company, block and aggregation of business in force. The Macaulay duration appropriate links the amortization to the AG-43VM-21 liability and supports the goal of reducing non-economic volatility in the statutory financial statements resulting from accounting mismatches between variable annuity reserves and related hedges.

68.67. Although some industry commenters did not support in concept a maximum amortization period, and suggested amortization periods in excess of 10-years (20 and 25 years), the Working Group agreed to limit the deferred asset/liability amortization timeframe to 10 years. In deciding the 10-year timeframe, the Working Group noted that deferred assets/liabilities do not meet the definition of actual assets or liabilities, and the recognized “assets” (which are deferred losses) do not satisfy statutory accounting criteria for admitted assets as they do not reflect amounts that can be used to satisfy policyholder claims. Furthermore, it was identified that the impact from the application of this special accounting guidance could be material in the financial statements and could significantly impact the review and financial solvency assessment of a company. The Working Group also noted that the longer the amortization period, the longer unrecognized losses (reported as assets) are delayed from recognition. Additionally, under the issue paper provisions, as long as the hedge program is effective, derivative losses may continue to be reported as deferred assets even after the derivative instrument generating the loss has matured, sold or disposed. By limiting the amortization timeframe, the scheduling process is anticipated to be manageable, allowing for more effective regulator review.

69.68. The 10-year timeframe is an increase to the original proposal, which would have required a standard 5-year amortization timeframe for deferred assets/liabilities. Under that proposal, the 5-year timeframe would have been required unless a company was able to adequately demonstrate a linkage to the expected AG-43VM-21 liability, and if that was demonstrated the company would have been permitted to extend the amortization to 10-years. The original 5-year timeframe was suggested from certain industry representatives, who noted it was a significant improvement to the fair value accounting approach in SSAP No. 86, where the derivative fair value fluctuations are recognized as they occur.
70.69. This issue paper also allows for reporting entities to accelerate amortization or terminate use of the special accounting provision at any time. With this provision, specific guidance has been included to ensure that deferred assets and deferred liabilities are recognized in an equitable manner in the financial statements. This guidance was added in response to comments supporting the ability to accelerate amortization, but to prevent interpretations allowing amortization of only deferred assets or deferred liabilities. These comments noted concern with the opportunity to elect provisions inequitably between deferred assets and deferred liabilities, as those elections could be occur to improve the financial results of the reporting entity. The comments supported acceleration that is applied proportionately between deferred assets and deferred liabilities in order to ensure that amortization is aligned with the overall hedge relationship.

a. Under the guidance, reporting entities are required to accelerate amortization equally between deferred assets and deferred liabilities within a single hedging strategy. This guidance prevents a reporting entity from electing to accelerate amortization of the deferred liabilities (recognizing the gains from fair value changes) without also accelerating amortization of the deferred assets (continuing to defer losses from fair value changes). If a reporting entity was allowed to only accelerate deferred liabilities, the reporting entity would have the opportunity to improve the presentation of their financial position by choosing to recognize gains, but continuing to defer losses (reported as assets). If a single hedging strategy only reflects deferred assets or deferred liabilities, the reporting entity is permitted to accelerate amortization without restrictions.

b. If a reporting entity has more than one hedging strategy, and the strategies have offsetting net positions (both deferred assets and deferred liabilities are recognized in the financial statements), a reporting entity’s election to accelerate amortization must be applied consistently to programs with offsetting net positions. In these situations, the other provisions for acceleration are also applicable, whereas, the accelerated amortization must also apply equally to the deferred assets and deferred liabilities within each individual hedging program. If a reporting entity with more than one hedging strategy only has net deferred assets or net deferred liabilities recognized, the reporting entity is permitted to accelerate amortization to a single program under the guidelines in paragraph 70a.

71.70. The intent of the guidance in paragraph 70.b is to ensure that the elections to accelerate amortization are not one-sided approaches that result in favorable financial statement presentation.

Amortization of Deferred Assets and Deferred Liabilities – Terminated or Ineffective Programs

72.71. This issue paper provides guidance addressing the treatment of deferred assets and deferred liabilities, initially recognized under qualifying programs, when the hedging program no longer qualifies under the standard, no longer is identified as a highly effective hedge, or that has been terminated by the reporting entity. Pursuant to this guidance, in order to avoid an immediate impact to surplus for the full deferred asset/deferred liability recognized, provisions have been established to allow reporting entities to continue amortizing the deferred assets and deferred liabilities over the remaining amortization period, not to exceed five years. If the remaining amortization period exceeds the five-year timeframe, the amortization schedule shall be revised to require full amortization within the shortened time period. The guidance also allows reporting entities to elect to accelerate amortization, however, the provisions for equal accelerated amortization for qualifying, highly effective programs also applies.

73.72. The decision to allow for a shortened amortization timeframe for these programs is a compromise position that considered the underlying nature of the deferred assets / liabilities (unrecognized gains and losses from fair value fluctuations) as well as the financial statement impact that could occur with an
immediate recognition to surplus. Although comments received supported continued amortization under the original established schedule, the Working Group noted that the continuation of the originally scheduled amortization of deferred assets/liabilities for these programs in inappropriate, as these items do not meet the definition of assets and liabilities and cannot be used for policyholder claims. The ability to recognize deferred assets and liabilities was based on the concept that the hedging program was effective, and the volatility mismatch was due to differing accounting measurements between the hedged item and the hedging instruments in the effective hedge. Once a program is no longer highly effective, the continued long-term deferral of the unrealized gains and losses from the hedging derivative instruments can no longer be supported. This is particularly true for an expired derivative instrument that has resulted in a loss (deferred asset). For expired derivatives the loss has actually been incurred to the reporting entity, as it has been “realized” (settled with the counterparty) and there is no potential for that derivative loss to be reversed.

74-73. In establishing the compromise position, the Statutory Accounting Principles (E) Working Group sent a referral in April 2017, to the Variable Annuity Issues (E) Working Group inquiring whether there is a future benefit of effective hedges offsetting a variable annuity reserve once the effective hedging program has been discontinued or becomes ineffective. This referral noted the key issue of whether the deferred assets (unrecognized losses) from previous fair value fluctuations of derivative instruments – recognized when the overall hedge strategy was in place and effective – should be perceived to offset future reserve changes even when the overall hedging strategy has been terminated or is ineffective. This referral recognized that the unrecognized losses (deferred assets) are likely going to be significant, and identified the industry concern if immediate recognition in the financial statements was required. The referral also identified that if the special accounting provisions were not established or followed, the statutory accounting provisions in SSAP No. 86—Derivatives, would require recognition of the hedging instruments at fair value, with changes in fair value recognized as unrealized gains or losses as incurred.

75-74. In August 2017, the Variable Annuities Issues (E) Working Group provided a referral response to the Statutory Accounting Principles (E) Working Group. This response suggested the compromise position – allowing for a maximum 5-year amortization timeframe – with inclusion of detailed disclosures to allow the regulators to consider the information in their ongoing monitoring of the reporting entity’s financial condition. With this referral response, it was identified that members of the Variable Annuity Issues (E) Working Group expressed no willingness to support the ACLI suggestion that the amortization schedule should continue as if the hedging program was still in place and highly effective. This referral response also provided the following detail regarding the compromise position:

The regulatory position and therefore question is driven by the concern that a regulator would have as the result of an unrecognized loss on an ineffective overall hedging strategy or one that has been disposed. More specifically, during a market uptick, when the customer base of the insurer can become disinterested with the variable annuity product. Under these circumstances the liability cash flows are mostly fees that were going to materialize on the balance sheet under the original policyholder behavior assumptions and with above expectation lapse no longer will do so to the extent previously expected. The deferral of the loss recognition was meant to make the loss recognition coincide with the fee revenue recognition. If policies lapse, so too will the future profits. However, 100% recognition of any derivatives that are currently in a loss position would be inconsistent with the remaining reduced cash flows that do materialize. This lapse effect could also materialize in idiosyncratic insurer distress scenarios even though such scenarios are relatively unlikely as they would have to occur under very favorable capital markets conditions for there to be a deferred hedge loss asset.

76-75. Rebalanced / Expired Derivative Instruments With the ability to rebalance derivative hedging instruments, this issue paper allows for individual derivative instruments to be removed from the portfolio, and/or expire, and not immediately result with an ineffective hedging assessment. Comments received indicate that this approach is consistent with guidance under SSAP No. 86, as gains and losses
are either allowed to be an adjustment to the hedged item, or are realized and included in IMR. However, the guidance in this issue paper allows for derivatives to be removed from the hedging strategy and not be identified as an ineffective hedge. This concept is not supported by the existing guidance within SSAP No. 86.

**77.76.** The provisions within this issue paper is only intended to encompass situations in which the overall hedging strategy is highly effective at the time that the derivative is either removed from the portfolio of hedging instruments or expires. If the hedging strategy is highly effective at that time, then regardless of future determination of effectiveness, the deferred assets or deferred liabilities recognized for the derivative instrument will continue to be amortized under the remaining amortization schedule established when the hedge was deemed highly effective.

**78.77.** For derivatives that have not expired, but were removed from the portfolio of hedging instruments, subsequent gains and losses from fair value fluctuations shall not impact the previously recognized deferred assets or deferred liabilities, but shall be recognized directly as unrealized gains and losses. With this approach, the gains or losses identified when the derivative was part of the effective portfolio, reflected as deferred assets or liabilities, will be “locked in” once the derivative is removed from the portfolio of hedging instruments.

**Measurement / Recognition of Realized and Unrealized Gains and Losses**

**79.78.** The provisions within this issue paper identifying recognition through realized or unrealized gains or losses has been specifically determined for the hedge accounting programs in scope. These provisions are not consistent with the “standard” allocation between realized and unrealized that occurs under statutory accounting principles.

a. Under traditional statutory accounting concepts, fair value fluctuations for “open” instruments held by a reporting entity are recognized as unrealized (directly to surplus) as the fair value change could reverse in subsequent periods. Once an instrument is sold, matured, terminated, etc., the unrealized gain or loss would be recognized as a realized gain or loss (impacting net income).

b. With the traditional statutory approach, there would be a statutory disconnect between how derivative gains and losses for outstanding instruments would be recognized (unrealized to surplus) in comparison to the reserve change (change to net income). Although this disconnect occurs under SSAP No. 86—Derivatives, the disconnect does not occur under U.S. GAAP. Under U.S. GAAP, offsetting fair value changes in hedged items and hedging instruments are concurrently reflected in earnings.

**80.79.** Although the recognition of the fair value fluctuations as an unrealized or realized impact does not impact overall surplus, by stipulating that the fair value fluctuation that offsets the reserve change should be recognized as a realized change, the impact of the highly effective derivative relationship is reflected in the same reporting line (net income). By reporting in the same line (and not split between net income and surplus), an improved financial statement presentation illustrating the impact of the derivative is provided.

**81.80.** In addition to the improved presentation on the Summary of Operations, by requiring all fair value fluctuations attributable to the hedged risk to be recognized as a realized impact (regardless if the derivative instrument is open), it eliminates concerns with tracking and reclassifying fair value fluctuations (from unrealized to realized) when a derivative instrument is removed from a portfolio of hedging instruments either due to rebalancing efforts, or because the derivative has matured.
Pursuant to the guidance reflected in the issue paper, the following concepts are intended to be followed when allocating between unrealized and realized gain/loss recognition:

a. Realized: Fair value fluctuations in the hedging instruments attributable to the hedged risk that offset the current period change in the hedged item.

b. Realized: Amortization of fair value fluctuations in open or expired hedging instruments attributed to the hedged item that were recognized as deferred assets or deferred liabilities for a hedging program that continues to qualify under the standard.

c. Realized: Amortization of fair value fluctuations from expired hedging instruments attributed to the hedged item that were recognized as deferred assets or deferred liabilities for a hedging program that no longer qualifies within the standard, is no longer a highly effective hedge, or is a program that has been terminated by the reporting entity.

d. Unrealized: Fair value fluctuations in open (non-expired) hedging instruments that are not attributed to the hedged risk, or are from excluded derivative instrument components.

e. Unrealized: Amortization of fair value fluctuations in open (non-expired) hedging instruments attributed to the hedged item that were recognized as deferred assets or deferred liabilities for a hedging program that no longer qualifies within the standard, is no longer a highly effective hedge, or is a program that has been terminated by the reporting entity.

Derivative Income

This issue paper requires that all derivative income earned for all derivative instruments within scope of this guidance shall be reported as investment income.

U.S. GAAP derivative guidance is focused on income statement matching. As such, under U.S. GAAP, the “effective” portion of gains and losses on a derivative instrument is reported consistently between the hedging instrument and hedged item resulting with an exact offset to gains and losses attributed to the hedged risk. The “ineffective” portion directly affects earnings because there is no offsetting adjustment for the ineffective aspect of the gain or loss. Although the focus for statutory accounting is less on income statement matching, and more on the balance sheet impact of the hedged item and the derivative hedging instruments (reducing non-economic volatility), the gains and losses from offsetting fair values (between the derivative instrument and the hedged item) will be concurrently recognized as realized impacts, regardless if the derivative is still outstanding, to improve financial presentation in the Summary of Operations.

The provisions to recognize income earned is also consistent with the SSAP No. 86 guidance in situations in which the derivative is not combined with the hedged item. Pursuant to current guidance, periodic cash flows and accruals of income/expense are to be reported in a manner consistent with the hedged item, usually as net investment income or another appropriate caption within operating income. (SSAP No. 86 is drafted with an assumption that the hedged item is an asset, there is no guidance in SSAP No. 86 that reflects consideration of designating a liability as a hedged item.)

The cash flow guidance in SSAP No. 86 is different for situations in which the derivative is combined with the hedged item. Under that guidance, the income reported for the derivative on Schedule DB is zero, and the cash flows are to be reported with the hedged item instead of with the derivative. There are concerns with regards to this existing guidance (both in SSAP No. 86, as well as this issue paper), as income from derivative instruments would not be identifiable within the financial statements or Schedule DB. Although there is a perception that this allowance is not often elected under SSAP No. 86,
with the need for clear reporting under this special accounting provision, this approach is not presented as an option within this issue paper.

87.86. Comments received supported continuation of the concepts in SSAP No. 86, in which changes in the carrying value or cash flow of the derivative shall be recognized in the same period and in the same category of income or surplus as the amortization or fair value changes of the hedged item; e.g., net gain from operations, realized capital gains and losses on investments, unrealized capital gains and losses on investments, or unrealized foreign exchange capital gain or loss. The comments received also identify that as cash flows from swaps are included in the calculation of the hedged item (e.g., projected within AG 43VM-21), swap income will be accrued and recorded when it is earned consistently with the hedge item. This issue paper does not reflect these comments. Rather, consideration of income shall be recognized as earned, and be included as a factor in determining the recognition of fair value fluctuations in the derivative instruments (e.g., the degree of offset between the AG 43VM-21 liability and the fair value fluctuations impacting the recognition of deferred assets and deferred liabilities). It is anticipated that this approach will not result in material differences in the financial statements, but will allow for proper recognition of income when earned.

Disclosures

88.87. The disclosure requirements in this issue paper are intended to result in a new schedule (perhaps a new DB, or other supplement schedule), along with new financial statement disclosures (data-captured) that specifically address the hedging strategies and related derivatives within this issue paper. The disclosure requirements also envision a schedule for all hedging instruments, with information regarding the cost, fair value, realized/unrealized gains and losses, deferred assets and deferred liabilities, and the amortization schedule. The intent of the proposed disclosures is to provide clear, transparent information regarding the use and impact of this special accounting provision within the financial statements.

Effective Date and Transition

89.88. The guidance is proposed to be effective as of January 1, on a prospective basis, to allow for the change to be initially effective at the beginning of the year. (Staff Note – The effective date, and whether early application shall be permitted is contingent on SAPWG discussion.)

90.89. The guidance also requires prospective application to qualifying hedge programs that are in place on or after the effective date. This prospective application does not allow reporting entities to reverse previously recognized unrealized gains/losses from derivative instrument fair value fluctuations and recognize those fluctuations as deferred assets or deferred liabilities. Hedging transactions within scope of this guidance, which were in place prior to the effective date, would not have been considered effective hedges under SSAP No. 86—Derivatives. As such, unless the reporting entity had a permitted or prescribed practice for alternative accounting treatment, the hedging transactions within scope of this guidance should have been accounted for under the fair value method in SSAP No. 86. Any unrealized gains or unrealized losses recognized for a derivative instrument recognized prior to the application of this standard shall continue to be reflected, adjusted for other unrealized impacts from the derivative instrument required under this standard (e.g., excluded components of the hedging derivative) until the derivative has expired.

91-90. In the development of the issue paper, it was identified that some reporting entities had already received permitted and prescribed practices to incorporate concepts similar to what is permitted in this issue paper. Although the issue paper does not incorporate guidance to allow those practices to be automatically captured within scope (e.g., grandfathered), consideration has occurred on how those practices could be brought into the standard without reporting entities having to eliminate the results from those permitted or prescribed practices. (The immediate recognition of deferred assets and deferred
liabilities as unrealized gains and unrealized losses could have a significant impact on surplus.) After this consideration, the Working Group agreed that each reporting entity shall work with their domiciliary state regulator to determine the appropriate method in transitioning from previously approved permitted practices. The reporting entity shall include disclosure of the transition approach approved by the domiciliary state in their financial statements in the first year of application. After the effective date of this Statement, domiciliary state provisions that differ from this Statement must be disclosed as a permitted or prescribed practice pursuant to SSAP No. 1. With this consideration, the following options have been incorporated for reporting entities that previously received permitted or prescribed practices for qualifying hedge programs that resulted with the recognition of deferred assets/deferred liabilities:

92. Continue application of the prior program. This election will require approval by the state of domicile as a permitted or prescribed practice, with SSAP No. 1 disclosure.

93. Adjust the prior program to comply with the provisions within this standard. This election will require adjustments to the previously recognized deferred assets or deferred liabilities so that they adhere to the provisions within this standard. This election will require the reporting entity to capture an additional disclosure identifying the deferred assets and deferred liabilities recognized as of the effective date, as well as a schedule of amortization for those items. This disclosure shall continue separately from the other disclosures required under this standard until the deferred assets/liabilities recognized at initial application have been fully amortized. If the reporting entity fully adjusts the prior permitted/prescribed program to reflect the provisions within this standard, this election will not be considered a permitted or prescribed practice. If the adjusted program (and resulting deferred assets/deferred liabilities) do not adhere to the provisions within this standard, the program would continue to be considered a permitted or prescribed practice and require SSAP No. 1 disclosure.

94. Discontinue the prior program. This election would require the reporting entity to eliminate the effects of the prior permitted or prescribed program. (For example, any deferred assets or deferred liabilities recognized under the prior program would be fully eliminated with recognition to gains and losses accordingly.) After discontinuation, the reporting entity may elect to apply the provisions within this statement on a prospective basis for qualifying hedging programs in place on or after the effective date of the guidance (which could include re-designation of previously discontinued hedges).

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

95. SSAP No. 86—Derivatives establishes statutory accounting guidance for derivatives and hedging, income generation and replication (synthetic asset) using selected concepts from FAS 133, Accounting for Derivative Instruments and Hedging Activities. The concepts presented within this issue paper on what is permitted to receive “effective hedge treatment,” and the accounting for derivative instruments involved in a highly effective hedge, are distinctly different from the guidance in SSAP No. 86. For example, derivative instruments involving macro-hedges and dynamic (rebalancing) hedging instruments do not qualify for effective hedge accounting recognition under SSAP No. 86.

96. As indicated throughout this issue paper, this guidance establishes statutory accounting principles to address certain, limited derivative transactions hedging variable annuity guarantees subject to fluctuations as a result of interest rate sensitivity. Eligibility for the special accounting provision within this standard is strictly limited to variable annuity contracts and other contracts involving certain guaranteed benefits similar to those offered with variable annuities that are reserved for in accordance with Valuation Manual 21: Requirements for Principal-Based Reserves for Variable Annuities (VM-
21)\textsuperscript{17} Actuarial Guideline XLIII, CARVM for Variable Annuities (AG 43). The statutory accounting guidance within is considered a special accounting provision, only permitted if all the components in the standard are met, and shall not be inferred as an acceptable statutory accounting approach for situations that do not meet the stated qualifications or that are not specifically addressed within this guidance.

97.93. Applying the provisions within this issue paper is an election by the reporting entity. Although a reporting entity may have derivative transactions that would qualify within this issue paper guidance, a reporting entity is not required to follow the provisions within this standard. A reporting entity that did not elect to follow the special accounting provisions in this issue paper would continue to report their derivative transactions based on the SSAP No. 86 guidance. As the derivative instruments that qualify for effective hedges in this issue paper would not qualify as effective hedges under SSAP No. 86, a reporting entity that follows the SSAP No. 86 guidance would be required to report these derivative instruments under the fair value accounting method. (This method requires the derivative instruments to be reported at fair value, with changes in the fair value reported as unrealized gains or losses.)

U.S. Generally Accepted Accounting Principles

98.94. U.S. GAAP guidance for derivatives is currently captured in Accounting Standards Codification Topic 815. The U.S. GAAP derivative guidance is based on four cornerstones (ASC 815-10-10-1):

a. Derivative instruments represent rights or obligations that meet the definitions of assets or liabilities and should be reported on the financial statements.

In making this decision, the FASB noted that derivatives are assets or liabilities because they represent rights or obligations and that recognizing those assets and liabilities will make financial statements more complete and more informative. The FASB noted that prior to FAS 133, many derivatives were off-balance-sheet, because, unlike conventional financial instruments (such as stocks, bonds and loans), derivatives often reflect at their inception only a mutual exchange of promises with little or no transfer of tangible consideration. 

b. Derivative instruments should be measured at fair value, and adjustments to the carrying amount of hedged items should reflect changes in their fair value (that is gains or losses) that are attributable to the risk being hedged and that arise while the hedge is in effect.

In making this decision, the FASB identified that fair value is the only relevant measurement attribute for derivatives. They noted that amortized cost is not a relevant measure for derivatives because the historical cost of a derivative often is zero, yet a derivative can be settled or sold at any time for an amount equivalent to its fair value. The reasoning for “held to maturity” instruments being held at amortized cost, was noted as not suitable for derivatives. 

FAS 133, BOC – Paragraph 223.

c. Only items that are assets or liabilities should be reported in the financial statements.

In making this decision, the FASB identified that derivatives are assets and liabilities, but the gains and losses that result in changes in the fair value of derivatives are not separate assets or liabilities because they have none of the essential characteristics of assets or

\textsuperscript{17} Actuarial Guideline XLIII, CARVM for Variable Annuities (AG 43) shall apply in states that have not adopted the Valuation Manual.
liabilities. The FASB identified that the act of designating a derivative as a hedging instrument does not convert a subsequent loss or gain into an asset or a liability. A loss is not an asset because no future economic benefit is associated with it. The loss cannot be exchanged for cash, a financial asset, or a nonfinancial asset used to produce something of value, or used to settle liabilities. Similarly, a gain is not a liability because no obligation exists to sacrifice assets in the future. *FAS 133, BOC – 229.*

d. Special accounting for items designated as being hedged should be provided only for qualifying items. One aspect of qualification should be an assessment of the expectation of effective offsetting changes in fair value or cash flows during the term of the hedge for the risk being hedged.

In making this decision, the FASB noted that a primary purpose of hedge accounting is to link items or transactions whose changes in fair values or cash flows are expected to offset each other. The FASB decided that one of the criteria for qualification for hedge accounting should focus on the extent to which offsetting changes in fair values or cash flows on the derivative and the hedged item or transaction during the term of the hedge are expected and ultimately achieved. *FAS 133, BOC – 230.*

Pursuant to the four cornerstones, as well as other components of the U.S. GAAP guidance, the provisions in this issue paper are not considered to be consistent with U.S. GAAP. Similar to SSAP No. 86, derivative instruments allowed to be considered part of an effective hedge under this issue paper, would not qualify to be considered part of an effective hedge under U.S. GAAP.

**Key Elements of U.S. GAAP Guidance:** (Only relevant excerpts are included.)

a. An entity shall recognize all of its derivative instruments in its statement of financial position as either assets or liabilities depending on the rights and obligations under the contracts. (815-10-25-1)

b. All derivative instruments shall be measured initially at fair value. (815-10-30-1)

c. All derivative instruments shall be measured subsequently at fair value. (815-10-35-1)

d. Forward contracts and purchased options within the scope of “Certain Contracts on Debt and Equity Securities” shall, at inception, be designated as held to maturity, available for sale, or trading in a manner consistent with the accounting prescribed for that category of securities. Such forward and option contracts are not eligible to be hedging instruments. (815-10-25-17)

e. Unless offsetting guidance is met (210-20-45-1), fair value of derivative instruments in a loss position shall not be offset against the fair value of derivative instruments in a gain position. (815-10-45-4)

f. An embedded derivative shall be separated from the host contract and accounted for as a derivative instrument if, and only if, the following criteria are met:

i. The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.

ii. The hybrid instrument is not remeasured at fair value under otherwise applicable GAAP with changes in fair value reported in earnings as they occur.
iii. A separate instrument with the same terms as the embedded derivative would be a derivative instrument. (815-15-25-1)

g. Concurrent designation and documentation of a hedge is critical; without it, an entity could retroactively identify a hedged item, a hedged transaction, or a method of measuring effectiveness to achieve a desired accounting result. To qualify for hedge accounting, there shall be, at inception of the hedge, formal documentation of specific elements. (815-20-25-3)

h. An asset or liability is eligible for designation as a hedged item in a fair value hedge if all of the following additional criteria are met. (Only including key excerpts) (815-20-25-12)

i. The hedged item presents an exposure to changes in fair value attributable to the hedged risk that could affect reported earnings.

ii. If the hedged item is all or a portion of a debt security (or a portfolio of similar debt securities) that is classified as held to maturity in accordance with Topic 320, the designated risk being hedged is the risk of changes in its fair value attributable to credit risk, foreign exchange risk or both.

i. Gains and losses on fair value hedges shall be accounted for as follows: (815-25-35-1)

i. The gain or loss on the hedging instrument shall be recognized currently in earnings.

ii. The gain or loss (that is, the change in fair value) on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedging item and be recognized currently in earnings.

If the fair value is fully effective, the gain or loss on the hedging instrument, adjusted for the component (if any) of that gain or loss that is excluded from the assessment of effectiveness under the defined risk management strategy for that particularly hedging relationship, is attributable to the hedged risk. Any difference that would arise would be the effect of hedge ineffectiveness, which consequently is recognized currently in earnings. (815-25-35-2)

International Financial Reporting Standards

401.97. Although International Financial Reporting Standards do not have guidance permitting effective hedge treatment as presented in this issue paper, the International Accounting Standards Board (IASB) is currently working on a similar project “Accounting for Dynamic Risk Management: A Portfolio Revaluation Approach to Macro Hedging.” In April 2014, the IFRS released a Discussion Paper as a first step in developing an accounting model for dynamic risk management.

402.98. The objectives of the IFRS project is to simplify and improve the usefulness of financial statements by developing accounting requirements for hedging within the context of open portfolios that are more closely aligned with a company’s risk management activities. The IFRS identified, as a primary driver for initiating the project, the problems associated with applying hedge accounting, which is a fundamentally static concept (linking hedged instruments to hedged items) to dynamic risk management of open portfolios. As such, the IFRS decided to consider a new model for dynamic risk management of open portfolios.
The IASB is currently considering comments received on the exposed Discussion Paper, however, in reviewing project updates, it is anticipated that the IASB will re-issue a revised Discussion Paper for comment before even considering an exposure draft. (This is partly due to the original Discussion Paper focusing on interest rate risk management at banks, and commenters requested additional focus on the management of interest rate risk and other risks within non-bank entities.) As such, there is no expected timeframe for completion of this project at the IASB. This project is considered to be in the early stages, and it is anticipated to take a significant time before a standard is issued. In reviewing comments received by the IASB, some commenters included reference to insurance contracts, identifying that the need for a portfolio accounting model is needed to avoid accounting mismatches. These commenters supported the inclusion of hedged risks within insurance contracts being included in the IASB’s dynamic risk management project.
August 2018 Exposed revisions to SSAP No. 61R and Appendix A-791

Note, as the full agenda item is over 35 pages only exposed revisions were included the materials.

On August 4, 2018, the Statutory Accounting Principles (E) Working Group:

1. Exposed nonsubstantive revisions to SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance to incorporate disclosures. The proposed revisions also update the question-and-answer guidance in Appendix A-791—Life and Health Reinsurance Agreements to clarify the applicability of A-791. Note that the exposure includes a request for comments on whether the proposed disclosures adequately address the Financial Analysis (E) Working Group referral. See attachment

These revisions were recommended by the Informal Life and Health Drafting Group. The revisions to Appendix A-791 Q&A assist with further defining the applicability of the Appendix. The informal drafting group will continue to work on revisions to the SSAP No. 61R—Life and Health Reinsurance, and the Statutory Accounting Principles (E) Working Group requests comments on the exposed A-791 revisions to assist the informal drafting group in developing revisions for Working Group consideration. In addition, the drafting group recommended SSAP No. 61R disclosures for exposure also with specific noted questions to assist with the drafting group’s work.

Comments are requested on the following items related to the exposed SSAP No. 61R disclosures:

1. The drafting group discussion determined that the prior exposure for SSAP No. 61R, paragraph 83, which was based on SSAP No. 62, paragraph 94 with modifications to be consistent with A-791 was repetitive on compliance with A-791. The subgroup reviewed existing paragraph 94 a-d, in SSAP No. 62R and determined it was not useful in the context of SSAP No. 61R. Regulator and industry input is requested on any additional contract features that should be identified for disclosure.

2. The FAWG, requested disclosures similar to existing disclosures in SSAP No. 62R—Property and Casualty Reinsurance for SSAP No. 61R. However, the existing SSAP No. 62R disclosures could not copied into SSAP No. 61R exactly because of variations between product types and the Appendix A-791. Regulator input is requested regarding whether proposed disclosures would be sufficient to address regulatory concerns and or the FAWG request.

3. Comments are requested regarding contracts identified for disclosure in paragraph 85 should be identified in the annual statement reinsurance schedule S with a signifier to avoid repeating details in the annual statement note, which may be in the statement schedule.

The Informal Life and Health Drafting Group is not recommending adoption of these revisions until the other revisions to the guidance in SSAP No. 61R are developed.

1. The two Appendix A-791 question and answers exposed revisions:

a. Appendix A-791 Life and Health Reinsurance Agreements proposed Q/A 1 revisions - The informal life and health reinsurance-drafting group identified that the existing phrase “certain non-proportional reinsurance arrangements” in the current A-791 could benefit from additional guidance to promote consistent application. The proposed revisions to the answer below are to help identify non-proportional contracts, which are not subject to the Appendix A-791. (Drafting Note: Bolding added for ease of review will not be in the final draft)
1. This Appendix shall not apply to assumption reinsurance, yearly renewable term reinsurance or certain non-proportional reinsurance such as stop loss or catastrophe reinsurance.

Q – Aside from assumption reinsurance, what other types of reinsurance are exempt from the accounting requirements?

A – Yearly renewable term (YRT) and certain nonproportional reinsurance arrangements, such as stop loss and catastrophe reinsurance are exempt because these do not normally provide significant surplus relief and therefore are outside the scope of this Appendix. If a catastrophe arrangement takes a reserve credit for actual losses beyond the attachment point or the unearned premium reserve (UPR) of the current year's premium, there will most likely be no regulatory concern.

Similarly, if a YRT treaty provides incidental reserve credits for the ceding insurer's net amount at risk for the year with no other allowance to enhance surplus, there will most likely be no regulatory concern. For purposes of this exemption, a treaty labeled as YRT does not meet the intended definition of YRT if the surplus relief in the first year is greater than that provided by a YRT treaty with zero first year reinsurance premium and no additional allowance from the reinsurer.

Additional pertinent information applicable to all YRT treaties and to non-proportional reinsurance arrangements is contained in paragraphs 19 and 20 of SSAP No. 61R.

To further elaborate on the phrase "certain non-proportional reinsurance" in paragraph 1, the beginning of the answer notes that contracts such as stop-loss and catastrophe do not normally provide significant surplus relief, and are therefore not subject to the accounting guidance in Appendix A-791. Non-proportional reinsurance agreements are considered not to provide significant surplus relief if they possess all of the following features. For the purposes of defining these features, the term “triggering event” means the event or sequence of events that would lead to a loss being reimbursable by the reinsurer pursuant to the terms of the reinsurance agreement.

1. The triggering event has not occurred at the time of the inception of the reinsurance agreement.
2. The triggering event is materially less likely than not to occur during each settlement period of the reinsurance agreement.
3. There is no initial reinsurance credit for ceded policy reserves and any reinsurance expense allowance or commission is reported so that surplus is not impacted until the related premium is reported as earned.

These criteria shall be evaluated separately for each measurement period under the reinsurance agreement, where the measurement period is that period of time for which the direct writer’s experience is used to determine the amounts owed to and from the reinsurer. If there are carry-forwards of experience debits or credits from one calendar year to the next, then those multiple years will be considered one settlement period.

The fact that the triggering event does eventually occur, is not itself evidence that the second criterion above has not been met. The criterion should be evaluated based on reasonable expectations rather than posteriori results.

b. The new Appendix A-791 question and answer proposed for exposure is regarding business that has a statutorily required medical loss ratio or similar refund / rebate.
August 2018 Exposed revisions to SSAP No. 61R and Appendix A-791

Q: If a company cedes health insurance business that is subject to a Medical Loss Ratio (MLR), or similar statutorily required refunds / rebates, must the reinsurer participate in the payment of any refunds / rebates?

A: The reinsurer needs to participate in the payment of its share of any statutorily required MLR or similar refund or rebate based on loss ratio calculations to the extent that the experience of the health business reinsured, during the period that it is reinsured, contributes to the calculation of the refund. Although the payment of such a refund based on the experience of business that is currently reinsured could result in a reduction of surplus on the part of the ceding insurer, if the reduction in surplus of the ceding insurer is entirely attributable to the experience prior to the effective date of the reinsurance, then it is outside of the contract requirements. Accordingly, such a provision should not cause a reinsurance agreement to be out of compliance with Appendix A-791 of the Accounting Practices and Procedure Manual. It is recognized that some refund calculations may involve multiple years.

Furthermore, just as an experience refund is not considered in the determination as to whether a reinsurance agreement is proportional, the requirement for the payment of a refund to policyholders based on a Medical Loss Ratio requirement should also not be considered.

Note: This Q&A only applies to refunds related to a statutory MLR or similar refund or rebate requirement for health insurance and should not be applied to any other situation.

2. Exposed SSAP No. 61R—Life and Health Reinsurance disclosures – These disclosures are proposed to replace the previously exposed disclosures, which were exposed in August 2018. The disclosures are to address the request from the Financial Analysis (E) Working Group for life and health reinsurance contracts to have disclosure, which identify contracts with certain features including, risk limiting features. The FAWG, requested disclosures similar to existing disclosures in SSAP No. 62R—Property and Casualty Reinsurance for SSAP No. 61R. However, the existing SSAP No. 62R disclosures could not copied into SSAP No. 61R exactly because of variations between product types and the Appendix A-791.

Comments Requested- Comments are specifically requested on the following:

1. The drafting group discussion determined that the prior exposure for SSAP No. 61R, paragraph 83, which was based on SSAP No. 62, paragraph 94 with modifications to be consistent with A-791 was repetitive on compliance with A-791. The subgroup reviewed existing paragraph 94 a-d, in SSAP No. 62R and determined it was not useful in the context of SSAP No. 61R. Regulator and industry input is requested on any additional contract features that should be identified for disclosure.

2. The FAWG, requested disclosures similar to existing disclosures in SSAP No. 62R—Property and Casualty Reinsurance for SSAP No. 61R. However, the existing SSAP No. 62R disclosures could not copied into SSAP No. 61R exactly because of variations between product types and the Appendix A-791. Regulator input is requested regarding whether proposed disclosures would be sufficient to address regulatory concerns and or the FAWG request.

3. Comments are requested regarding contracts identified for disclosure in paragraph 85 should be identified in the annual statement reinsurance schedule S with a signifier to avoid repeating details in the annual statement note, which may be in the statement schedule.

81. Disclosures for paragraphs 82-87, which are required to be included with the annual audit report financial statements beginning with the period ended December 31, 201X regarding
reinsurance contracts. The disclosures required within paragraphs 82-87 shall be included in accompanying supplemental schedules of the annual audit report beginning in year-end 201X. These disclosures shall be limited to reinsurance contracts entered into, renewed or amended on or after January 1, 1996. This limitation applies to the annual audit report only and does not apply to the statutory annual statement interrogatories and the reinsurance summary supplemental filing. (Drafting Note: From SSAP No. 62R, paragraph 92)

82. Disclose any reinsurance contracts (or multiple contracts with the same reinsurer or its affiliates) subject to A-791 that includes a provision, which limits the reinsurer’s assumption of significant risks identified as in A-791. Examples of risk limiting features include provisions such as a deductible, a loss ratio corridor, a loss cap, an aggregate limit or similar effect. If true, indicate the number of reinsurance contracts to which such provisions apply. For contracts subject A-791, indicate if deposit accounting was applied for all contracts, which limit significant risks. (Drafting Note: Similar to SSAP No. 62R, paragraph 93, and is also relevant to A-791 evaluations.)

83. Disclose any reinsurance contracts (or multiple contracts with the same reinsurer or its affiliates) not subject to A-791, for which reinsurance accounting was applied and includes a provision that limits the reinsurer’s assumption of risk. Examples of risk limiting features include provisions such as a deductible, a loss ratio corridor, a loss cap, an aggregate limit or similar effect. If true, indicate the number of reinsurance contracts to which such provisions apply. If affirmative, indicate if the reinsurance credit was reduced for the risk limiting features. (Drafting Note: Similar to SSAP No. 62R, paragraph 93.)

84. Disclose if any reinsurance contracts which contain features (except reinsurance contracts with a federal or state facility) described below which result in delays in payment in form or in fact:

a. Provisions which permit the reporting of losses, or settlements are made, less frequently than quarterly or payments due from the reinsurer are not made in cash within ninety (90) days of the settlement date (unless there is no activity during the period). (Drafting Note: From SSAP No. 62R, paragraph 94.e. and Appendix A-791, paragraph 2.e.)

b. Payment schedule, accumulating retentions from multiple years or any features inherently designed to delay timing of the reimbursement to the ceding entity. (Drafting Note: From SSAP No. 62R, paragraph 94.f., also relevant to risk transfer guidance in SSAP No. 61R)

85. Disclose if the reporting entity has reflected reinsurance accounting credit for any contracts not subject Appendix A-791 and not yearly renewable term, which meet the risk transfer requirements of SSAP No. 61R and identify the type of contracts and the reinsurance contracts.

a. Assumption Reinsurance – new for the reporting period.

b. Non-proportional reinsurance, which does not result in significant surplus relief. If yes, indicate if the insured event(s) triggering contract coverage has been recognized.

86. Disclose if the reporting entity ceded any risk which is not subject to A-791 and not yearly renewable term reinsurance, under any reinsurance contract (or multiple contracts with the same reinsurer or its affiliates) during the period covered by the financial statement, and either: (Drafting Note: From SSAP No. 62R, paragraph 97)
August 2018 Exposed revisions to SSAP No. 61R and Appendix A-791

a. Accounted for that contract as reinsurance under statutory accounting principles (“SAP”) and as a deposit under generally accepted accounting principles (“GAAP”); or

b. Accounted for that contract as reinsurance under GAAP and as a deposit under SAP.

87. If affirmative disclosure is required for paragraph 86, explain why the contract(s) is treated differently for GAAP and SAP. (Drafting Note: From SSAP No. 62R, paragraph 98)

Drafting Note - These disclosures are expected to begin at existing paragraph 77 in SSAP No. 61R. The paragraph numbering exposed is based on the August 2017 exposure of the SSAP No. 61R, which proposed other new paragraphs, which are under review by the informal life and health drafting group.
This page intentionally left blank.
Exposure Draft
SSAP No. 62R—Property and Casualty Reinsurance

Hearing Date: 2018 Fall National Meeting or Interim Conference Call
Location: 2018 Fall National Meeting or Interim Conference Call
Deadline for Written Notice of Intent to Speak: October 5, 2018
Deadline for Receipt of Written Comments: October 5, 2018

Notice of Public Hearing and Request for Written Comments

Basis for hearings. The Statutory Accounting Principles Working Group (SAPWG) will hold a public hearing to obtain information from and views of interested individuals and organizations about the standards proposed in this Exposure Draft. The SAPWG will conduct the hearing in accordance with the National Association of Insurance Commissioners (NAIC) policy statement on open meetings. An individual or organization desiring to speak must notify the NAIC in writing by October 5, 2018. Speakers will be notified as to the date, location, and other details of the hearings.

Oral presentation requirements. The intended speaker must submit a position paper, a detailed outline of a proposed presentation or comment letter addressing the standards proposed in the Exposure Draft by October 5, 2018. Individuals or organizations whose submission is not received by that date will only be granted permission to present at the discretion of the SAPWG chair. All submissions should be addressed to the NAIC staff at the address listed below.

Format of the hearings. Speakers will be allotted up to 10 minutes for their presentations to be followed by a period for answering questions from the SAPWG. Speakers should use their allotted time to provide information in addition to their already submitted written comments as those comments will have been read and analyzed by the SAPWG. Those submissions will be included in the public record and will be available at the hearings for inspection.

Copies. Exposure Drafts can be obtained on the Internet at the NAIC Home Page (http://www.naic.org). The documents can be downloaded using Microsoft Word.

Written comments. Participation at a public hearing is not a prerequisite to submitting written comments on this Exposure Draft. Written comments are given the same consideration as public hearing testimony.

The Statutory Accounting Principles Statement of Concepts was adopted by the Accounting Practices & Procedures (EX4) Task Force on September 20, 1994, in order to provide a foundation for the evaluation of alternative accounting treatments. All issues considered by the SAPWG will be evaluated in conjunction with the objectives of statutory reporting and the concepts set forth in the Statutory Accounting Principles Statement of Concepts. Whenever possible, establish a relationship between your comments and the principles defining statutory accounting.

The exposure period is not meant to measure support for, or opposition to, a particular accounting treatment but rather to accumulate an analysis of the issues from other perspectives and persuasive comments supporting them. Therefore, form letters and objections without valid support for their conclusions are not helpful in the deliberations of the working group. Comments should not simply register your agreement or disagreement without a detailed explanation, a description of the impact of the proposed guidelines, or possible alternative recommendations for accomplishing the regulatory objective.

Any individual or organization may send written comments addressed to the Working Group to the attention of Julie Gann at jgann@naic.org, Robin Marcotte at rmarcotte@naic.org, Fatima Sediqzad at fsediqzad@naic.org and Jake Stultz at jstultz@naic.org no later than October 5, 2018. Electronic submission is preferred Robin Marcotte is the NAIC Staff that is the project lead for this topic.

National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500, Kansas City, MO 64106-2197
(816) 842-3600
This page intentionally left blank.
Drafting Note: Drafting notes are descriptive to facilitate review. Most of the suggested revisions incorporate guidance from EITF D-035 which relates to EITF 93-6 which is adopted with modification in SSAP No. 62R. Some revisions suggest moving items from the existing SSAP No. 62R, Exhibit A which is based on EITF D-034. Gray shading reflects modifications to ASC language which are illustrated for ease of review.

Statement of Statutory Accounting Principles No. 62 - Revised

Property and Casualty Reinsurance

STATUS

Type of Issue ...................................... Common Area
Issued............................................... Finalized March 13, 2000; Substantively revised December 5, 2009, and December 18, 2012
Effective Date .................................... January 1, 2001; Substantive revisions in paragraphs 34, 36, e., 84, 84102-105 and 99120 (detailed in Issue Paper No. 137) effective January 1, 2010; Certified reinsurer changes effective December 31, 2012
Affects ............................................... Supersedes SSAP No. 75 with guidance incorporated August 2011; Nullifies and incorporates INT 02-06 and INT 02-09
Affected by ........................................ No other pronouncements
Interpreted by ..................................... INT 02-22; INT 03-02
Relevant Appendix A Guidance........... A-440; A-785
Funds Held Under Reinsurance Treaties ................................................................. 21
Provision for Reinsurance ..................................................................................... 21
Asbestos and Pollution Contracts – Counterparty Reporting Exception ............... 21
Syndicated Letters of Credit ................................................................................... 22
Disputed Items ....................................................................................................... 23
Uncollectible Reinsurance ..................................................................................... 23
Commutations ....................................................................................................... 23
National Flood Insurance Program ....................................................................... 23
Accounting for the Transfer of Property and Casualty Run-Off Agreements ....... 24
Disclosures ............................................................................................................ 25
Relevant Literature ............................................................................................... 29
Effective Date and Transition ............................................................................... 31
REFERENCES ....................................................................................................... 32
Relevant Issue Papers ......................................................................................... 32
CLASSIFYING REINSURANCE CONTRACTS .................................................... 33
EXHIBIT A – IMPLEMENTATION QUESTIONS AND ANSWERS ....................... 34
EXHIBIT B – P&C RUNOFF REINSURANCE TRANSACTIONS ....................... 47
EXHIBIT C – ILLUSTRATION OF A REINSURANCE CONTRACT THAT IS ACCOUNTED FOR AS A DEPOSIT USING THE INTEREST METHOD ........................................... 47
Property and Casualty Reinsurance

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for property and casualty reinsurance. A wide range of methods for structuring reinsurance arrangements can be employed depending on the requirements of individual companies. This statement deals with the more commonly employed methods.

SUMMARY CONCLUSION

General

2. Reinsurance is the assumption by an insurer of all or part of a risk undertaken originally by another insurer. The transaction whereby a reinsurer cedes all or part of the reinsurance it has assumed to another reinsurer is known as a retrocession.

3. Reinsurance has many beneficial purposes. Among them are that it enables an insurance entity to (a) expand its capacity, (b) share large risks with other insurers, (c) spread the risk of potential catastrophes and stabilize its underwriting results, (d) finance expanding volume by sharing the financial burden of reserves, (e) withdraw from a line or class of business, and (f) reduce its net liability to amounts appropriate to its financial resources.

4. Reinsurance agreements are generally classified as treaty or facultative. Treaty reinsurance refers to an arrangement involving a class or type of business written, while facultative reinsurance involves individual risks offered and accepted.

- Drafting Note: The definition below is shortened from the August 2017 exposure based on comments received and drafting group recommendations.

5. Reinsurance coverage can be pro rata (i.e., proportional reinsurance) where the reinsurer shares a pro rata portion of the losses and in the same proportion as it shares premium of the ceding entity or excess of loss (i.e., non-proportional) where the reinsurer, subject to a specified limit, indemnifies the ceding entity against the amount of loss in excess of a specified retention. Most reinsurance agreements fall into one of the following categories:

a. Treaty Reinsurance Contracts—Pro Rata:
   i. Quota Share Reinsurance—The ceding entity is indemnified against a fixed percentage of loss on each risk covered in the agreement;
   ii. Surplus Share Reinsurance—The ceding entity establishes a retention or “line” on the risks to be covered and cedes a fraction or a multiple of that line on each policy subject to a specified maximum cession;

b. Treaty Reinsurance Contracts—Excess of Loss:
   i. Excess Per Risk Reinsurance—The ceding entity is indemnified, subject to a specified limit, against the amount of loss in excess of a specified retention with respect to each risk covered by a treaty;
   ii. Aggregate Excess of Loss Reinsurance—The ceding entity is indemnified against the amount by which the ceding entity’s net retained losses incurred during a
specific period exceed either a predetermined dollar amount or a percentage of the entity’s subject premiums for the specific period subject to a specified limit;

c. Treaty Reinsurance Contracts—Catastrophe: The ceding entity is indemnified, subject to a specified limit, against the amount of loss in excess of a specified retention with respect to an accumulation of losses resulting from a catastrophic event or series of events;

d. Facultative Reinsurance Contracts—Pro Rata: The ceding entity is indemnified for a specified percentage of losses and loss expenses arising under a specific insurance policy in exchange for that percentage of the policy’s premium;

e. Facultative Reinsurance Contracts—Excess of Loss: The ceding entity is indemnified, subject to a specified limit, for losses in excess of its retention with respect to a particular risk.

Characteristics of Reinsurance Agreements

6. Common contract provisions that may affect accounting practices include:
   a. Reporting responsibility of the ceding entity—Details required and time schedules shall be established;
   b. Payment terms—Time schedules, currencies intended, and the rights of the parties to withhold funds shall be established;
   c. Payment of premium taxes—Customarily the responsibility of the ceding entity, a recital of nonliability of the reinsurer may be found;
   d. Termination—May be on a cut-off or run-off basis. A cut-off provision stipulates that the reinsurer shall not be liable for loss as a result of occurrences taking place after the date of termination. A run-off provision stipulates that the reinsurer shall remain liable for loss under reinsured policies in force at the date of termination as a result of occurrences taking place after the date of termination until such time as the policies expire or are canceled; and
   e. Insolvency clause—Provides for the survival of the reinsurer’s obligations in the event of insolvency of the ceding entity, without diminution because of the insolvency.

7. Reinsurance contracts shall not permit entry of an order of rehabilitation or liquidation to constitute an anticipatory breach by the reporting entity, nor grounds for retroactive revocation or retroactive cancellation of any contracts of the reporting entity.

Required Terms for Reinsurance Agreements

8. In addition to credit for reinsurance requirements applicable to reinsurance transactions generally, no credit or deduction from liabilities shall be allowed by the ceding entity for reinsurance recoverable where the agreement was entered into after the effective date of these requirements (see paragraphs 108, 129, and 130) unless each of the following conditions is satisfied:
   a. The agreement must contain an acceptable insolvency clause;
b. Recoveries due the ceding entity must be available without delay for payment of losses and claim obligations incurred under the agreement, in a manner consistent with orderly payment of incurred policy obligations by the ceding entity;

c. The agreement shall constitute the entire contract between the parties and must provide no guarantee of profit, directly or indirectly, from the reinsurer to the ceding entity or from the ceding entity to the reinsurer;

d. The agreement must provide for reports of premiums and losses, and payment of losses, no less frequently than on a quarterly basis, unless there is no activity during the period. The report of premiums and losses shall set forth the ceding entity’s total loss and loss expense reserves on the policy obligations subject to the agreement, so that the respective obligations of the ceding entity and reinsurer will be recorded and reported on a basis consistent with this statement;

e. The agreement must include a proper reinsurance intermediary clause, if applicable, which stipulates that the credit risk for the intermediary is carried by the assuming insurance entity;

f. With respect to reinsurance contracts involving a certified reinsurer, the agreement must include a proper funding clause, which requires the certified reinsurer to provide and maintain security in an amount sufficient to avoid the imposition of any financial statement penalty on the ceding insurance entity for reinsurance ceded to the certified reinsurer. However, this does not preclude negotiation for higher contractual collateral amounts; and

g. With respect to retroactive reinsurance agreements, the following additional conditions apply:

i. The consideration to be paid by the ceding entity for the retroactive reinsurance must be a sum certain stated in the agreement;

ii. Direct or indirect compensation to the ceding entity or reinsurer is prohibited;

iii. Any provision for subsequent adjustment on the basis of actual experience in regard to policy obligations transferred, or on the basis of any other formula, is prohibited in connection with a retroactive reinsurance transaction, except that provision may be made for the ceding entity’s participation in the reinsurer’s ultimate profit, if any, under the agreement;

iv. A retroactive reinsurance agreement shall not be canceled or rescinded without the approval of the commissioner of the domiciliary state of the ceding entity.

Reinsurance Agreements with Multiple Cedents

9. Reinsurance agreements with multiple cedents require allocation agreements. The allocation agreement can be part of the reinsurance agreement or a separate agreement. If the agreement has multiple cedents:

a. The allocation must be in writing and

b. The terms of the allocation agreement must be fair and equitable.
10. The essential ingredient of a reinsurance contract is the transfer of risk. The essential element of every true reinsurance agreement is the undertaking by the reinsurer to indemnify the ceding entity, i.e., reinsured entity, not only in form but in fact, against loss or liability by reason of the original insurance. Unless the agreement contains this essential element of risk transfer, no credit shall be recorded. (INT 02-22)

11. Insurance risk involves uncertainties about both (a) the ultimate amount of net cash flows from premiums, commissions, claims, and claims settlement expenses (underwriting risk) and (b) the timing of the receipt and payment of those cash flows (timing risk). Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous—the possibility of adverse events occurring is outside the control of the insured.

12. Determining whether an agreement with a reinsurer provides indemnification against loss or liability (transfer of risk) relating to insurance risk requires a complete understanding of that contract and other contracts or agreements between the ceding entity and related reinsurers. A complete understanding includes an evaluation of all contractual features that (a) limit the amount of insurance risk to which the reinsurer is subject (e.g., experience refunds, cancellation provisions, adjustable features, or additions of profitable lines of business to the reinsurance contract) or (b) delay the timely reimbursement of claims by the reinsurer (e.g., payment schedules or accumulating retentions from multiple years). (Drafting Note: from 944-20-15-40 from FAS 113, paragraph 8)

13. Indemnification of the ceding entity against loss or liability relating to insurance risk in reinsurance requires both of the following:

   a. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance agreements; and

   b. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

The conditions are independent and the ability to meet one does not mean that the other has been met. A substantive demonstration that both conditions have been met is required for a short-duration contract to transfer risk. (Drafting Note - Source 944-20-15-41 Reinsurance of Short-Duration Contracts from EITF D-035 paragraph 10.)

14. The reference in (a) in the preceding paragraph 13.a. acknowledges that a ceding entity may reinsure only part of the risks associated with the underlying contracts. For example, a proportionate share of all risks or only specified risks may be reinsured. The conditions for reinsurance accounting are evaluated in relation to the reinsured portions of the underlying insurance contracts, rather than all aspects of those contracts. (Drafting Note – Source 944-20-15-42 Reinsurance of Short-Duration Contracts from FAS 113, paragraph 62. Per 5-2-18 discussion kept for clarity/ match GAAP.)
15. The word timely is used in paragraph 12 in the ordinary temporal sense to refer to the length of time between payment of the underlying reinsured claims and reimbursement by the reinsurer. While the test for reasonable possibility of significant loss to the reinsurer provides for a present-value-based assessment of the economic characteristics of the reinsurance contract, the concept of timely reimbursement relates to the transfer of insurance risk (the condition in paragraph 13.a.), not the reasonable possibility of significant loss (the condition in paragraph 13.b.). Accordingly, timely reimbursement shall be evaluated based solely on the length of time between payment of the underlying reinsured claims and reimbursement by the reinsurer. (Drafting Note: Moves existing SSAP No. 62 Exhibit A question 19 to provide detail on the word “timely” to be consistent with GAAP. Source 944-20-15-48 from EITF D-034, paragraph 22).

14. Whether underwriting risk has transferred to the reinsurer depends on how much uncertainty about the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract has been transferred to the reinsurer. A reinsurer shall not have assumed significant insurance risk under the reinsured contracts if the probability of a significant variation in either the amount or timing of payments by the reinsurer is remote. Implicit in this condition is the requirement that both the amount and timing of the reinsurer’s payments depend on and directly vary with the amount and timing of claims settled by the ceding entity. Accordingly, the significance of the amount of underwriting risk transferred shall be evaluated in relation to the ceding entity's claims payments. Contractual provisions that delay timely reimbursement to the ceding entity prevent this condition from being met. (Drafting Note: Source 944-20-15-46 Significant Insurance Risk from FAS 113, paragraph 9. Additional new wording Source 944-20-15-47 Reinsurance of Short-Duration Contracts from EITF D-035, paragraph 11.)

15. The ceding entity’s evaluation of whether it is reasonably possible for a reinsurer to realize a significant loss from the transaction shall be based on the present value of all cash flows between the ceding and assuming companies under reasonably possible outcomes, without regard to how the individual cash flows are described or characterized. An outcome is reasonably possible if its probability is more than remote. The same interest rate shall be used to compute the present value of cash flows for each reasonably possible outcome tested. A constant interest rate shall be used in determining those present values because the possibility of investment income varying from expectations is not an element of insurance risk. Judgment is required to identify a reasonable and appropriate interest rate. To be reasonable and appropriate, that interest rate shall reflect both of the following:

a. The expected timing of payments to the reinsurer
b. The duration over which those cash flows are expected to be invested by the reinsurer

• Drafting Note: This revision moves existing SSAP No. 62R Exhibit A, questions 16 to paragraph 17 to more closely match the risk transfer wording in GAAP. Source 944-20-15-49 based on EITF D-034, paragraph 19.

16. Significance of loss shall be evaluated by comparing the present value of all cash flows, determined as described in paragraph 15, with the present value of the amounts paid or deemed to have been paid to the reinsurer. (Drafting Note: Source 944-20-15-51, some concepts in the remainder of the ASC paragraph are in the -SSAP No. 62R Exhibit A.) If, based on this comparison, the reinsurer is not exposed to the reasonable possibility of significant loss, the ceding entity shall be considered indemnified against loss or liability relating to insurance risk only if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance agreements has been assumed by the reinsurer. In this narrow circumstance, the reinsurer's economic position is virtually equivalent to having written the insurance contract directly. This condition is met only if insignificant insurance risk is retained by the ceding entity on the reinsured portions of the underlying insurance contracts, so that the reinsurer's
exposure to loss is essentially the same as the reporting entity's. The assessment of that condition shall be made by comparing both of the following:

a. The net cash flows of the reinsurer under the reinsurance contract

b. The net cash flows of the ceding entity on the reinsured portions of the underlying insurance contracts

If the economic position of the reinsurer relative to the insurer cannot be determined, the contract shall not qualify under the exception in this paragraph. *(Drafting Note: Source 944-20-15-53 from EITF D-034, paragraph 24)*

19. An extremely narrow and limited exemption is provided for contracts that reinsure either an individual risk or an underlying book of business that is inherently profitable. When substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer, the contract meets the conditions for reinsurance accounting. To qualify under this exception, no more than insignificant trivial insurance risk on the reinsured portions of the underlying insurance contracts may be retained by the ceding entity. *(Drafting Note: Moves existing SSAP No. 62R QA question 20 similar to GAAP format. Source ASC 944-20-15-54 (main accounting), which is based on EITF D-034, paragraph 23. Note that QA question 21 is related, but it is in the GAAP implementation section. Information that was repetitive in the QA has been deleted.)*

- 5-2-18 Drafting Note - GAAP has a variation in terms on the use of insignificant and trivial. Changed “trivial” to use “insignificant” term as it is defined in GAAP.

47-20. Payment schedules and accumulating retentions from multiple years are contractual features inherently designed to delay the timing of reimbursement to the ceding entity. Regardless of what a particular feature might be called, any feature that can delay timely reimbursement violates the conditions for reinsurance accounting. Transfer of insurance risk requires that the reinsurer’s payment to the ceding entity depend on and directly vary with the amount and timing of claims settled under the reinsured contracts. Contractual features that can delay timely reimbursement prevent this condition from being met. Therefore, any feature that may affect the timing of the reinsurer’s reimbursement to the ceding entity shall be closely scrutinized.

21. Contracts that reinsure insurance risks over a significantly longer period than the underlying insurance contract are, in substance, financing transactions, if any of the following conditions exist:

a. Premiums are deferred over a period beyond the term of the underlying insurance contracts.

b. Losses are recognized in a different period than the period in which the event causing the loss takes place.

c. Both events a. and b. occur at different points in time.

Contracts that are in substance financing receive deposit accounting treatment. *(Drafting Note - 944-20-15-45 Reinsurance of Short-Duration Contracts from EITF D-035, paragraph 8.)*

- 5-18-18 Drafting Note – prior discussions noted that the above paragraph is appropriate, but rare; therefore, it was moved to the end of the risk transfer section.

2 See additional detail on this topic in Exhibit A implementation question 19.
Accounting for Reinsurance

18.22. Reinsurance recoverables shall be recognized in a manner consistent with the liabilities (including estimated amounts for claims incurred but not reported) relating to the underlying reinsured contracts. Assumptions used in estimating reinsurance recoverables shall be consistent with those used in estimating the related liabilities. Certain assets and liabilities are created by entities when they engage in reinsurance contracts. Reinsurance assets meet the definition of assets as defined by SSAP No. 4—Assets and Nonadmitted Assets and are admitted to the extent they conform to the requirements of this statement.

19.23. Accounting for members of a reinsurance pool shall follow the accounting for the pool member which issued the underlying policy. (INT 03-02) Specific accounting rules for underwriting pools and associations are addressed in SSAP No. 63—Underwriting Pools (SSAP No. 63).

20.24. Reinsurance recoverable on loss payments is an admitted asset. Notwithstanding the fact that reinsurance recoverables on paid losses may meet the criteria for offsetting under the provisions of SSAP No. 64—Offsetting and Netting of Assets and Liabilities (SSAP No. 64), reinsurance recoverables on paid losses shall be reported as an asset without any available offset. Unauthorized reinsurance and reinsurance ceded to certified reinsurers is included in this asset and reflected separately as a liability to the extent required. Penalty for overdue authorized reinsurance shall be reflected as a liability.

21.25. Funds held or deposited with reinsured companies, whether premiums withheld as security for unearned premium and outstanding loss reserves or advances for loss payments, are admitted assets provided they do not exceed the liabilities they secure and provided the reinsured is solvent. Those funds which are in excess of the liabilities, and any funds held by an insolvent reinsured shall be nonadmitted.

22.26. Prospective reinsurance is defined as reinsurance in which a reinsurer agrees to reimburse a ceding entity for losses that may be incurred as a result of future insurable events covered under contracts subject to the reinsurance. Retroactive reinsurance is defined as reinsurance in which a reinsurer agrees to reimburse a ceding entity for liabilities incurred as a result of past insurable events covered under contracts subject to the reinsurance. A reinsurance agreement may include both prospective and retroactive reinsurance provisions.

23.27. The distinction between prospective and retroactive reinsurance agreements is based on whether the agreement reinsures future or past insured events covered by the underlying insurance policies. For example, in occurrence-based insurance, the insured event is the occurrence of a loss covered by the insurance contract. In claims-made insurance, the insured event is the reporting to the insurer, within the period specified by the policy, of a claim for a loss covered by the insurance agreement. A claims-made reinsurance contract that reinsures claims asserted to the reinsurer in a future period as a result of insured events that occurred prior to entering into the reinsurance agreement is a retroactive agreement. (However, a reinsurance agreement that reinsures claims reported to an insurer that are covered under currently effective claims-made insurance policies is a prospective reinsurance agreement.)

24.28. It is not uncommon for a reinsurance arrangement to be initiated before the beginning of a policy period but not finalized until after the policy period begins. Whether there was agreement in principle at the beginning of the policy period and, therefore, the agreement is substantively prospective shall be determined based on the facts and circumstances. However, except as respects business assumed by a U.S. reinsurer from ceding companies domiciled outside the U.S. and not affiliated with such reinsurer, or business assumed by a U.S. reinsurer where either the lead reinsurer or a majority of the capacity on the agreement is domiciled outside the U.S. and is not affiliated with such reinsurer, if an agreement entered into, renewed or amended on or after January 1, 1994 has not been finalized, reduced to a written form and signed by the parties within nine months after the commencement of the policy period covered by the reinsurance arrangement, then the arrangement is presumed to be retroactive and shall be accounted for as
a retroactive reinsurance agreement. This presumption shall not apply to: (a) facultative reinsurance contracts, nor to (b) reinsurance agreements with more than one reinsurer which are signed by the lead reinsurer (i.e., the reinsurer setting the terms of the agreement for the reinsurers) within nine months after the commencement of the policy period covered by the reinsurance agreement, nor to (c) reinsurance agreements with more than one reinsurer (whether signed by the lead reinsurer or not) which were entered into, renewed or amended on or before December 31, 1996, (and which were not renewed or amended after that date) if reinsurers representing more than 50% of the capacity on the agreement have signed cover notes, placement slips or similar documents describing the essential terms of coverage and exclusions within nine months after the commencement of the policy period covered by the reinsurance arrangement. Also exempt from this presumption are reinsurance agreements where one of the parties is in conservation, rehabilitation, receivership or liquidation proceedings.

25.29. Prospective and retroactive provisions included within a single agreement shall be accounted for separately. If separate accounting for prospective and retroactive provisions included within a single agreement is impracticable, the agreement shall be accounted for as a retroactive agreement provided the conditions for reinsurance accounting are met.

Accounting for Prospective Reinsurance Agreements

26.30. Amounts paid for prospective reinsurance that meet the conditions for reinsurance accounting shall be reported as a reduction of written and earned premiums by the ceding entity and shall be earned over the remaining contract period in proportion to the amount of reinsurance protection provided or, if applicable, until the reinsurer’s maximum liability under the agreement has been exhausted. If the amounts paid are subject to adjustment and can be reasonably estimated, the basis for amortization shall be the estimated ultimate amount to be paid. Reinstatement premium, if any, shall be earned over the period from the reinstatement of the limit to the expiration of the agreement.

27.31. Changes in amounts of estimated reinsurance recoverables shall be recognized as a reduction of gross losses and loss expenses incurred in the current period statement of income. Reinsurance recoverables on paid losses shall be reported as an asset, reinsurance recoverables on loss and loss adjustment expense payments, in the balance sheet. Reinsurance recoverables on unpaid case-basis and incurred but not reported losses and loss adjustment expenses shall be netted against the liability for gross losses and loss adjustment expenses.

32. Prospective reinsurance agreements that meet the conditions for reinsurance accounting shall only reflect reinsurance credit for the portion of risk which is ceded. Provisions that would limit the reinsurer’s losses (e.g., a deductible, a loss ratio corridor, a loss cap, an aggregate limit or any similar provisions) caused by any applicable risk limiting provision(s) shall be reflected adjustments to ceded premiums, commissions or losses. Reporting entities shall only take credit for reinsurance, i.e., record a reinsurance recoverable, for non-proportional reinsurance when and to the extent that incurred losses on the underlying subject business exceed the attachment point of the applicable reinsurance contracts(s). (Drafting Note: This includes concepts from the SSAP No. 62R, paragraph 93 disclosures, with comments from interested parties received from the August, paragraph 28 and 29 exposures with minor drafting group modifications. The revisions in the last half of the paragraph replace the August 2017 exposed language on non-proportional reinsurance credits which included too many life concepts from SSAP No. 61R, paragraph 38.)

Accounting for Retroactive Reinsurance Agreements

28.33. Certain reinsurance agreements which transfer both components of insurance risk cover liabilities which occurred prior to the effective date of the agreement. Due to potential abuses involving the creation
of surplus to policyholders and the distortion of underwriting results, special accounting treatment for these agreements is warranted.

29.34. All retroactive reinsurance agreements entered into, renewed or amended on or after January 1, 1994 (including subsequent development of such transactions) shall be accounted for and reported in the following manner:

a. The ceding entity shall record, without recognition of the retroactive reinsurance, loss and loss expense reserves on a gross basis on the balance sheet and in all schedules and exhibits;

b. The assuming entity shall exclude the retroactive reinsurance from loss and loss expense reserves and from all schedules and exhibits;

c. The ceding entity and the assuming entity shall report by write-in item on the balance sheet, the total amount of all retroactive reinsurance, identified as retroactive reinsurance reserve ceded or assumed, recorded as a contra-liability by the ceding entity and as a liability by the assuming entity;

d. The ceding entity shall, by write-in item on the balance sheet, restrict surplus resulting from any retroactive reinsurance as a special surplus fund, designated as special surplus from retroactive reinsurance account;

e. The surplus gain from any retroactive reinsurance shall not be classified as unassigned funds (surplus) until the actual retroactive reinsurance recovered exceeds the consideration paid;

f. The special surplus from retroactive reinsurance account for each respective retroactive reinsurance agreement shall be reduced at the time the ceding entity begins to recover funds from the assuming entity in amounts exceeding the consideration paid by the ceding entity under such agreement, or adjusted as provided in paragraph 29.34.j.;

g. For each agreement, the reduction in the special surplus from retroactive reinsurance account shall be limited to the lesser of (i) the actual amount recovered in excess of consideration paid or (ii) the initial surplus gain resulting from the respective retroactive reinsurance agreement. Any remaining balance in the special surplus from retroactive reinsurance account derived from any such agreement shall be returned to unassigned funds (surplus) upon elimination of all policy obligations subject to the retroactive reinsurance agreement;

h. The ceding entity shall report the initial gain arising from a retroactive reinsurance transaction (i.e., the difference between the consideration paid to the reinsurer and the total reserves ceded to the reinsurer) as a write-in item on the statement of income, to be identified as Retroactive Reinsurance Gain and included under Other Income;

i. The assuming entity shall report the initial loss arising from a retroactive reinsurance transaction, as defined in the preceding paragraph 29.34.g., as a write-in item on the statement of income, to be identified as Retroactive Reinsurance Loss and included under Other Income;

j. Any subsequent increase or reduction in the total reserves ceded under a retroactive reinsurance agreement shall be reported in the manner described in the preceding
paragraphs 2934.h. and 2934.i., in order to recognize the gain or loss arising from such increase or reduction in reserves ceded. The Special Surplus from Retroactive Reinsurance Account write-in entry on the balance sheet shall be adjusted, upward or downward, to reflect such increase or reduction in reserves ceded. The Special Surplus from Retroactive Reinsurance Account write-in entry shall be equal to or less than the total ceded reserves under all retroactive reinsurance agreements in-force as of the date of the financial statement. Special surplus arising from a retroactive reinsurance transaction shall be considered to be earned surplus (i.e., transferred to unassigned funds (surplus)) only when cash recoveries from the assuming entity exceed the consideration paid by the ceding entity as respects such retroactive reinsurance transaction; and

k. The consideration paid for a retroactive reinsurance agreement shall be reported as a decrease in ledger assets by the ceding entity and as an increase in ledger assets by the assuming entity.

(For an illustration of ceding entity accounting entries see question 3331 in Exhibit A.)

30.35. Portfolio reinsurance is the transfer of an insurer’s entire liability for in force policies or outstanding losses, or both, of a segment of the insurer’s business. Loss portfolio transactions are to be accounted for as retroactive reinsurance.

31.36. The accounting principles for retroactive reinsurance agreements in paragraph 2934 shall not apply to the following types of agreements (which shall be accounted for as prospective reinsurance agreements unless otherwise provided in this statement):

a. Structured settlement annuities for individual claims purchased to implement settlements of policy obligations;

b. Novations, (i.e., (i) transactions in which the original direct insurer’s obligations are completely extinguished, resulting in no further exposure to loss arising on the business novated or (ii) transactions in which the original assuming entity’s obligations are completely extinguished) resulting in no further exposure to loss arising on the business novated, provided that (1) the parties to the transaction are not affiliates (or if affiliates, that the transaction has the prior approval of the domiciliary regulators of the parties) and (2) the accounting for the original reinsurance agreement will not be altered from retroactive to prospective;

c. The termination of, or reduction in participation in, reinsurance treaties entered into in the ordinary course of business;

d. Intercompany reinsurance agreements, and any amendments thereto, among companies 100% owned by a common parent or ultimate controlling person provided there is no gain in surplus as a result of the transaction; or

e. Reinsurance/retrocession agreements that meet the criteria of property/casualty run-off agreements described in paragraphs 81-84102-105.

32.37. Retroactive reinsurance agreements resulting in surplus gain to the ceding entity (with or without risk transfer) entered into between affiliates or between insurers under common control (as those terms are defined in Appendix A-440) shall be reported as follows:
a. The consideration paid by the ceding entity shall be recorded as a deposit and reported as a nonadmitted asset; and

b. No deduction shall be made from loss and loss adjustment expense reserves on the ceding entity’s balance sheet, schedules, and exhibits.

33.38. The accounting and reporting provisions applicable to retroactive reinsurance apply to all transactions transferring liabilities in connection with a court-ordered rehabilitation, liquidation, or receivership. The requirement to include stipulated contract provisions in the reinsurance agreements shall not apply to these transactions, with written approval of the ceding entity’s domiciliary commissioner.

34.39. Novations meeting the requirements of paragraph 34.36. b. shall be accounted for as prospective reinsurance agreements. The original direct insurer, or the original assuming insurer, shall report amounts paid as a reduction of written and earned premiums, and unearned premiums to the extent that premiums have not been earned. Novated balances (e.g., loss and loss adjustment expense reserves) shall be written off through the accounts, exhibits, and schedules in which they were originally recorded. The assuming insurer shall report amounts received as written and earned premiums, and obligations assumed as incurred losses in the statement of income.

Deposit Accounting

35.40. To the extent that a reinsurance agreement does not, despite its form, transfer both components of insurance risk, all or part of the agreement shall be accounted for and reported as deposits in the following manner:

a. At the outset of the reinsurance agreement, the net consideration paid by the ceding entity (premiums less commissions or other allowances) shall be recorded as a deposit by the ceding company and as a liability by the assuming entity. The deposit shall be reported as an admitted asset by the ceding company if (i) the assuming company is licensed, accredited or otherwise qualified in the ceding company’s state of domicile as described in Appendix A-785 or (ii) there are funds held by or on behalf of the ceding company which meet the requirements of paragraph 18 of Appendix A-785;

b. At subsequent reporting dates, the amount of the deposit/liability shall be adjusted by calculating the effective yield on the deposit agreement to reflect actual payments to date (receipts and disbursements shall be recorded through the deposit/liability accounts) and expected future payments (as discussed below), with a corresponding credit or charge to interest income or interest expense;

c. The calculation of the effective yield shall use the estimated amount and timing of cash flows. If a change in the actual or estimated timing or amount of cash flows occurs, the effective yield shall be recalculated to reflect the revised actual or estimated cash flows. The deposit shall be adjusted to the amount that would have existed at the reporting date had the new effective yield been applied since the inception of the reinsurance agreement. Changes in the carrying amount of the deposit asset/liability resulting from changes in the effective yield shall be recorded as interest income or interest expense;

d. It shall be assumed that any cash transactions for the settlement of losses will reduce the asset/liability accounts by the amount of cash transferred. When the remaining losses are revalued upward, an increase in the deposit liability shall be recorded as interest expense – by the assuming company. Conversely, the ceding company shall increase its
deposit (asset) with an offsetting credit to interest income; and increase its outstanding loss liability with an offsetting charge to incurred losses;

e. No deduction shall be made from the loss and loss adjustment expense reserves on the ceding company’s Statement of Financial Position, schedules, and exhibits;

f. The assuming company shall record net consideration to be returned to the ceding company as a liability.

(For an illustration of the provisions of paragraph 3540, see Exhibit C)

41. Deposit accounting shall not be used to avoid loss recognition that would otherwise be required; for example, if the ceding entity has no future coverage relating to the deposit with the reinsurer and, therefore, the deposit is not recoverable. (Drafting Note 944-20-35-12 from EITF 93-06 Discussion.)

Assumed Reinsurance

36-42. Reinsurance premiums receivable at the end of the accounting period are combined with direct business receivables and reported as agents’ balances or uncollected premiums. Where the ceding entity withholds premium funds pursuant to the terms of the reinsurance agreement, such assets shall be shown by the assuming entity as funds held by or deposited with reinsured companies. Reporting entities shall record any interest earned or receivable on the funds withheld as a component of aggregate write-ins for miscellaneous income.

37-43. If the assuming entity receives reinsurance premium prior to the effective date of the reinsurance contract, consistent with SSAP No. 53—Property Casualty Contracts—Premiums, paragraph 15, advance premiums shall be reported as a liability in the statutory financial statement and not considered income until the effective date of the coverage. Such amounts are not included in written premium or the unearned premium reserve. If the assuming entity receives reinsurance premium after the effective date of the reinsurance contract but prior to the due date, the amount received shall be reported as a reduction of the asset for deferred but not yet due (earned but unbilled premiums).

38-44. Reinsurance premiums more than 90 days overdue shall be nonadmitted except (a) to the extent the assuming entity maintains unearned premium and loss reserves as to the ceding entity, under principles of offset accounting as discussed in SSAP No. 64, or (b) where the ceding entity is licensed and in good standing in assuming entity’s state of domicile. Reinsurance premiums are due pursuant to the original contract terms (as the agreement stood on the date of execution). In the absence of a specific contract date, reinsurance premiums will be deemed due thirty (30) days after the date on which (i) notice or demand of premium due is provided to the ceding entity or (ii) the assuming entity books the premium (see SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers).

39-45. A lag will develop between the time of the entry of the underlying policy transaction on the books of the ceding entity and the transmittal of information and entry on the books of the assuming entity. Assuming companies shall estimate unreported premiums and related costs to the extent necessary to prevent material distortions in the loss development contained in the assuming entity’s annual statement schedules where calendar year premiums are compared to accident year losses.

40-46. Proportional reinsurance (i.e., first dollar pro rata reinsurance) premiums shall be allocated to the appropriate annual statement lines of business in the Underwriting and Investment exhibits. Non-proportional assumed reinsurance premiums shall be classified as reinsurance under the appropriate subcategories.
41.47. Assumed retroactive reinsurance premiums shall be excluded from all schedules and exhibits as addressed in paragraph 2934.

42.48. Amounts payable by reinsurers on losses shall be classified as unpaid losses. Assumed reinsurance payable on paid losses shall be classified as a separate liability item on the balance sheet. IBNR losses on assumed reinsurance business shall be netted with ceded losses on the balance sheet and listed separately by annual statement line of business in the Underwriting and Investment exhibits.

Ceded Reinsurance

43.49. Ceded reinsurance premiums payable (net of ceding commission) shall be classified as a liability. Consistent with SSAP No. 64, ceded reinsurance premiums payable may be deducted from amounts due from the reinsurer, such as amounts due on assumed reinsurance, when a legal right of offset exists.

44.50. With regard to reinsurance premium paid prior to the effective date of the contract, the ceding entity shall reflect the prepaid item as a write-in admitted asset and it should not be recognized in the income statement until the effective date of the coverage. Such amounts are not included in ceded written premiums or ceded unearned premium but should be subject to impairment analysis. With regard to reinsurance premium paid by ceding entity after the reinsurance contract is in effect but prior to the due date, the ceding entity shall treat this item as a reduction to the liability for ceded reinsurance premiums payable. That liability reflects not only premiums unpaid but also amounts booked but deferred and not yet due.

45.51. Amounts withheld by the ceding entity that would otherwise be payable under the reinsurance agreement shall be reported as funds held by entity under reinsurance treaties. Reporting entities shall record any interest due or payable on the amounts withheld as a component of aggregate write-ins for miscellaneous income.

46.52. Ceded reinsurance transactions shall be classified in the annual statement line of business which relates to the direct or assumed transactions creating the cession or retrocession.

47.53. Ceded retroactive reinsurance premiums shall be excluded from all schedules and exhibits as addressed in paragraph 2934.

48.54. Reinsurance accounting shall not be allowed for modeled trigger securitizations. Modeled trigger securitization transactions do not result in the kind of indemnification (in form and in fact) required by this SSAP, and are therefore not eligible for reinsurance accounting. Modeled trigger transactions should be evaluated as securitization transactions rather than as reinsurance transactions and should receive the accounting treatment recommended for securitization transactions.

Adjustable Features/Retrospective Rating

49.55. Reinsurance treaties may provide for adjustment of commission, premium, or amount of coverage, based on loss experience. The accounting for common examples is outlined in the following paragraphs:

Commission Adjustments

50.56. An accrual shall be maintained for the following adjustable features based upon the experience recorded for the accounting period:
a. Contingent or Straight Profit—The reinsurer returns to the ceding entity a stipulated percentage of the profit produced by the business assumed from the ceding entity. Profit may be calculated for any specified period of time, but the calculation is often based on an average over a period of years; and

b. Sliding Scale—A provisional rate of commission is paid over the course of the agreement, with a final adjustment based on the experience of the business ceded under the agreement.

Premium Adjustments

$4.57. If the reinsurance agreement incorporates an obligation on the part of the ceding entity to pay additional premium to the assuming entity based upon loss experience under the agreement, a liability in the amount of such additional premium shall be recognized by the ceding entity during the accounting period in which the loss event(s) giving rise to the obligation to pay such additional premium occur(s). The assuming entity shall recognize an asset in a consistent manner. If the reinsurance agreement incorporates an obligation on the part of the assuming entity to refund to the ceding entity any portion of the consideration received by the assuming entity based upon loss experience under the agreement, an asset in the amount of any such refund shall be recognized by the ceding entity during the accounting period in which the loss event(s) giving rise to the obligation to make such refund occur(s). The initial provisional or deposit premium is recalculated retrospectively, based on loss experience under the agreement during a specified period of time; the calculation is often based on an average over a period of years. The assuming entity shall recognize a liability in a consistent manner.

Adjustments in the Amount of Coverage

$2.58. The amount of coverage available for future periods is adjusted, upward or downward, based on loss experience under the agreement during a specified period of time. If the reinsurance agreement incorporates a provision under which the reinsurance coverage afforded to the ceding entity may be increased or reduced based upon loss experience under the agreement, an asset or a liability shall be recognized by the ceding entity in an amount equal to that percentage of the consideration received by the assuming entity which the increase or reduction in coverage represents of the amount of coverage originally afforded. The asset or liability shall be recognized during the accounting period in which the loss event(s) (or absence thereof) giving rise to the increase or decrease in reinsurance coverage occur(s), and shall be amortized over all accounting periods for which the increased or reduced coverage is applicable. The term “consideration” shall mean, for this purpose, the annualized deposit premium for the period used as the basis for calculating the adjustment in the amount of coverage to be afforded thereafter under the agreement.

59. The ceding entity and the assuming entity shall account for changes in coverage in the same manner as changes in other contract costs. For example, the effects of decreases in coverage without a commensurate reduction in premium shall be recognized as a loss by the ceding entity and as a gain by the assuming entity when the event causing the decrease in coverage takes place. (Drafting Note Source 944-20-35-9 and 944-20-35-10)

60. Changes in either the probability or amount of potential future recoveries are considered a change in coverage. For example, if the contract limit stayed the same, but the ceding entity could not receive any recoveries unless losses for the industry as a whole reached a certain level, coverage has been reduced. What matters is not the specific contract provisions regarding coverage, but whether the probability or amount of potential future recoveries has increased or decreased as a result of those provisions. (Drafting Note Source 944-20-35-11)
Multiple-Year Retrospectively Rated Contracts

61. Many short-duration insurance and reinsurance contracts have retrospective rating provisions. A retrospectively rated contract is a multiple-year contract in which events in one period of the contract create rights and obligations in another. For example, if losses above a certain level occur in one contract year, premiums increase in future years unless the ceding entity compensates the reinsurer through a settlement adjustment. The ceding entity has an obligation because it must pay either the settlement adjustment or the higher future premiums. (Drafting Note: Source 944-20-05-41 Overview and Background Multiple-Year Retrospectively Rated Reinsurance Contract from EITF D-035, paragraph 4)

62. An insurer (ceding entity) may enter into a multiple-year retrospectively rated reinsurance contract with a reinsurer (assuming entity). Examples of these contracts may include transactions referred to as funded catastrophe covers. These contracts include a retrospective rating provision that provides for at least one of the following based on contract experience:

   a. Changes in the amount or timing of future contractual cash flows, including premium adjustments, settlement adjustments, or refunds to the ceding entity

   b. Changes in the contract’s future coverage (Drafting Note: 944-20-05-42 Overview and Background Multiple-Year Retrospectively Rated Reinsurance Contract from EITF 93-06 - Issue)

63. A critical distinguishing feature of these contracts is that part or all of the retrospective rating provision is obligatory such that the retrospective rating provision creates future rights and obligations as a result of past events. Therefore, a retrospectively rated contract that could be cancelled without further obligation (because it does not create rights and obligations that will be realized in a future period) is excluded. (Drafting Note: 944-20-05-43 Overview and Background Multiple-Year Retrospectively Rated Reinsurance Contract from EITF 93-06 paragraph - Issue and EITF D-035 paragraph 4)

64. A retrospectively rated contract is a multiple-year contract in which events in one period of the contract create rights and obligations in another. The principal issues in accounting for a multiple-year retrospectively rated contract involve how to recognize and measure assets and liabilities resulting from the obligatory retrospective rating provisions. While it may be difficult for some types of multiple-year retrospectively rated contracts to pass the risk transfer test, the recognition and measurement questions are present regardless of whether the contract transfers risk. In fact, the questions become clearly evident with contracts that meet the risk transfer test and are accounted for as reinsurance. (Drafting Note: 944-20-10-5 Multiple-Year Retrospectively Rated Contracts Objectives from EITF D-035, paragraph 1.)

   • 5-18-18 Drafting Note - The initial sentence was identified as repetitive so it was deleted. Multiple-year was added to address RAA comments.

Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Entities

65. To be accounted for as reinsurance, a reinsurance contract that reinsures risks arising from short-duration insurance contracts must meet all of the following conditions:


   b. The contract shall not contain features that prevent the risk transfer criteria in this Subsection from being reasonably applied and those the risk transfer criteria shall be met.
b. The ultimate premium expected to be paid or received under the contract shall be reasonably estimable and allocable in proportion to the reinsurance protection provided as required by paragraphs 944-605-25-2 and 944-605-35-8.

If any of these conditions are not met, a deposit method of accounting shall be applied by the ceding and assuming entities. *(Drafting Note 944-20-15-55 from EITF 93-06, discussion sequence 14)*

66. Condition ba. in the preceding paragraph 65 applies to a contract and determining the substance of a contract is a judgmental matter. If an agreement with a reinsurer consists of both risk transfer and nonrisk transfer coverages that have been combined into a single legal document, those coverages must be considered separately for accounting purposes. This statement Section 944-20-15 does not intend for different kinds of exposures combined in a program of reinsurance to be evaluated for risk transfer and accounted for together because that would allow contracts that do not meet the conditions for reinsurance accounting to be accounted for as reinsurance by being designated as part of a program that in total meets the conditions for reinsurance accounting. *(Drafting Note 944-20-15-56 from EITF 93-06, discussion sequence 15)*

- 5-18-18 Drafting Note – omitted two paragraphs from EITF D-035 regarding retrospectively rated contracts with provisions that do not create future period obligations 944-20-15-57 and 944-20-15-5 based on prior informal drafting group recommendation.

67. Recognizing a smaller asset based on potential unfavorable loss development implies that claim liabilities are understated at the financial reporting date. Accordingly, changes in estimates of claim liabilities shall not be recognized in measuring the related asset until the change in estimate takes place. *(Drafting Note 944-20-35-7 from EITF D-035, paragraph 24.)*

- 5-18-18 Drafting Notes: the informal drafting group recommended that it was helpful to include the below two paragraphs from EITF D-035, paragraph 3 with modifications for SAP language. Note Subtopic 450-20 is on loss contingences so the reference was updated to SSAP No. 5R.

**Obligatory Retrospective Rating Provision**

68. This implementation guidance discusses how the guidance on multiple-year retrospectively rated contracts in the Reinsurance Contracts Subsections of this Subtopic is based on the concept that there is a substantive difference between a contract that contains an obligatory retrospective rating provision and one that does not. This distinction derives from Subtopic 450-20 SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets (SSAP No. 5R), which requires recognition of liabilities (which are defined as present obligations) as of a financial reporting date, but prohibits recognition of losses and expenses that will result from future events. For example, it may be a virtual certainty that an entity will pay employee salaries next year. But because there is no present obligation to pay those salaries, they are not recognized today. *(Drafting note: source ASC 944-20-55-36)*

69. Similarly, under Subtopic 450-20 SSAP No. 5R even if there is a high probability that an asset will be impaired in the future or a liability incurred in the future, the conditions for accrual have not been met because there is no present impairment or obligation to be recognized. Consistent with this principle, the guidance on multiple-year retrospectively rated contracts in the Reinsurance Contracts Subsections of this Subtopic does not permit recognition of the effects of retrospective rating provisions unless those provisions are obligatory. *(Drafting note: source ASC 944-20-55-37)*
Allocation of Certain Payments Between Coverage and Past Losses

70. This implementation guidance addresses a circumstance in which, under a multiple-year retrospectively rated reinsurance contract, the ceding entity has to make additional payments to the reinsurer, but the ceding entity also receives expanded coverage. The single payment is allocated to the two separate transactions. In one transaction, the ceding entity has acquired an asset by making a payment to the reinsurer in exchange for expanded coverage. In the other, the ceding entity has incurred a loss or liability to the extent that it is reimbursing the reinsurer for past losses. Because a variety of factors may affect the value of reinsurance coverage at any point in time, the most appropriate measure of the value of additional coverage generally is the price of the initial coverage. For example, if coverage of $6.00 was acquired for a $1.00 premium, and the ceding entity would pay $4.00 more for another $6.00 of coverage if a loss occurs, the most relevant measure of the amount of premium that relates to the new coverage would be $1.00. The other $3.00 presumably is a reimbursement for the loss that has been incurred. (Drafting Note: ASC 944-20-55-59 from EITF D-035, paragraph 32)

Multiple Contingent Contractual Termination Features

71. In some circumstances, the ceding entity will be relieved of its obligation if the reinsurer cancels the contract and only has to pay additional amounts if either:

a. The contract remains in force
b. The ceding entity cancels before the end of the contract term

Unless the reinsurer has terminated the contract, the ceding entity has an obligation for the additional amounts and must recognize the related liability. The effect of termination, which is to relieve the ceding entity of its liability, shall not be recognized until termination takes place. (Drafting Note 944-20-35-14 from EITF D-035, paragraph 22)

- 5-18-18 Drafting Note- the drafting group recommended updates to the heading as Multiple Contingent Contract Features” doesn’t appear to fit.
- 5-18-18 Drafting recommendation was not to include ASC Note 944-20-35-17 through 19 from EITF 93-06 on termination choices, because of the SSAP No. 62R modification of EITF 93-6.

72. If either party entering into a new contract in consideration for canceling a retrospectively rated contract would not have agreed to cancel the existing retrospectively rated contract unless a new contract were entered into, the two contracts are in effect the same contract for purposes of measuring assets and liabilities and shall be accounted for in that way. (Drafting Notes: 944-20-25-6 from EITF D-035, paragraph 7)

Impairment

53-73. Include as a nonadmitted asset, amounts accrued for premium adjustments on retrospectively rated reinsurance agreements with respect to which all uncollected balances due from the ceding company have been classified as nonadmitted

74. The amount of the asset to be recognized may be affected by credit risk, and appropriate valuation allowances shall be established. Impairment shall be recognized for any amounts deemed uncollectible. However, the ceding entity shall not consider the likelihood of future losses in evaluating whether the asset is realizable at the financial reporting date. The effect of those future losses on the asset, if any, shall be recognized in the period of the loss. Potential future unfavorable development on
the incurred losses covered by the contract shall not be considered in measuring the asset at the financial reporting date. The relevant recorded claim liability at that date represents the ceding entity’s best estimate of the expected ultimate claim liability, and is the liability that must be used in measuring the refundable amount based on contract experience to date. (Drafting Note 944-20-35-6 from EITF D-035, paragraph 24)

- 6-26-18 discussion was to delete part of the ASC guidance above to avoid any potential issues with the ECL standard.

Commissions

54.75. Commissions payable on reinsurance assumed business shall be included as an offset to Agents’ Balances or Uncollected Premiums. Commissions receivable on reinsurance ceded business shall be included as an offset to Ceded Reinsurance Balances Payable.

55.76. If the ceding commission paid under a reinsurance agreement exceeds the anticipated acquisition cost of the business ceded, the ceding entity shall establish a liability, equal to the difference between the anticipated acquisition cost and the reinsurance commissions received, to be amortized pro rata over the effective period of the reinsurance agreement in proportion to the amount of coverage provided under the reinsurance contract.

Unauthorized Reinsurance

56.77. If the assuming reinsurer is not authorized, otherwise approved or certified to do business in the ceding entity’s domiciliary state, the assumed reinsurance is considered to be unauthorized. A provision is established to offset credit taken in various balance sheet accounts for reinsurance ceded to unauthorized reinsurers. Credit for reinsurance with unauthorized reinsurers shall be permitted to the extent the ceding entity holds collateral in accordance with Appendix A-785. If the assuming reinsurer is not licensed or is not an authorized reinsurer in the domiciliary state of the ceding entity or if the reinsurance does not meet required standards, the ceding entity must set up a provision for reinsurance liability in accordance with the NAIC Annual Statement Instructions for Property and Casualty Insurance Companies Schedule F.

57.78. The provision defined in paragraph 5677 shall never be less than zero for any particular reinsurer. The change in liability for unauthorized reinsurance is a direct charge or credit to surplus.

Reinsurance Ceded to a Certified Reinsurer

58.79. The term certified reinsurer shall have the same meaning as set forth in the Appendix A-785.

59.80. Credit for reinsurance ceded to a certified reinsurer is permitted if security is held by or on behalf of the ceding entity in accordance with the certified reinsurer’s rating assigned by the domestic state of the ceding insurance entity, and in accordance with Appendix A-785 of this manual. However, nothing in this guidance would prohibit the parties to a reinsurance agreement from agreeing to provisions establishing security requirements that exceed the minimum security requirements established for certified reinsurers.

60.81. An upgrade in a certified reinsurer’s assigned rating applies on a prospective basis, i.e., the revised collateral requirement applies only to contracts entered into or renewed on or after the effective date of the new rating (see A-785). A downgrade in a certified reinsurer’s rating applies on a retroactive basis, i.e., the revised collateral requirement applies to all reinsurance obligations incurred by the assuming insurer under its certified reinsurer status. Notwithstanding a change in a certified reinsurer’s...
rating or revocation of its certification, a reporting entity that has ceded reinsurance to such certified reinsurer is allowed a three (3)-month grace period before recording a provision for reinsurance due to collateral deficiency associated with such rating downgrade and increased collateral requirement for all reinsurance ceded to such assuming insurer under its certified reinsurer status, unless the reinsurance is found by the commissioner of the reporting entity’s domestic state to be at high risk of uncollectibility.

61.82. A provision is established by the ceding entity to offset credit taken in various balance sheet accounts for reinsurance ceded to a certified reinsurer in an amount proportionate to any deficiency in the amount of acceptable security that is provided by the certified reinsurer as compared to the amount of security that is required to be provided in accordance with the certified reinsurer’s rating. The calculation of the provision for a collateral shortfall is separate from the calculation of the provision for overdue reinsurance ceded to certified reinsurers and shall be calculated in accordance with the NAIC Annual Statement Instructions for Property and Casualty Insurance Companies.

62.83. The provision defined in paragraph 61.82 shall never be less than zero for any particular certified reinsurer. The change in liability for reinsurance with certified reinsurers is a direct charge or credit to surplus.

Funds Held Under Reinsurance Treaties

63.84. This liability is established for funds deposited by or contractually withheld from reinsurers or reinsurers.

Provision for Reinsurance

64.85. The NAIC Annual Statement Instructions for Property and Casualty Companies for Schedule F—Provision for Overdue Reinsurance, provide for a minimum reserve for uncollectible reinsurance with an additional reserve required if an entity’s experience indicates that a higher amount should be provided. The minimum reserve Provision for Reinsurance is recorded as a liability and the change between years is recorded as a gain or loss directly to unassigned funds (surplus). Any reserve over the minimum amount shall be recorded on the statement of income by reversing the accounts previously utilized to establish the reinsurance recoverable.

65.86. The provision for reinsurance is calculated separately for unauthorized, authorized and certified reinsurers. An authorized reinsurer is licensed, accredited or approved by the ceding entity’s state of domicile; a certified reinsurer is certified by the ceding entity’s state of domicile; an unauthorized reinsurer is not so licensed, accredited, approved or certified.

Asbestos and Pollution Contracts – Counterparty Reporting Exception

66.87. Upon approval by the domiciliary regulator(s) of the ceding entity (either the original direct insurer in the case of a reinsurance agreement or the original assuming reinsurer in the case of a retrocession agreement), an exception may be allowed with respect to a retroactive reinsurance agreement providing substantially duplicate coverage as prior reinsurance agreements on asbestos and/or pollution exposures, including reinsurance provided through an affiliated reinsurer that retrocedes to the retroactive reinsurance counterparty. Under this exception, a reporting entity may aggregate reinsurers into one line item in Schedule F reflecting the counterparty under the retroactive agreement for the purposes of determining the Provision for Reinsurance regarding overdue amounts paid by the retroactive counterparty (both authorized and unauthorized). This exception would allow the Provision for Reinsurance to be reduced by reflecting that amounts have been recovered by the reporting entity under the duplicate coverage provided by the retroactive contract, and that inuring balances from the original
contract(s) are payable to the retroactive counterparty. In addition, such approval would also permit the substitution of the retroactive counterparty for authorized original reinsurers without overdue balances for purposes of reporting on the primary section of the annual statement Schedule F. An agreement must meet all of the requirements in paragraphs 6687.a. through 6687.e. in order to be considered for this exception.

a. The underlying agreement clearly indicates the credit risk associated with the collection of the reporting entity’s insuring reinsurance recoverables and losses related to the credit risk will be covered by the retroactive reinsurance counterparty.

b. The retroactive reinsurance agreement must transfer significant risk of loss.

c. The assuming retroactive reinsurance counterparty must have a financial strength rating from at least two nationally recognized statistical rating organizations (NRSRO), the lowest of which is higher than or equal to the NRSRO ratings of the underlying third-party reinsurers.

d. The transaction is limited to reinsurance recoverables attributable to asbestos, and/or pollution.

e. The recoverables from the insuring reinsurers remain subject to credit analysis and contingent liability analysis.

67.88. With the approval of the reporting entity’s domestic state commissioner pursuant to the applicable state credit for reinsurance law regarding the use of other forms of collateral acceptable to the commissioner, the reporting entity shall present the amount of other approved security related to the retroactive reinsurance agreement as an “Other Allowed Offset Item” with respect to the uncollateralized amounts recoverable from unauthorized reinsurers for paid and unpaid losses and loss adjustment expenses under the original reinsurance contracts. Amounts approved as “Other Allowed Offset Items” shall be reflected as amounts recoverable from the retroactive counterparty and aggregated reporting described in paragraph 6687 shall also be applied for unpaid losses and loss adjustment expenses under the original reinsurance contracts. The security applied as an “Other Allowed Offset Item” shall also be reflected in the designated sub-schedule and disclosed as a prescribed or permitted practice. (See Appendix Exhibit D illustration in this statement.)

68.89. The reporting entity will continue to detail the reporting of original reinsurers that were aggregated for one line reporting per paragraph 6687 as provided in the annual statement instructions. The aggregation reporting in schedule F applies only to the extent that insuring balances currently receivable under original reinsurance contracts are also payable to the retroactive reinsurance counterparty, and additionally to reinsurance recoverable on unpaid losses if the domestic state commissioner has approved amounts related to the retroactive reinsurance contract as any other form of security acceptable under the applicable provisions of the state’s credit for reinsurance law. This guidance is not intended to otherwise change the application of retroactive accounting guidance for the retroactive portions of the contract that are not duplicative of the original reinsurance. Other than measurement of the provision for reinsurance and presentation in Schedule F, the retroactive contracts should continue to follow guidance applicable to retroactive accounting and reporting.

**Syndicated Letters of Credit**

69.90. With a Syndicated Letter of Credit (Syndicated LC), the reinsurer enters into an agreement with a group of banks (the “Issuing Banks”) and an agent bank (the “Agent”). Each Issuing Bank and the Agent is an NAIC-approved bank and a “qualified bank”. This agreement requires the Agent to issue, on behalf
of the each of the Issuing Banks, letters of credit in favor of the ceding insurer. The credit is issued (as an administrative matter) only through the Agent’s letter of credit department. Each issuing bank signs the Syndicated LC through the Agent, as its attorney-in-fact. Syndicated LCs are consistent with A-785, in that the Syndicated LC is the legal equivalent of multiple letters of credit separately issued by each of the issuing banks. Reporting entities shall take a reduction in the liability on account of reinsurance recoverables secured by the Syndicated LC if all of the following conditions are met:

- All listed banks on the letter of credit are qualified and meet the criteria of the NAIC SVO approved bank listing;
- Banks are severally and not jointly liable; and
- Specific percentages for each assuming bank are listed in the letter of credit.

Disputed Items

70.91. Occasionally a reinsurer will question whether an individual claim is covered under a reinsurance agreement or may even attempt to nullify an entire agreement. A ceding entity, depending upon the individual facts, may or may not choose to continue to take credit for such disputed balances. A ceding entity shall take no credit whatsoever for reinsurance recoverables in dispute with an affiliate.

71.92. Items in dispute are those claims with respect to which the ceding entity has received formal written communication from the reinsurer denying the validity of coverage.

Uncollectible Reinsurance

72.93. Uncollectible reinsurance balances shall be written off through the accounts, exhibits, and schedules in which they were originally recorded.

Commutations

73.94. A commutation of a reinsurance agreement, or any portion thereof, is a transaction which results in the complete and final settlement and discharge of all, or the commuted portion thereof, present and future obligations between the parties arising out of the reinsurance agreement.

74.95. In commutation agreements, an agreed upon amount determined by the parties is paid by the reinsurer to the ceding entity. The ceding entity immediately eliminates the reinsurance recoverable recorded against the ultimate loss reserve and records the cash received as a negative paid loss. Any net gain or loss shall be reported in underwriting income in the statement of income.

75.96. The reinsurer eliminates a loss reserve carried at ultimate cost for a cash payout calculated at present value. Any net gain or loss shall be reported in underwriting income in the statement of income.

76.97. Commuted balances shall be written off through the accounts, exhibits, and schedules in which they were originally recorded.

National Flood Insurance Program

77.98. The National Flood Insurance Program was created by the Federal Emergency Management Agency (FEMA) and is designed to involve private insurers in a write-your-own (WYO) flood insurance program financially backed by FEMA at no risk to the insurer. To become a participating WYO entity,
the entity signs a document with the Federal Insurance Administration (FIA) of the Federal Emergency Management Agency known as the Financial Assistance/Subsidy Arrangement.

78.99. Premium rates are set by FEMA. The WYO participating companies write the flood insurance coverage qualifying for the program on their own policies, perform their own underwriting, premium collections, claim payments, administration, and premium tax payments for policies written under the program.

79.100. Monthly accountings are made to FIA and participants draw upon FEMA letters of credit for deficiencies of losses, loss expenses, and administrative expenses in excess of premiums, subject to certain percentage limitations on expenses.

80.101. Policies written by the reporting entity under the National Flood Insurance Program are considered insurance policies issued by the reporting entity, with reinsurance ceded to FEMA. (Such policies are not considered uninsured plans under SSAP No. 47—Uninsured Plans) Balances due from or to FEMA shall be reported as ceded reinsurance balances receivable or payable. The commission and fee allowances received from FEMA shall be reported consistent with reinsurance ceding commission.

Accounting for the Transfer of Property and Casualty Run-Off Agreements

84.102. Property and casualty run-off agreements are reinsurance or retrocession agreements that are intended to transfer essentially all of the risks and benefits of a specific line of business or market segment that is no longer actively marketed by the transferring insurer or reinsurer. A property and casualty run-off agreement is not a novation as the transferring insurer or reinsurer remains primarily liable to the policyholder or ceding entity under the original contracts of insurance or reinsurance. Reinsurance agreements between affiliates or between insurers under common control (as those terms are defined in Appendix A-440) are not eligible for the exception for property and casualty run-off agreements in paragraph 3136.e.

Criteria

82.103. The accounting treatment for property and casualty run-off agreements must be approved by the domiciliary regulators of the transferring entity (either the original direct insurer in the case of a reinsurance agreement or the original assuming reinsurer in the case of a retrocession agreement) and the assuming entity. If the transferring entity and assuming entity are domiciled in the same state, then the regulator of the state where the majority of the transferred liabilities is located shall be asked to approve the accounting treatment. In determining whether to approve an agreement for this accounting treatment, the regulators shall require the following:

a. Assuming Entity Properly Licensed – The entity assuming the run-off agreement must have the appropriate authority or license to write the business being assumed.

b. Limits and Coverages – The reinsurance or retrocession agreement shall provide the same limits and coverages that were afforded in the original insurance or reinsurance agreement.

c. Non-recourse – The reinsurance or retrocession agreement shall not contain any adjustable features or profit share or retrospective rating, and there shall be no recourse (other than normal representations and warranties that would be associated with a purchase and sale agreement) directly or indirectly against the transferring entity.
d. **Risk Transfer** – The reinsurance or retrocession agreement must meet the requirements of risk transfer as described in this statement.

e. **Financial Strength of Reinsurer** – The assuming reinsurer shall have a financial strength rating from at least two independent rating agencies (from NAIC credit rating providers (CRP)) which is equal to or greater than the current ratings of the transferring entity. The lowest financial strength rating received from an NAIC acceptable rating organization rating agency will be used to compare the financial strength ratings of the transferring and assuming entities.

f. **Assessments** – The assuming reinsurer or retrocessionaire (if required in the original reinsurance contract) shall be financially responsible for any and all assessments, including guaranty fund assessments, that are assessed against the transferring entity related to the insurance business being assumed.

g. **Applicable Only to “Run-off” Business** – The reinsurance or retrocession agreement shall only cover liabilities relating to a line(s) of business or specific market segments no longer actively marketed by the transferring entity.

h. **Non-cancelable Reinsurance** – The reinsurance or retrocession agreement shall provide that the reinsurance or retrocessional coverage provided by the proposed agreement cannot be cancelable by either party for any reason. (However, this provision will not override standard contracts law and principles and will not prevent any remedies, including rescission or termination that might be available for breach, misrepresentation, etc.)

**Statutory Schedules and Exhibits**

**§3-104.** At the inception of the transaction, the transferring entity shall record the consideration paid to the assuming entity as a paid loss. If the consideration paid by the transferring entity is less than the loss reserves transferred, the difference shall be recorded by the ceding entity as a decrease in losses incurred. The assuming entity shall record the consideration received as a negative paid loss. In addition, the transferring entity shall record an increase to ceded reinsurance recoverable for the amount of the transferred reserve. Journal entries illustrating these transactions, including situations in which the transaction includes an unearned premium reserve, are included in Exhibit B of this Statement.

**§4-105.** The assuming entity will report the business in the same line of business as reported by the original insurer or reinsurer. The assuming entity will report the business at the same level of detail using the appropriate statutory schedules and exhibits.

**Disclosures**

**§5-106.** Unsecured Reinsurance Recoverables:

a. If the entity has with any individual reinsurers, authorized, unauthorized, or certified an unsecured aggregate recoverable for losses, paid and unpaid including IBNR, loss adjustment expenses, and unearned premium, that exceeds 3% of the entity’s policyholder surplus, list each individual reinsurer and the unsecured aggregate recoverable pertaining to that reinsurer; and
b. If the individual reinsurer is part of a group, list the individual reinsurers, each of its related group members having reinsurance with the reporting entity, and the total unsecured aggregate recoverables for the entire group.

86.107. Reinsurance Recoverables in Dispute—Reinsurance recoverable on paid and unpaid (including IBNR) losses in dispute by reason of notification, arbitration or litigation shall be identified if the amounts in dispute from any entity (and/or affiliate) exceed 5% of the ceding entity’s policyholders surplus or if the aggregate of all disputed items exceeds 10% of the ceding entity’s policyholders surplus. Notification means a formal written communication from a reinsurer denying the validity of coverage.

87.108. Uncollectible Reinsurance—Describe uncollectible reinsurance written off during the year reported in the following annual statement classifications, including the name(s) of the reinsurer(s):

a. Losses incurred;

b. Loss adjustment expenses incurred;

c. Premiums earned; and

d. Other.

88.109. Commutation of Ceded Reinsurance—Describe commutation of ceded reinsurance during the year reported in the following annual statement classifications, including the name(s) of the reinsurer(s):

a. Losses incurred;

b. Loss adjustment expenses incurred;

c. Premiums earned; and

d. Other.

89.110. Retroactive Reinsurance—The table illustrated in the NAIC Annual Statement Instructions for Property and Casualty Companies under Retroactive Reinsurance in the Notes to Financial Statements section shall be completed for all retroactive reinsurance agreements that transfer liabilities for losses that have already occurred and that will generate special surplus transactions. The insurer (assuming or ceding) shall assign a unique number to each retroactive reinsurance agreement and shall utilize this number for as long as the agreement exists. Transactions utilizing deposit accounting shall not be reported in this note.

90.111. Reinsurance Assumed and Ceded—The tables illustrated in the NAIC Annual Statement Instructions for Property and Casualty Companies under “Reinsurance Assumed and Ceded in the Notes to Financial Statements” section shall be completed as follows:

a. The financial statements shall disclose the maximum amount of return commission which would have been due reinsurers if all reinsurance were canceled with the return of the unearned premium reserve; and

b. The financial statements shall disclose the accrual of additional or return commission, predicated on loss experience or on any other form of profit sharing arrangements as a result of existing contractual arrangements.
91.112. A specific interrogatory requires information on reinsurance of risk accompanied by an agreement to release the reinsurer from liability, in whole or in part, from any loss that may occur on the risk or portion thereof.

92.113. Disclosures for paragraphs 93-98 represent annual statement interrogatories, which are required to be included with the annual audit report beginning with audit reports on financial statements as of and for the period ended December 31, 2006. The disclosures required within paragraphs 93-98 shall be included in accompanying supplemental schedules of the annual audit report beginning in year-end 2006. These disclosures shall be limited to reinsurance contracts entered into, renewed or amended on or after January 1, 1994. This limitation applies to the annual audit report only and does not apply to the statutory annual statement interrogatories and the reinsurance summary supplemental filing.

93.114. Disclose if any risks are reinsured under a quota share reinsurance contract with any other entity that includes a provision that would limit the reinsurer’s losses below the stated quota share percentage (e.g. a deductible, a loss ratio corridor, a loss cap, an aggregate limit or any similar provisions)? If yes, indicate the number of reinsurance contracts containing such provisions and if the amount of reinsurance credit taken reflects the reduction in quota share coverage caused by any applicable limiting provision(s).

94.115. Disclose if the reporting entity ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statement:
   (i) it recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders; (ii) it accounted for that contract as reinsurance and not as a deposit; and (iii) the contract(s) contain one or more of the following features or other features that would have similar results:
   a. A contract term longer than two years and the contract is noncancellable by the reporting entity during the contract term;
   b. A limited or conditional cancellation provision under which cancellation triggers an obligation by the reporting entity, or an affiliate of the reporting entity, to enter into a new reinsurance contract with the reinsurer, or an affiliate of the reinsurer;
   c. Aggregate stop loss reinsurance coverage;
   d. A unilateral right by either party (or both parties) to commute the reinsurance contract, whether conditional or not, except for such provisions which are only triggered by a decline in the credit status of the other party;
   e. A provision permitting reporting of losses, or payment of losses, less frequently than on a quarterly basis (unless there is no activity during the period); or
   f. Payment schedule, accumulating retentions from multiple years or any features inherently designed to delay timing of the reimbursement to the ceding entity.

95.116. Disclose if the reporting entity during the period covered by the statement ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statement it recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders; excluding cessions to approved pooling arrangements or to captive insurance companies that are directly or indirectly controlling, controlled by, or under common control with (i) one
or more unaffiliated policyholders of the reporting entity, or (ii) an association of which one or more
unaffiliated policyholders of the reporting entity is a member, where:

a. The written premium ceded to the reinsurer by the reporting entity or its affiliates
represents fifty percent (50%) or more of the entire direct and assumed premium written
by the reinsurer based on its most recently available financial statement; or

b. Twenty-five percent (25%) or more of the written premium ceded to the reinsurer has
been retroceded back to the reporting entity or its affiliates in separate reinsurance
contract.

96.117. If affirmative disclosure is required for paragraph 94115 or 95116, provide the following
information:

a. A summary of the reinsurance contract terms and indicate whether it applies to the
contracts meeting paragraph 94115 or 95116;

b. A brief discussion of management's principal objectives in entering into the reinsurance
contract including the economic purpose to be achieved; and

c. The aggregate financial statement impact gross of all such ceded reinsurance contracts on
the balance sheet and statement of income.

97.118. Except for transactions meeting the requirements of paragraph 3136, disclose if the reporting
entity ceded any risk under any reinsurance contract (or multiple contracts with the same reinsurer or its
affiliates) during the period covered by the financial statement, and either:

a. Accounted for that contract as reinsurance (either prospective or retroactive) under
statutory accounting principles (SAP) and as a deposit under generally accepted
accounting principles (GAAP); or

b. Accounted for that contract as reinsurance under GAAP and as a deposit under SAP.

98.119. If affirmative disclosure is required for paragraph 97118, explain in a supplemental filing why the
contract(s) is treated differently for GAAP and SAP.

99.120. Disclosures for the Transfer of Property and Casualty Run-off Agreements

a. Disclose if the reporting entity has entered into any agreements which have been
approved by their domiciliary regulator and have qualified pursuant to paragraph 3136.e.
(also see paragraphs 81-84102-105).

b. If affirmative, provide a description of the agreement and the amount of consideration
paid and liabilities transferred.

100.121. The financial statements shall disclose the following with respect to reinsurance
agreements which qualify for reinsurer aggregation in accordance with paragraphs 66-68;87-89:

a. A description of the significant terms of the reinsurance agreement, including
established limits and collateral, and

b. The amount of unexhausted limit as of the reporting date.
c. To the extent that the domestic state insurance department approves the use of the retroactive contract as an acceptable form of security related to the original reinsurers under the applicable provisions of the state’s credit for reinsurance law, the use of such discretion shall be disclosed in the annual statement Note 1 as a prescribed or permitted practice. In addition, Note 1 shall disclose as part of the total impact on the provision for reinsurance the impact on the overdue aspects of the calculation if the reporting entity also receives commissioner approval pursuant to paragraph 6687 related to overdue paid amounts (both authorized and unauthorized).

401-122. The financial statements shall disclose the following with respect to reinsurance agreements that have been accounted for as deposits:

a. A description of the reinsurance agreements.

b. Any adjustment of the amounts initially recognized for expected recoveries. The individual components of the adjustment (e.g., interest accrual, change due to a change in estimated or actual cash flow) shall be disclosed separately.

402-123. The financial statements shall disclose the impact on any reporting period in which a certified reinsurer’s rating has been downgraded or its certified reinsurer status is subject to revocation and additional collateral has not been received as of the filing date. The disclosure should include the following:

a. Name of certified reinsurer downgraded or subject to revocation of certified reinsurer status and relationship to the reporting entity;

b. Date of downgrade or revocation and jurisdiction of action;

c. Collateral percentage requirements pre and post downgrade or revocation;

d. Net ceded recoverable subject to collateral;

e. As of the end of the current quarter, the estimated impact of the collateral deficiency to the reporting entity as a result of the assuming entity’s downgrade or revocation of certified reinsurer status. (At year-end the actual impact of the collateral deficiency on the provision for reinsurance shall be disclosed.)

403-124. U.S. domiciled reinsurers are eligible for certified reinsurer status. If the reporting entity is a certified reinsurer, the financial statements shall disclose the impact on any reporting period in which its certified reinsurer rating is downgraded or status as a certified reinsurer is subject to revocation. Such disclosure shall include information similar to paragraphs 402-123.b., 402-123.c. and 402-123.d. and the expectation of its certified reinsurer’s ability to meet the increased requirements.

404-125. Refer to the Preamble for further discussion regarding disclosure requirements.

Relevant Literature

405-126. This statement adopts with modification FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts (FAS 113) and FASB Emerging Issues Task Force No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises for the following:
a. Reinsurance recoverables on unpaid case-basis and incurred but not reported losses and loss adjustment expenses shall be reported as a contra-liability netted against the liability for gross losses and loss adjustment expenses;

b. Amounts paid for prospective reinsurance that meet the conditions for reinsurance accounting shall be reported as a reduction of unearned premiums;

c. The gain created by a retroactive reinsurance agreement because the amount paid to the reinsurer is less than the gross liabilities for losses and loss adjustment expenses ceded to the reinsurer is reported in the statement of income as a write-in gain in other income by the ceding entity and a write-in loss by the assuming entity. The gain created by a retroactive reinsurance agreement is restricted as a special surplus account until the actual retroactive reinsurance recovered is in excess of the consideration paid;

d. This statement requires that a liability (provision for reinsurance) be established through a provision reducing unassigned funds (surplus) for unsecured reinsurance recoverables from unauthorized or certified reinsurers and for certain overdue balances due from authorized reinsurers;

e. Some reinsurance agreements contain adjustable features that provide for adjustment of commission, premium or amount of coverage, based on loss experience. This statement requires that the asset or liability arising from the adjustable feature be computed based on experience to date under the agreement, and the impact of early termination may only be considered at the time the agreement has actually been terminated;

Drafting Note: The highlighted text is relevant for the “with and without” discussion. The informal drafting group did not recommend including the GAAP “with and without” guidance because of the modification above.

f. Structured settlements are addressed in SSAP No. 65—Property and Casualty Contracts. Statutory accounting and FAS 113 are consistent in accounting for structured settlement annuities where the reporting entity is the owner and payee and where the claimant is the payee and the reporting entity has been released from its obligation. FAS 113 distinguishes structured settlement annuities where the claimant is the payee and a legally enforceable release from the reporting entity’s liability is obtained from those where the claimant is the payee but the reporting entity has not been released from its obligation. GAAP requires the deferral of any gain resulting from the purchase of a structured settlement annuity where the reporting entity has not been released from its obligation; and

g. This statement requires that reinsurance recoverables on unpaid losses and loss adjustment expenses be presented as a contra-liability. Requirements for offsetting and netting are addressed in SSAP No. 64.

This statement adopts American Institute of Certified Public Accountants (AICPA) Statement of Position 98-7, Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk (SOP 98-7) paragraphs 10-12 and 19 (subsection b only). This statement rejects AICPA SOP 98-7 paragraphs 13-17 and 19 (subsections a and c).

This statement rejects AICPA Statement of Position No. 92-5, Accounting for Foreign Property and Liability Reinsurance. This statement incorporates Appendix A-785 as applicable.
Effective Date and Transition

108.129. This statement shall apply to:

a. Reinsurance agreements entered into, renewed, or amended on or after January 1, 1994. An amendment is any revision or adjustment of contractual terms. The payment of premiums or reimbursement of losses recoverable under the agreement shall not constitute an amendment; and

b. Reinsurance agreements in force on January 1, 1995, which cover losses occurring or claims made on or after that date on policies reinsured under such agreements.

109.130. The guidance shall not apply to:

a. Reinsurance agreements which cover only losses occurring or claims made before January 1, 1994, and which were entered into before January 1, 1994, and were not subsequently renewed or amended; and

b. Reinsurance agreements that expired before and were not renewed or amended after January 1, 1995.

110.131. The guidance in paragraphs 49-5355-73 shall be effective for all accounting periods beginning on or after January 1, 1996, and shall apply to reinsurance agreements entered into, renewed or amended on or after January 1, 1994.

111.132. This statement, including the guidance in paragraph 3540 incorporated from SSAP No. 75, is effective for years beginning January 1, 2001. Changes resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors.

a. Revisions to paragraph 3436.e., related to paragraphs 81-84102-105, and disclosures in paragraph 90120 documented in Issue Paper No. 137—Transfer of Property and Casualty Reinsurance Run-off Agreements are effective for contracts entered on or after January 1, 2010.

b. The guidance in paragraphs 3540, 401122 and 406137 was previously included within SSAP No. 75—Reinsurance Deposit Accounting—An Amendment to SSAP No. 62R, Property and Casualty Reinsurance (SSAP No. 75) and was also effective for years beginning January 1, 2001. In 2011, the guidance from SSAP No. 75 was incorporated within this statement, with SSAP No. 75 nullified. The original guidance included in this statement for deposit accounting, as well as the original guidance adopted in SSAP No. 75, are retained for historical purposes in Issue Paper No. 104. The guidance in paragraph 4854 was originally contained within INT 02-06: Indemnification in Modeled Trigger Transactions and was effective June 9, 2002. The guidance in paragraph 6090 was originally contained within INT 02-09: A-785 and Syndicated Letters of Credit and was effective September 12, 2004.

c. The guidance related to certified reinsurers is applicable only to cedants—cedents domiciled in states that have enacted/promulgated the new collateral framework and only for their cessions to reinsurers certified under that domestic law/rule. The requirements applicable to contracts with certified reinsurers shall be effective for all reporting periods beginning on or after December 31, 2012.
The guidance in paragraphs 66-6887-89 and paragraph 100121 which allowed retroactive reinsurance exceptions for asbestos and pollution contracts was effective for all accounting periods beginning on or after January 1, 2014, for paid losses. This guidance was revised to also allow for unpaid losses effective for reporting periods ending on and after December 31, 2015.

REFERENCES

Relevant Issue Papers

- Issue Paper No. 75—Property and Casualty Reinsurance
- Issue Paper No. 104—Reinsurance Deposit Accounting – An Amendment to SSAP No. 62R—Property and Casualty Reinsurance
- Issue Paper No. 137—Transfer of Property and Casualty Reinsurance Run-off Agreements
- Issue Paper No. 153—Counterparty Reporting Exception for Asbestos and Pollution Contracts
CLASSIFYING REINSURANCE CONTRACTS

Was the contract entered into, renewed, amended, or does the contract have an anniversary date (i.e., multi-year contract) during or after 1994? No

Yes

Has the reinsurer assumed significant insurance risk, both as to timing of risk (including timely reimbursement) and amount of insurance loss under the reinsured portions of the underlying contracts? No

Yes

Is it reasonably possible that the reinsurer may realize a significant loss from the transaction? No

Yes

The contract has transferred risk and should be accounted for as reinsurance in accordance with SSAP No. 62R.

Does the contract only reinsure losses from insured events that may occur after the date the contract is entered into? Yes

Account for the contract as a prospective reinsurance.

No

Does the contract only reinsure losses from insured events that occurred prior to the date the contract is entered into? Yes

Account for the contract as a retroactive unless one of the paragraph 2436 exceptions are met, then account for either prospective reinsurance or as indicated.

No

Is it practicable to identify and account separately for the prospective and retroactive portions of a blended contract? Yes

Account for the prospective and retroactive components separately.

No
EXHIBIT A – IMPLEMENTATION QUESTIONS AND ANSWERS

Drafting note this Exhibit is based on EITF D-034. Future discussion will look more closely at 944-20-55 Implementation Guidance and Illustrations. Also, the references to the removal of the word "new" are consistent with the recently adopted editorial revisions.

Applicability

1. Q: The accounting practices in SSAP No. 62R specify the accounting and reporting for reinsurance contracts. What contracts are considered reinsurance contracts for purposes of applying these accounting practices?

   A: Any transaction that indemnifies an insurer against loss or liability relating to insurance risk shall be accounted for in accordance with the accounting practices included in SSAP No. 62R. Therefore, all contracts, including contracts that may not be structured or described as reinsurance, shall be accounted for as reinsurance when those conditions are met.

2. Q: The provisions of this statement will apply to (a) reinsurance contracts entered into, renewed or amended on or after January 1, 1994, and (b) any other reinsurance contracts that are in force on January 1, 1995 and cover insurable events on the underlying insurance policies that occur on or after that date. What contracts would be exempt from the new accounting rules included in SSAP No. 62R?

   A: The only exempt contracts are:

   1) Purely retroactive reinsurance contracts that cover only insured events occurring before January 1, 1994, provided those contracts were entered into before that date and are not subsequently amended and

   2) Contracts that expired before January 1, 1995 and are not amended after that date.

3. Q: This statement is to be applied to contracts which are amended on or after January 1, 1994. What if the change in terms is not significant, or the terms changed have no financial effect on the contract?

   A: In general, the term amendment should be viewed broadly to include all but the most trivial changes. Examples of amendments include, but are not limited to, replacing one assuming entity with another (including an affiliated entity), or modifying the contract’s limit, coverage, premiums, commissions, or experience-related adjustable features. No distinction is made between financial and non-financial terms.

4. Q: Must the accounting provisions of SSAP No. 62R be applied to an otherwise exempt contract if the ceding entity pays additional premiums under the contract on or after January 1, 1994?

   A: The answer depends on why the additional premiums are paid. If the additional premiums are the result of a renegotiation, adjustment, or extension of terms, the contract is subject to the accounting provisions of SSAP No. 62R. However, additional premiums paid without renegotiation, adjustment, or extension of terms would not make an otherwise exempt contract subject to those provisions.
5. Q: Prospective and retroactive portions of a reinsurance contract are allowed to be accounted for separately, if practicable. Can the retroactive portion of an existing contract be segregated and, therefore, exempted with other retroactive contracts covering insured events occurring prior to January 1, 1994?

A: No. The transition provisions apply to an entire contract, which is either subject to or exempt from the revised provisions of SSAP No. 62R. A ceding entity may bifurcate a contract already subject to the new-accounting rules in SSAP No. 62R and then account for both the prospective and retroactive portions in accordance with the new-accounting standard.

Risk Transfer

6. Q: Do the new risk transfer provisions apply to existing contracts?

A: Yes, the new risk transfer provisions apply to some existing contracts. SSAP No. 62R applies in its entirety only to existing contracts which were renewed or amended on or after January 1, 1994, or which cover losses occurring or claims made after that date. Therefore, those contracts must be evaluated to determine whether they transfer risk and qualify for reinsurance accounting. For accounting periods commencing on or after January 1, 1995, balances relating to such contracts which do not transfer insurance risk shall be reclassified as deposits and shall be accounted for and reported in the manner described under the caption Reinsurance Contracts Must Include Transfer of Risk.

SSAP No. 62R does not apply to existing contracts which were entered into before, and were not renewed or amended on or after, January 1, 1994, and which cover only losses occurring or claims made before that date, nor to contracts which expired before, and were not renewed or amended on or after, January 1, 1995. Those contracts will continue to be accounted for in the manner provided by SSAP No. 62R before these revisions.

7. Q: How does the effective date affect the assessment of whether a significant loss to the reinsurer was reasonably possible?

A: The risk transfer assessment is made at contract inception, based on facts and circumstances known at the time. Because that point in time has passed for existing contracts, some have suggested that the risk transfer provisions be applied as of the effective date. However, that approach to the risk transfer assessment would violate the requirement to consider all cash flows from the contract. Therefore, the test must be applied from contract inception, considering the effect of any subsequent contract amendments. Careful evaluation and considered judgment will be required to determine whether a significant loss to the reinsurer was reasonably possible at inception.

8. Q: Should risk transfer be reassessed if contractual terms are subsequently amended?

A: Yes. When contractual terms are amended, risk transfer should be reassessed. For example, a contract that upon inception met the conditions for reinsurance accounting could later be amended so that it no longer meets those conditions. The contract should then be reclassified and accounted for as a deposit.

9. Q: How should the risk transfer assessment be made when a contract has been amended?

A: No particular method is prescribed for assessing risk transfer in light of a contract amendment. Whether an amended contract in substance transfers risk must be determined considering all of
the facts and circumstances in light of the risk transfer requirements. Judgment also will be required to determine whether an amendment in effect creates a new contract.

10. Q: For purposes of evaluating whether a contract with a reinsurer transfers risk, what constitutes a contract?

A: A contract is not defined, but is essentially a question of substance. It may be difficult in some circumstances to determine the boundaries of a contract. For example, the profit-sharing provisions of one contract may refer to experience on other contracts and, therefore, raise the question of whether, in substance, one contract rather than several contracts exist.

The inconsistency that could result from varying interpretations of the term "contract" is limited by requiring that features of the contract or other contracts or agreements that directly or indirectly compensate the reinsurer or related reinsurers for losses be considered in evaluating whether a particular contract transfers risk. Therefore, if agreements with the reinsurer or related reinsurers, in the aggregate, do not transfer risk, the individual contracts that make up those agreements also would not be considered to transfer risk, regardless of how they are structured.

11. Q: If the assessment of risk transfer changes after the initial assessment at contract inception, how should the ceding entity account for the change?

A: The status of a contract should be determinable at inception and, absent amendment, subsequent changes should be very rare. If the risk of significant loss was not deemed reasonably possible at inception, and a significant loss subsequently occurred, the initial assessment was not necessarily wrong, because remote events do occur. Likewise, once a reasonable possibility of significant loss has been established, such loss need not occur in order to maintain the contract’s status as reinsurance.

12. Q: SSAP No. 62R requires that reasonably possible outcomes be evaluated to determine the reinsurer’s exposure to significant loss. What factors should be considered in determining whether a scenario being evaluated is reasonably possible?

A: The term “reasonably possible” means that the probability is more than remote. The test is applied to a particular scenario, not to the individual assumptions used in the scenario. Therefore, a scenario is not reasonably possible unless the likelihood of the entire set of assumptions used in the scenario occurring together is reasonably possible.

13. Q: In determining the amount of the reinsurer’s loss under reasonably possible outcomes, may cash flows directly related to the contract other than those between the ceding and assuming companies, such as taxes and operating expenses of the reinsurer, be considered in the calculation?

A: No. The evaluation is based on the present value of all cash flows between the ceding and assuming enterprises under reasonably possible outcomes and, therefore, precludes considering other expenses of the reinsurer in the calculation.

14. Q: In evaluating the significance of a reasonably possible loss, should the reasonably possible loss be compared to gross or net premiums?

A: Gross premiums should be used.
15. Q: How does a commutation clause affect the period of time over which cash flows are evaluated for reasonable possibility of significant loss to the reinsurer?

A: All cash flows are to be assessed under reasonably possible outcomes. Therefore, unless commutation is expected in the scenario being evaluated, it should not be assumed in the calculation. Further, the assumptions used in a scenario must be internally consistent and economically rational in order for that scenario’s outcome to be considered reasonably possible.

16. Q: What interest rate should be used in each evaluated scenario to make the present value calculation?

A: A reasonable and appropriate rate is required, which generally would reflect the expected timing of payments to the reinsurer and the duration over which those cash flows are expected to be invested by the reinsurer.

_Drafting Note- Moved this guidance in 944-20-15-49 based on EITF D-034, paragraph 17 to SSAP No. 62R, paragraph 17 to more closely match the risk transfer wording in GAAP._

17. Q: SSAP No. 62R refers to payment schedules and accumulating retentions from multiple years as features that delay timely reimbursement of claims. Does the presence of those features generally prevent a contract from meeting the conditions for reinsurance accounting?

A: Yes. Payment schedules and accumulating retentions from multiple years are contractual features inherently designed to delay the timing of reimbursement to the ceding entity. Regardless of what a particular feature might be called, any feature that can delay timely reimbursement violates the conditions for reinsurance accounting. Transfer of insurance risk requires that the reinsurer’s payments to the ceding entity depend on and directly vary with the amount and timing of claims settled under the reinsured contracts. Contractual features that can delay timely reimbursement prevent this condition from being met. Therefore, any feature that may affect the timing of the reinsurer’s reimbursement to the ceding entity should be closely scrutinized.

18. Q: What if a contract contains a feature such as a payment schedule or accumulating retention but could still result in the reasonable possibility of significant loss to the reinsurer?

A: Both of the following conditions are required for reinsurance accounting:

a. Transfer of significant risk arising from uncertainties about both (i) the ultimate amount of net cash flows from premiums, commission, claims, and claim settlement expenses paid under a contract (underwriting risk) and (ii) the timing of the receipt and payment of those cash flows (timing risk); and

b. Reasonable possibility of significant loss to the reinsurer.

Because both condition (a) and condition (b) must be met, failure to transfer significant timing and underwriting risk is not overcome by the possibility of significant loss to the reinsurer.

19. Q: Can a reinsurance agreement compensate a reinsurer for losses?

A: A contract does not meet the conditions for reinsurance accounting if features of the reinsurance contract or other contracts or agreements directly or indirectly compensate the reinsurer or related reinsurers for losses to an extent that risk transfer criteria is violated. That compensation may take many forms, and an understanding of the substance of the contracts or agreements is required to
determine whether the ceding entity has been indemnified against loss or liability relating to insurance risk. For example, contractual features may limit the reinsurer’s exposure to insurance risk or delay the reimbursement of claims so that investment income mitigates exposure to insurance risk. Examples of those contractual features, noted in paragraph 12944-20-15-40(a) through (b), are not all-inclusive. (Drafting Note – Source 944-20-55-58 Reinsurance of Short-Duration Contracts from FAS 113, paragraph 58)

• 5-2-18 Drafting Comment - In the current ASC 55-58 in implementation, in FAS 113 this is in the basis of conclusions. Therefore this was moved to the QA. RAA has noted a preference to add more context to this answer and will provide further comments.

• 19. Q: Is it permissible to evaluate timely reimbursement on a present value basis?
A: No. The word timely is used in the ordinary temporal sense to refer to the length of time between payment of the underlying reinsured claims and reimbursement by the reinsurer.

While the test for reasonable possibility of significant loss to the reinsurer provides for a present value-based assessment of the economic characteristics of the reinsurance contract, the concept of timely reimbursement relates to the transfer of insurance risk (condition a. above), not the reasonable possibility of significant loss (condition b. above). Accordingly, timely reimbursement should be evaluated based solely on the length of time between payment of the underlying reinsured losses and reimbursement by the reinsurer.

(Drafting Note: QA 19 is recommended to be moved to SSAP No. 62R, paragraph 15 so that the detailed guidance is in the same section as the related guidance on the use of timely in paragraph 12 Source 944-20-15-48 from EITF D-034, paragraph 22 renumbering would be required in the QA).

20. Q: Are there any circumstances under which the conditions for risk transfer need not be met?
A: Yes. An extremely narrow and limited exemption is provided for contracts that reinsure either an individual risk or an underlying book of business that is inherently profitable. When substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer, the contract meets the conditions for reinsurance accounting. To qualify under this exception, no more than trivial insurance risk on the reinsured portions of the underlying insurance contracts may be retained by the ceding entity. The reinsurer’s economic position must be virtually equivalent to having written the relevant portions of the reinsured contracts directly. (Drafting Note: The above is similar to ASC 944-20-15-54 (main accounting), which is based on EITF D-034, paragraph 23. It is recommended to be moved to SSAP No. 62R, paragraph 19.)

19. Q: In determining whether a reinsurance contract qualifies under the exception referred to in the preceding question paragraph 18, how should the economic position of the reinsurer be assessed in relation to that of the ceding entity?
A: The assessment should be made by comparing the net cash flows of the reinsurer under the reinsurance contract with the net cash flows of ceding entity on the reinsured portions of the underlying insurance contracts. This may be relatively easy for reinsurance of individual risks or for unlimited-risk quota-share reinsurance, because the premiums and losses on these types of reinsurance generally are the same as the premiums and losses on the reinsured portions of the underlying insurance policies.

In other types of reinsurance, determining the reinsurer’s net cash flows relative to the insurer is likely to be substantially more difficult. For example, it generally would be difficult to demonstrate that the ceding entity’s premiums and losses for a particular layer of insurance are the same as the reinsurer’s premiums and losses related to that layer. If the economic position of
the reinsurer relative to the insurer cannot be determined, the contract would not qualify under the exception.

Drafting Note: The above is similar to ASC 944-20-55-56 (implementation), which is based on EITF D-034, paragraph 24, staff does not recommend moving it but pointers to relevant implementation guidance are recommended in a footnote to the risk transfer paragraph.

Accounting Provisions

2220. Q: An existing contract that was accounted for as reinsurance no longer qualifies for reinsurance accounting under the new—accounting rules included in SSAP No. 62R. How should the ceding and assuming companies account for the contract in future periods?

A: Because the statement of income cannot be restated, previously recognized gains and losses are not revised. If the contract was entered into before, and not renewed or amended on or after, January 1, 1994 and covers only losses occurring or claims made before that date, or the contract expired before January 1, 1995 and was not renewed or amended on or after that date, it would continue to be accounted for in the manner provided before these revisions.

For accounting periods commencing on or after January 1, 1995, existing balances relating to contracts which do not transfer insurance risk and which were entered into on or after January 1, 1994 (covering losses occurring or claims made after that date) would be reclassified as deposits.

Premium payments to a reinsurer would be recorded as deposits. Likewise, losses recoverable from a reinsurer would not be recognized as receivables. Rather, any reimbursement for losses would be accounted for upon receipt as a refund of a deposit.

2221. Q: What is the definition of past insurable events that governs whether reinsurance coverage is prospective or retroactive? For example, could a reinsurance contract that covers losses from asbestos and pollution claims on occurrence-based insurance policies effective during previous periods be considered prospective if the reinsurance coverage is triggered by a court interpretation that a loss is covered within the terms of the underlying insurance policies?

A: The distinction between prospective and retroactive reinsurance is based on whether a contract reinsures future or past insured events covered by the underlying reinsurance contracts. In the example above, the insured event is the occurrence of loss within the coverage of the underlying insurance contracts, not the finding of a court. Therefore, the fact that the asbestos exposure or pollution is covered under insurance policies effective during prior periods makes the reinsurance coverage in this example retroactive.

2422. Q: Would the answer to the above question change if the reinsurance were written on a claims-made basis?

A: No. The form of the reinsurance—whether claims-made or occurrence-based—does not determine whether the reinsurance is prospective or retroactive. A claims-made reinsurance contract that reinsures claims asserted to the reinsurer in a future period as a result of insured events that occurred prior to entering into the reinsurance contract is a retroactive contract.

2423. Q: What is the effect of adjustments to future premiums or coverage in determining whether reinsurance is prospective or retroactive?
A: Adjustments to future premiums or coverage may affect the accounting for a reinsurance contract. Whenever an adjustment results in a reinsurer providing new or additional coverage for past insurable events, that coverage is retroactive. For example, if subsequent years’ premiums under a multiple accident year contract create additional coverage for previous accident years, the additional coverage is retroactive, even if the original coverage provided in the contract for those accident years was prospective. Likewise, if current losses under a multiple-year contract eliminate coverage in future periods, some or all of the premiums to be paid in those future periods should be charged to the current period.

2624. Q: A reinsurance contract is entered into after the contract’s effective date. Is the coverage between the contract’s effective date and the date the contract was entered into prospective or retroactive?

A: The portion of the contract related to the period of time between the effective date of the contract and the date the contract was entered into is retroactive because it covers insured events that occurred prior to entering into the reinsurance contract.

2725. Q: How is the date the reinsurance contract was entered into determined?

A: It is not uncommon for a reinsurance arrangement to be initiated before the beginning of a policy period but not finalized until after the policy period begins. Whether there was agreement in principle at the beginning of the policy period and, therefore, the contract is substantively prospective must be determined based on the facts and circumstances. For example, a contract may be considered to have been substantively entered into even though regulatory approval of that contract has not taken place.

The absence of agreement on significant terms, or the intention to establish or amend those terms at a later date based on experience or other factors, generally indicates that the parties to the contract have not entered into a reinsurance contact, but rather have agreed to enter into a reinsurance contract at a future date. If contractual provisions under a contract substantively entered into at a future date covered insurable events prior to that date, that coverage is retroactive.

In any event, SSAP No. 62R provides that if a contract (except facultative contracts and contracts signed by the lead reinsurer and certain cover notes or similar documents signed by reinsurers representing more than 50% of the capacity on the contract) has not been finalized, reduced to written form and signed by the parties within 9 months after its effective date, it is presumed to be retroactive.

2826. Q: Are contracts to reinsure calendar-year incurred losses considered blended contracts that have both prospective and retroactive elements?

A: Yes. Most reinsurance contracts covering calendar-year incurred losses combine coverage for insured events that occurred prior to entering into the reinsurance contract with coverage for future insured events and, therefore, include both prospective and retroactive elements.

In any event, SSAP No. 62R provides that if a contract (except facultative contracts, contracts signed by the lead reinsurer and certain cover notes or similar documents signed by reinsurers representing more than 50% of the capacity on the contract) has not been finalized, reduced to written form and signed by the parties within 9 months after its effective date it is presumed retroactive.
Q: When the prospective and retroactive portions of a contract are being accounted for separately, how should premiums be allocated to each portion of the contract?

A: No specific method for allocating the reinsurance premiums to the risks covered by the prospective and retroactive portions of a contract is required. However, separate accounting for the prospective and retroactive portions of a contract may take place only when an allocation is practicable.

Practicability requires a reasonable basis for allocating the reinsurance premiums to the risks covered by the prospective and retroactive portions of the contract, considering all amounts paid or deemed to have been paid regardless of the timing of payment. If a reasonable basis for allocating the premiums between the prospective and retroactive coverage does not exist, the entire contract must be accounted for as a retroactive contract.

Q: A retroactive reinsurance contract contains a cut-through provision that provides the ceding entity’s policyholders and claimants with the right to recover their claims directly from the reinsurer. May the ceding entity immediately recognize earned surplus associated with this type of contract?

A: No. SSAP No. 62R states that earned surplus may not be recognized “until the actual retroactive reinsurance recovered exceeds the consideration paid.”

Q: A ceding entity enters into a retroactive reinsurance agreement that gives rise to segregated surplus. If the reinsurer prepays its obligation under the contract, may the ceding entity recognize earned surplus at the time the prepayment is received?

A: Segregated surplus arising from retroactive reinsurance transactions is earned as actual liabilities that have been transferred are recovered or terminated. Therefore, earned surplus is based on when the reinsurer settles its obligations to the ceding entity, and it may be appropriate to recognize earned surplus at the time the prepayment is received.

However, all of the facts and circumstances must be considered to determine whether the ceding entity has substantively recovered the liabilities transferred to the reinsurer. For example, if the ceding entity agrees to compensate the reinsurer for the prepayment, such as by crediting the reinsurer with investment income on prepaid amounts or balances held, the ceding entity has not, in substance, recovered its transferred liabilities but rather has received a deposit from the reinsurer that should be accounted for accordingly.

Q: If the ceding entity does not expect to receive any recoveries because the reinsurer has agreed to reimburse claimants under the reinsured contracts directly, would the ceding entity be considered to have recovered or terminated its transferred liabilities?

A: No. In the example given, the reinsurer is substantively acting as disbursing agent for the ceding entity. Therefore, the ceding entity cannot be said to have recovered amounts due from the reinsurer before payment is made to the claimant.

Q: What accounting entries would a ceding entity make to report a retroactive reinsurance contract?

A: Accounting Entries for a Ceding Entity to Report a Retroactive Reinsurance Contract:

Entry 1
Retroactive Reinsurance Reserves
To record initial portfolio transfer see items #3 and #8. The ceding entity must establish the segregated surplus per item #4.

**Entry 1A**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retro. Reins. Gain</td>
<td>2,000</td>
</tr>
<tr>
<td>Profit/Loss Account</td>
<td>2,000</td>
</tr>
</tbody>
</table>

To close gain from retroactive transaction.

**Entry 1B**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit/Loss Account</td>
<td>2,000</td>
</tr>
<tr>
<td>Special Surplus from Retro. Reins.</td>
<td>2,000</td>
</tr>
</tbody>
</table>

To close profit from retroactive reinsurance to special surplus.

**Entry 2**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>2,000</td>
</tr>
<tr>
<td>Retroactive Reinsurance Reserves</td>
<td>2,000</td>
</tr>
<tr>
<td>Ceded or Assumed (B/S)</td>
<td></td>
</tr>
</tbody>
</table>

To record recovery of paid losses from the reinsurer. Outstanding ceded reserves after this recovery equals $8,000, and special surplus from retroactive reinsurance account equals $2,000; therefore, segregated surplus account is not changed per item #10.

**Entry 3**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retroactive Reinsurance Reserves</td>
<td>3,000</td>
</tr>
<tr>
<td>Ceded or Assumed (B/S)</td>
<td></td>
</tr>
<tr>
<td>Retroactive Reinsurance Gain (I/S)</td>
<td>3,000</td>
</tr>
</tbody>
</table>

To record subsequent revision of the initial reserves ceded per item #10. The segregated surplus account is increased to $5,000 as a result of this upward development.

**Entry 3A**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retro. Reinsurance Gain</td>
<td>3,000</td>
</tr>
<tr>
<td>Profit/Loss Account</td>
<td>3,000</td>
</tr>
</tbody>
</table>

To close profit from retroactive reinsurance.

**Entry 3B**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit/Loss (I/S)</td>
<td>3,000</td>
</tr>
<tr>
<td>Special Surplus from Retro. Reins.</td>
<td>3,000</td>
</tr>
</tbody>
</table>

To close profit and loss account to special surplus. (Retroactive reinsurance reserves ceded or assumed account balance equals $11,000. Special Surplus from retroactive reinsurance balance equals $5,000.)

**Entry 4**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>4,000</td>
</tr>
</tbody>
</table>
Retroactive Reinsurance Reserves
Ceded or Assumed (B/S)  4,000

To record recovery of paid losses from the reinsurer. Outstanding ceded reserves after this recovery equals $7,000, therefore segregated surplus account is not changed per item #10.

Entry 5
Cash 3,000
Retroactive Reinsurance Reserves
Ceded or Assumed (B/S) 3,000

To record recovery of paid losses from reinsurer. Outstanding ceded reserves after recovery equals $4,000, therefore the following entry is needed per items #6 and #10.

Entry 5A
Special Surplus—Retro. Reins. 1,000
Unassigned Funds 1,000
Retroactive Reinsurance reserves ceded or assumed after this entry equals $4,000.

Entry 6
Retroactive Reinsurance Loss (I/S) 1,000
Retroactive Reinsurance Reserves
Ceded or Assumed (B/S) 1,000

To record subsequent revision of the initial reserves ceded per item #10. The segregated surplus account is decreased as a result of this downward development to $3,000. The following entry is needed per items #6 and #10.

Entry 6A
Profit/Loss Account 1,000
Retro. Reins. Loss 1,000

To close loss to profit and loss account.

Entry 6B
Special Surplus from Retro. Reins. 1,000
Profit/Loss Account 1,000

To close profit and loss account to special surplus. (Remaining balance of retroactive reinsurance reserve ceded or assumed account equals $3,000.) (Special surplus from retro. reins. account balance equals $3,000.)

Entry 7
Cash 2,500
Retroactive Reinsurance Gain (I/S) 500
Retroactive Reinsurance Reserves
Ceded or Assumed (B/S) 3,000

Entry 7A
Profit and Loss Account 500
Retro. Reins. Gain 500
To close other income to profit and loss account.

**Entry 7B**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Special Surplus from Retro. Reins.</td>
<td>500</td>
</tr>
<tr>
<td>Profit/Loss Account</td>
<td>500</td>
</tr>
</tbody>
</table>

To close profit and loss account to special surplus. (Remaining balance of special surplus from retro. reins. account equals $2,500.) (Remaining balance of retroactive reinsurance reserve ceded or assumed account -0-.)

**Entry 7C**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Special Surplus from Retro. Reins.</td>
<td>2,500</td>
</tr>
<tr>
<td>Unassigned Funds</td>
<td>2,500</td>
</tr>
</tbody>
</table>

To close remaining special surplus account to unassigned surplus.

Q: How should the parties account for an adverse loss development reinsurance contract where, as of the statement date, the attachment level of the contract exceeds the ceding company’s current case and IBNR reserves for the covered accident years (i.e. no surplus gain and no reinsurance recoverable as of the statement date), and the ceding company transferred cash to the reinsurer at the inception of the contract?

A: An adverse loss development reinsurance contract covering prior accident years meets the definition of “retroactive reinsurance” set forth in paragraph 2226 of SSAP No. 62R:

….reinsurance in which a reinsurer agrees to reimburse a ceding entity for liabilities incurred as a result of past insurable events covered under contracts subject to the reinsurance....

Paragraph 2934.k. of SSAP No. 62R specifically provides that the consideration paid for a retroactive reinsurance contract is to be recorded as a decrease in ledger assets by the ceding entity and an increase in ledger assets by the assuming entity.

Question 3331 illustrates the accounting entries for retroactive reinsurance contracts.

If the retroactive reinsurance contract transfers both components of insurance risk then, pursuant to paragraph 2934 of SSAP No. 62R, the ceding company would record the consideration paid as a decrease in ledger assets, recognize an expense for the reinsurance ceded through Other Income or Loss accounts as a write-in item identified as “Retroactive Reinsurance Ceded”, and record the recoverable from the reinsurer as a contra liability.

No contra liability is established until and unless (and then only to the extent that) the ceding company establishes reserves which exceed the attachment point.

For the contract described, at inception no contra liability is recorded to offset current liability for the business ceded, since the ceded retroactive reinsurance premium relates to coverage in excess of the current liabilities recorded by the ceding company.

Once the ceding company’s recorded liabilities exceed the attachment point of the adverse loss development reinsurance contract and triggers reinsurance recoverable from the reinsurer, a contra liability is established by the ceding company for the amount of the reinsurance recoverable. Any surplus resulting from the retroactive reinsurance is carried as a write-in item on
the balance sheet designated as “Special Surplus from Retroactive Reinsurance Account.” The surplus gain may not be classified as unassigned funds (surplus) until the actual retroactive reinsurance recovered exceeds the consideration paid.

If any portion of a retroactive reinsurance contract does not transfer insurance risk, then the portion which does not transfer risk is accounted for as a deposit pursuant to paragraph 3340. The deposit is reported as an admitted asset of the ceding company if the reinsurer is licensed, accredited, certified or otherwise qualified in the ceding company’s state of domicile as described in Appendix A-785, or if there are funds held by or on behalf of the ceding company as described in that appendix. Receipts and disbursements under the contract are recorded through the deposit/liability accounts. Amounts received in excess of the deposit made are recognized as a gain in the Other Income or Loss account.

Accounting entries for a ceding entity to report a retroactive reinsurance contract at the inception of which the cedent’s reserves are lower than the attachment point of the reinsurance coverage:

Assume the company pays $16m to purchase adverse development coverage of $50m, above an attachment point.

**Entry 1: Payment of Retrospective Reinsurance Premium**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retrospective Reinsurance Expense*</td>
<td>$16m</td>
</tr>
<tr>
<td>Cash</td>
<td>$16m</td>
</tr>
</tbody>
</table>

The company pays $16m premium for the retrospective reinsurance contract.

*This is an Other Expense item, it does not flow through Schedule F or Schedule P.

**Entry 2: Adverse Development Reaches the Attachment Point**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Losses Incurred</td>
<td>$25m</td>
</tr>
<tr>
<td>Gross Loss Reserve</td>
<td>$25m</td>
</tr>
<tr>
<td>Recoverable on Retro Reinsurance Contract**</td>
<td>$25m</td>
</tr>
<tr>
<td>Other Income*</td>
<td>$9m</td>
</tr>
<tr>
<td>Contra – Retro Reinsurance Expense*</td>
<td>$16m</td>
</tr>
<tr>
<td>Surplus***</td>
<td>$9m</td>
</tr>
<tr>
<td>Segregated Surplus***</td>
<td>$9m</td>
</tr>
</tbody>
</table>

The company incurs $25m development on reserves related to the contract.

*These are Other Income/Expense items do not flow through Schedule F or Schedule P.

**A contra-liability write-in item, not netted against loss reserves.

***Surplus is segregated in the amount of [$25m - $16m = $9m] recoverables less consideration paid.

**Entry 3: Cash is Recovered on Paid Losses**

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$20m</td>
</tr>
<tr>
<td>Recoverable on Retrospective Reinsurance Contract</td>
<td>$20m</td>
</tr>
<tr>
<td>Segregated Surplus</td>
<td>$4m</td>
</tr>
<tr>
<td>Surplus</td>
<td>$4m</td>
</tr>
</tbody>
</table>
The company recovers $20m cash from reinsurer on this retro contract. Segregated Surplus decreases in the amount of [$20m - $16m = $4m] (decreases for amount recovered in excess of consideration paid).

3533. Q: How should a ceding company account for payment of the premium for a retroactive reinsurance contract by the ceding company’s parent company or some other person not a party to the reinsurance contract (for example, adverse loss development reinsurance contracts purchased by the parent company in the context of the purchase or sale of the ceding company)?

A: If the reinsurance premium is not paid directly by the ceding company but is instead paid on behalf of the ceding company by the ceding company’s parent company or some other entity not a party to the reinsurance contract, then the ceding company should (1) record an increase in gross paid in and contributed surplus in the amount of the reinsurance premium to reflect the contribution to surplus by the parent or third party payor, and (2) record an expense in the amount of the reinsurance premium and account for the contract as provided in questions 3331 and 3432.
EXHIBIT B – P&C RUNOFF REINSURANCE TRANSACTIONS

Omitted to save space. Not needed for drafting group discussion.

EXHIBIT C – ILLUSTRATION OF A REINSURANCE CONTRACT THAT IS ACCOUNTED FOR AS A DEPOSIT USING THE INTEREST METHOD

Omitted to save space. Not needed for drafting group discussion.
This page intentionally left blank.
Notice of Public Hearing and Request for Written Comments

Basis for hearings. The Statutory Accounting Principles Working Group (SAPWG) will hold a public hearing to obtain information from and views of interested individuals and organizations about the standards proposed in this Exposure Draft. The SAPWG will conduct the hearing in accordance with the National Association of Insurance Commissioners (NAIC) policy statement on open meetings. An individual or organization desiring to speak must notify the NAIC in writing by October 5, 2018. Speakers will be notified as to the date, location, and other details of the hearings.

Oral presentation requirements. The intended speaker must submit a position paper, a detailed outline of a proposed presentation or comment letter addressing the standards proposed in the Exposure Draft by October 5, 2018. Individuals or organizations whose submission is not received by that date will only be granted permission to present at the discretion of the SAPWG chair. All submissions should be addressed to the NAIC staff at the address listed below.

Format of the hearings. Speakers will be allotted up to 10 minutes for their presentations to be followed by a period for answering questions from the SAPWG. Speakers should use their allotted time to provide information in addition to their already submitted written comments as those comments will have been read and analyzed by the SAPWG. Those submissions will be included in the public record and will be available at the hearings for inspection.

Copies. Exposure Drafts can be obtained on the Internet at the NAIC Home Page (http://www.naic.org). The documents can be downloaded using Microsoft Word.

Written comments. Participation at a public hearing is not a prerequisite to submitting written comments on this Exposure Draft. Written comments are given the same consideration as public hearing testimony.

The Statutory Accounting Principles Statement of Concepts was adopted by the Accounting Practices & Procedures (EX4) Task Force on September 20, 1994, in order to provide a foundation for the evaluation of alternative accounting treatments. All issues considered by the SAPWG will be evaluated in conjunction with the objectives of statutory reporting and the concepts set forth in the Statutory Accounting Principles Statement of Concepts. Whenever possible, establish a relationship between your comments and the principles defining statutory accounting.

The exposure period is not meant to measure support for, or opposition to, a particular accounting treatment but rather to accumulate an analysis of the issues from other perspectives and persuasive comments supporting them. Therefore, form letters and objections without valid support for their conclusions are not helpful in the deliberations of the working group. Comments should not simply register your agreement or disagreement without a detailed explanation, a description of the impact of the proposed guidelines, or possible alternative recommendations for accomplishing the regulatory objective.

Any individual or organization may send written comments addressed to the Working Group to the attention of Julie Gann at jgann@naic.org, Robin Marcotte at rmarcotte@naic.org, Fatima Sediqzad at fsediqzad@naic.org and Jake Stultz at jstultz@naic.org no later than October 5, 2018. Electronic submission is preferred. Julie Gann is the NAIC Staff that is the project lead for this topic.

National Association of Insurance Commissioners
1100 Walnut Street, Suite 1500, Kansas City, MO 64106-2197
(816) 842-3600
Unaffiliated Common Stock

Statement of Statutory Accounting Principles No. 30 - Revised

Unaffiliated Common Stock

STATUS

Type of Issue ...................................... Common Area
Issued............................................... Initial Draft
Effective Date ................................. January 1, 2001; Substantively Revised
Affects .............................................. Nullifies INT 02-07
Affected by ............................ No other pronouncements
Interpreted by ......................... INT 06-02; INT 06-07
Relevant Appendix A Guidance .... None

SCOPE OF STATEMENT ................................................................. 4

SUMMARY CONCLUSION ............................................................. 4

Acquisitions and Sales ............................................................... 5
Balance Sheet Amount ............................................................... 5
Impairment .............................................................................. 6
Income ..................................................................................... 6
Stock Splits, Stock Dividends, Payment in Kind Dividends, and Stock Exchanges ................................................. 6
FHLB Capital Stock ................................................................. 6
Disclosures ............................................................................. 7
FHLB Disclosures ................................................................. 8
Relevant Literature ................................................................. 8
Effective Date and Transition ................................................... 8

REFERENCES .............................................................................. 9

Other ........................................................................................ 9
Relevant Issue Papers ............................................................. 9
Unaffiliated Common Stock

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for common stocks.

2. Investments in common stock of subsidiaries, controlled or affiliated entities (investments in affiliates) are not within the scope of this statement. They are addressed in SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities (SSAP No. 97).

SUMMARY CONCLUSION

3. Common stocks (excluding investments in affiliates) are securities which represent a residual / subordinate ownership in a corporation. This definition includes and shall include:
   a. Publicly traded common stocks;
   b. Common stocks that are not publicly traded;
   c. Common stocks restricted as to transfer of ownership.

4. In addition, the following equity investments are captured within scope of this statement:
   a. Master limited partnerships trading as common stock and American deposit receipts only if the security is traded on the New York, American, or NASDAQ exchanges;
   b. Publicly traded common stock warrants;
   c. Shares of SEC registered Investment Companies captured under the Investment Company Act of 1940 (open-end investment companies (mutual funds), closed-end funds and unit investment trusts), regardless of the types or mix of securities owned by the fund (e.g., bonds, or stocks, money market instruments), except for Bond Mutual Funds which qualify for bond treatment, as identified in Part Six, Section 2, of the Purposes and Procedures Manual of the NAIC Investment Analysis Office;
      i. Money Market Mutual Funds on the U.S. Direct Obligations/Full Faith and Credit Exempt List, as identified in Part Six, Section 2, of the Purposes and Procedures Manual of the NAIC Investment Analysis Office;

---

1 Restricted stock shall be defined as a security for which sale is restricted by governmental or contractual requirement (other than in connection with being pledged as collateral), except where that requirement terminates within one year or if the holder has the power by contract otherwise to cause the requirement to be met within one year. Any portion of the security that can be reasonably expected to qualify for sale within one year is not considered restricted. Regardless of redemption timeframe, FHLB capital stock is considered restricted stock until actual redemption by the FHLB.

2 Unless as specifically noted, the equity investments identified within scope are subject to the provisions of this standard as if they were common stock investments.

3 Non-SEC registered investment companies (e.g., private investment companies or hedge funds) are excluded from the scope of this statement.

4 Money market mutual funds are considered cash equivalents under SSAP No. 2R.

5 Pursuant to SSAP No. 2R, effective December 31, 2017, money market mutual funds shall be reported as cash equivalents and valued at fair value (net asset value allowed as a practical expedient).
Exchange Traded Funds, except for those identified for bond or preferred stock treatment, as identified in Part Six, Section 2, of the Purposes and Procedures Manual of the NAIC Investment Analysis Office; and

Common stocks that are not publicly traded, including equity interests in certified capital companies in accordance with INT 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO); and

Common stocks that are restricted as to transfer of ownership. Restricted stock shall be defined as a security for which sale is restricted by governmental or contractual requirement (other than in connection with being pledged as collateral), except where that requirement terminates within one year or if the holder has the power by contract or otherwise to cause the requirement to be met within one year. Any portion of the security that can be reasonably expected to qualify for sale within one year is not considered restricted. Regardless of redemption timeframe, FHLB capital stock is considered restricted stock until actual redemption by the FHLB.

Investments within scope of this statement meet the definition of assets as defined in SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement.

**Acquisitions and Sales**

At acquisition, common stocks shall be reported at their cost, including brokerage and other related fees. Common stock acquisitions and dispositions shall be recorded on the trade date. Private placement stock transactions shall be recorded on the funding date. A reporting entity may become qualified for use of equity method accounting by an increase in the level of ownership. In this situation, the reporting entity shall add the cost of acquiring additional interest in the investee to the current basis of the previously held interest and shall apply the equity method, as prescribed in SSAP No. 97, prospectively, as of the date the investment becomes qualified for equity method accounting.

A reporting entity can subscribe for the purchase of stock, but not be required to make payment until a later time. Transactions of this nature are common in the formation of corporations. Common stock acquired under a subscription represents a conditional transaction in a security authorized for issuance but not yet actually issued. Such transactions are settled if and when the actual security is issued and the exchange or National Association of Securities Dealers (NASD) rules that the transactions are to be settled. Common stock acquired under a subscription shall be recorded as an admitted asset when the reporting entity or its designated custodian or transfer agent takes delivery of the security and the security is recorded in the name of the reporting entity or its nominee (i.e., the accounting for such common stock acquisitions shall be on the settlement date).

**Balance Sheet Amount**

Investments in scope of this standard unaffiliated common stocks shall be valued reported at fair value. For FHLB capital stock, which is only redeemable at par, the fair value shall be presumed to be par, unless considered other-than-temporarily impaired. Mutual funds, unit-investment funds and exchange traded funds, without a readily determinable fair value, are permitted to be reported at net asset value if permitted as a practical expedient pursuant to the guidance in SSAP No. 100R. Closed-end funds are not permitted to be reported at net asset value and shall be reported at fair value. Changes in fair value (or net asset value, as permitted) shall be recorded as unrealized gains or losses.
8.9. For reporting entities required to maintain an Asset Valuation Reserve (AVR), the accounting for unrealized capital gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve (SSAP No. 7). For reporting entities not required to maintain an AVR, unrealized capital gains and losses shall be recorded as a direct credit or charge to surplus.

Impairment

9.10. For any decline in the fair value of a common stock which is determined to be other than temporary (INT 06-07) the common stock shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. For those reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with SSAP No. 7. Subsequent fluctuations in fair value shall be recorded as unrealized gains or losses. Future declines in fair value which are determined to be other than temporary shall be recorded as realized losses. A decline in fair value which is other than temporary includes situations where a reporting entity has made a decision to sell a security at an amount below its carrying value.

Income

10.11. Dividends on common stock shall be recorded as investment income on the ex-dividend date with a corresponding receivable to be extinguished upon receipt of cash (i.e., dividend income shall be recorded on stocks declared to be ex-dividends on or prior to the statement date).

11.12. For reporting entities required to maintain an AVR, the accounting for realized capital gains and losses on sales of common stock shall be in accordance with SSAP No. 7. For reporting entities not required to maintain an AVR, realized gains and losses on sales of common stock shall be reported as realized gains/losses in the statement of operations.

Stock Splits, Stock Dividends, Payment in Kind Dividends, and Stock Exchanges

12.13. Stock splits, stock dividends, payment in kind dividends, and stock exchanges shall be accounted for in accordance with SSAP No. 95—Nonmonetary Transactions (SSAP No. 95).

FHLB Capital Stock

13.14. FHLB capital stock is held by reporting entities that are members of an FHLB. Each reporting entity must acquire FHLB capital stock for membership and maintain capital stock holding sufficient to support its business activity (borrowings6) in accordance with the respective FHLB’s capital plan. The price of FHLB capital stock cannot fluctuate, and all FHLB capital stock must be purchased, repurchased or transferred at its par value. FHLB capital stock is restricted for redemption in accordance with the FHLB capital plan and shall be coded as restricted within the financial statements (e.g., investment schedules and general interrogatories).

14.15. Acquisition of FHLB capital stock allows members to conduct business activity (borrowings) from an FHLB. The amount of capital stock acquired determines the reporting entity’s eligible borrowing amount. At a minimum, all borrowings from an FHLB (regardless of structure) must also be fully collateralized in accordance with the FHLB capital plan, which determines the amount of collateral required by type of pledged instrument. Collateral pledged to an FHLB shall be coded as restricted within

---

6 Membership in an FHLB allows reporting entities to take advances / borrow from the FHLB. These borrowings can be structured in a variety of ways, for example: debt, funding agreements, repurchase agreements, securities lending, etc. Borrowings from an FHLB shall be reflected in the financial statements in accordance with the SSAP that addresses the substance of the agreement.
the financial statements (e.g., investments schedules and general interrogatories). Collateral pledged to an FHLB is considered an admitted asset if all of the following conditions are met:

a. the asset would have been admitted under SSAP No. 4;
b. the pledging insurer continues to receive the income on the pledged collateral;
c. the pledging insurer can remove and substitute other securities with little or advance notice to the FHLB as long as the insurer complies with related investment quality and market value provisions; and
d. there has been no uncured default or event to indicate an impairment or loss contingency for the pledged assets.

Disclosures

15.16. The following disclosures regarding common stocks shall be made in the financial statements:

a. Basis at which the common stocks are stated; and
b. A description, as well as the amount, of common stock that is restricted outside of FHLB agreements and the nature of the restriction. (Disclosures of FHLB capital stock are captured in paragraph 16.)
c. For each balance sheet presented, all common stocks in an unrealized loss position for which other-than-temporary declines in value have not been recognized,
   i. The aggregate amount of unrealized losses (that is, the amount by which cost or amortized cost exceeds fair value) and
   ii. The aggregate related fair value of common stocks with unrealized losses.
d. The disclosures in (i) and (ii) above should be segregated by those common stocks that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with SSAP No. 100R—Fair Value.
e. As of the most recent balance sheet presented, additional information should be included describing the general categories of information that the investor considered in reaching the conclusion that the impairments are not other-than-temporary.
f. When it is not practicable to estimate fair value, the investor should disclose the following additional information, if applicable, as of each date for which a statement of financial position is presented in its annual financial statements:
   i. The aggregate carrying value of the investments not evaluated for impairment, and
   ii. The circumstances that may have a significant adverse effect on the fair value.
FHLB Disclosures

16.17. For FHLB agreements, the following information shall be disclosed in the financial statements for current and prior year and between general account and separate account activity. The information in the disclosures shall be presented gross even if a right to offset per SSAP No. 64 exists.

a. General description of FHLB agreements, with information on the nature of the agreement, type of borrowing (advances, lines of credit, borrowed money, etc.) and use of the funding.

b. Amount of FHLB capital stock held, in aggregate, and classified as follows: i) membership stock (separated by Class A and Class B); ii) Activity Stock; and iii) Excess Stock. For membership stock, report the amount of FHLB capital stock eligible for redemption and the anticipated timeframe for redemption: i) less than 6 months, ii) 6 months to 1 year, iii) 1 year to 3 years, and iv) 3 to 5 years.

c. Amount (fair value and carrying value) of collateral pledged to the FHLB as of the reporting date. In addition, report the maximum amount of collateral pledged to the FHLB at any time during the current reporting period. (Maximum shall be determined on the basis of carrying value, but with fair value also reported)

d. Aggregate amount of borrowings at the reporting date from the FHLB, reflecting compilation of all advances, loans, funding agreements, repurchase agreements, securities lending, etc., outstanding with the FHLB, and classify whether the borrowing is in substance: i) debt (SSAP No. 15—Debt and Holding Company Obligations), ii) a funding agreement (SSAP No. 52—Deposit-Type Contracts), or iii) Other. For funding agreements, report the total reserves established. Report the maximum amount of aggregate borrowings from an FHLB at any time during the current reporting period, the actual or estimated maximum borrowing capacity as determined by the insurer, with a description of how the borrowing capacity was determined, and whether current borrowings are subject to prepayment penalties.

17.18. The disclosures in paragraphs 15.c. through 15.f. shall be included in the annual audited statutory financial reports only. The FHLB disclosures in paragraph 16 are required in all interim and annual financial statements regardless if the activity is materially different from the activity reported during the prior reporting period. Refer to the Preamble for further discussion regarding disclosure requirements.

Relevant Literature

18.19. This statement adopts ASU 2016-07, Investments - Equity Method and Joint Ventures, modified to reflect statutory terms including the definition of control and statutory reporting concepts. This statement rejects ASU 2016-01, Financial Instruments – Overall and FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities.

Effective Date and Transition

19.20. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors. Revisions adopted to this statement in

---

7 For FHLB membership stock to be eligible for redemption, written notification must have been provided to the FHLB prior to the reporting date.
October 2013 amending SSAP No. 15 and SSAP No. 52 to incorporate FHLB disclosure information are initially effective for interim and annual reporting periods after January 1, 2014. Revisions adopted to this statement in _______, incorporating closed-end funds and unit investment trusts within scope, are initially effective January 1, 2019.

REFERENCES

Other

- Purposes and Procedures Manual of the NAIC Investment Analysis Office
- NAIC Valuation of Securities product prepared by the Securities Valuation Office

Relevant Issue Papers

- Issue Paper No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)
Exposure Draft

**ISSUE PAPER NO. XX—UNAFFILIATED COMMON STOCK**

**Hearing Date:** 2018 Fall National Meeting or Interim Conference Call  
**Location:** 2018 Fall National Meeting or Interim Conference Call

**Deadline for Written Notice of Intent to Speak:**  
October 5, 2018  
**Deadline for Receipt of Written Comments:**  
October 5, 2018

Notice of Public Hearing and Request for Written Comments

**Basis for hearings.** The Statutory Accounting Principles Working Group (SAPWG) will hold a public hearing to obtain information from and views of interested individuals and organizations about the standards proposed in this Exposure Draft. The SAPWG will conduct the hearing in accordance with the National Association of Insurance Commissioners (NAIC) policy statement on open meetings. An individual or organization desiring to speak must notify the NAIC in writing by **October 5, 2018**. Speakers will be notified as to the date, location, and other details of the hearings.

**Oral presentation requirements.** The intended speaker must submit a position paper, a detailed outline of a proposed presentation or comment letter addressing the standards proposed in the Exposure Draft by **October 5, 2018**. Individuals or organizations whose submission is not received by that date will only be granted permission to present at the discretion of the SAPWG chair. All submissions should be addressed to the NAIC staff at the address listed below.

**Format of the hearings.** Speakers will be allotted up to 10 minutes for their presentations to be followed by a period for answering questions from the SAPWG. Speakers should use their allotted time to provide information in addition to their already submitted written comments as those comments will have been read and analyzed by the SAPWG. Those submissions will be included in the public record and will be available at the hearings for inspection.

**Copies.** Exposure Drafts can be obtained on the Internet at the NAIC Home Page (http://www.naic.org). The documents can be downloaded using Microsoft Word.

**Written comments.** Participation at a public hearing is not a prerequisite to submitting written comments on this Exposure Draft. Written comments are given the same consideration as public hearing testimony.

The Statutory Accounting Principles Statement of Concepts was adopted by the Accounting Practices & Procedures (EX4) Task Force on September 20, 1994, in order to provide a foundation for the evaluation of alternative accounting treatments. All issues considered by the SAPWG will be evaluated in conjunction with the objectives of statutory reporting and the concepts set forth in the Statutory Accounting Principles Statement of Concepts. Whenever possible, establish a relationship between your comments and the principles defining statutory accounting.

The exposure period is not meant to measure support for, or opposition to, a particular accounting treatment but rather to accumulate an analysis of the issues from other perspectives and persuasive comments supporting them. Therefore, form letters and objections without valid support for their conclusions are not helpful in the deliberations of the working group. Comments should not simply register your agreement or disagreement without a detailed explanation, a description of the impact of the proposed guidelines, or possible alternative recommendations for accomplishing the regulatory objective.

Any individual or organization may send written comments addressed to the Working Group to the attention of Julie Gann at jgann@naic.org, Robin Marcotte at rmarcotte@naic.org, Fatima Sediqzad at fsediqzad@naic.org and Jake Stultz at jstultz@naic.org no later than **October 5, 2018**. Electronic submission is preferred. Julie Gann is the NAIC Staff that is the project lead for this topic.

National Association of Insurance Commissioners  
1100 Walnut Street, Suite 1500, Kansas City, MO 64106-2197  
(816) 842-3600
Attachment 15
Ref #2017-32
Common Stock
IP No. XX
Statutory Issue Paper No. XX

Unaffiliated Common Stock

STATUS
Exposure Draft – August 4, 2018

Original SSAP: SSAP No. 30

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The guidance within this issue paper introduces substantive revisions to SSAP No. 30—Unaffiliated Common Stock (SSAP No. 30) pursuant to the Statutory Accounting Principles (E) Working Group’s (Working Group) Investment Classification Project. The Investment Classification Project reflects a comprehensive review to address a variety of issues pertaining to definitions, measurement and overall scope of the investment SSAPs.

2. The substantive revisions to SSAP No. 30 (illustrated in Exhibit A) under the Investment Classification Project, detailed within this issue paper, reflect the following key elements:

   a. Improves the common stock definition, with identification of the items that technically do not meet the definition, but warrant common stock treatment.

   b. Revises the guidance to include closed-end funds and unit investment trusts within scope.

   c. Suggests reporting enhancements to capture NAIC designations on D-2-2, allowing RBC to be driven from underlying risk of fund holdings (if determined appropriate by Capital Adequacy (E) Task Force).

DISCUSSION

3. This issue paper intends to provide information on discussions that occurred when considering revisions to SSAP No. 30 under the Investment Classification Project, as well as the adopted revisions.

Common Stock Definition

4. The historical definition of common stock within SSAP No. 30 is “securities which represent a residual ownership in a corporation.” This definition has been identified as generally consistent with market terms, including the NASDAQ and FASB Codification definitions for common stock:

   a. NASDAQ Definition: Securities that represent equity ownership in a company. Common shares let an investor vote on such matters as the election of directors. They also give the holder a share in a company's profits via dividend payments or the capital appreciation of the security. Units of ownership of a public corporation with junior status to the claims of secured/unsecured creditors, bondholders and preferred shareholders in the event of liquidation.

   b. FASB Codification: A stock that is subordinate to all other stock of the issuer.

5. Although the historical definition of common stock in SSAP No. 30 is comparable to market terms, the actual scope of SSAP No. 30 has historically included investments that are not considered...
“common stocks” but may be captured in the definition of an “equity security.” The FASB Codification, reflecting the revisions from ASU 2016-01, Financial Instruments, defines an equity security in Topic 320 (Investments: Debt and Equity Securities) as:

Any security representing an ownership interest in an entity (for example, common, preferred, or other capital stock) or the right to acquire (for example, warrants, rights, forward purchase contracts, and call options) or dispose of (for example, put options and forward sale contracts) an ownership interest in an entity at fixed or determinable prices. The term equity security does not include any of the following:

i. Written equity options (because they represent obligations of the writer, not investments)

ii. Cash-settled options on equity securities or options on equity-based indexes (because those instruments do not represent ownership interests in an entity)

iii. Convertible debt or preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor.

6. Although the FASB definition of an “equity security” captures some investments that are currently identified within the scope of SSAP No. 30, the FASB “equity security” definition also captures investments that are not captured within SSAP No. 30, and are addressed within other SSAPs.

7. Consistent with comments received from interested parties, this issue paper recommends revisions to SSAP No. 30 to align the scope format to be consistent with the structure of SSAP No. 26R—Bonds. With this approach, securities that do not meet the common stock definition, but that have been identified to be captured within the scope of SSAP No. 30 will be specifically identified and reflected as examples of “common stock.”

Scope of SSAP No. 30 – Closed-End Funds and Unit Investment Trusts

8. The key substantive revision detailed within this issue paper is the expansion of SSAP No. 30 to include SEC registered Investment Companies. This revision expands the previous inclusion of “mutual funds” (SEC registered open-end investment companies) to also include SEC registered closed-end funds and unit investment trusts within scope of SSAP No. 30.

Closed-End Funds / Unit Investment Trusts

9. SSAP No. 30 includes “mutual funds” and “exchange traded funds” within the listing of securities captured in scope, but SSAP No. 30 makes no mention of “closed-end funds” or “unit investment trusts,” which are two other types of “investments companies” registered with the SEC. The term “mutual fund” represents an investment in an open-end investment company, and the use of this specific term in SSAP No. 30 results in the exclusion of investments in closed-end investment companies and unit investment trusts.

10. Per the SEC, an "investment company" is a company (corporation, business trust, partnership, or limited liability company) that issues securities and is primarily engaged in the business of investing in securities. An investment company invests the money it receives from investors on a collective basis, and each investor shares in the profits and losses in proportion to the investor's interest in the investment company. The performance of the investment company will be based on (but it won't be identical to) the performance of the securities and other assets that the investment company owns.

11. The federal securities laws categorize investment companies into three basic types:
• Mutual funds - legally known as open-end companies;
• Closed-end funds (CEF) - legally known as closed-end companies;
• Unit Investment Trusts (UITs) - legally known as unit investment trusts.

12. Key elements of SEC registered investments, divided by type of fund, include:

a. Selling Shares / Secondary Market / Price:

i. Mutual Fund: Shares are generally sold on a continuous basis, although some funds will stop selling when they reach a certain level of assets under management. Shares are acquired from the fund itself, or through a broker for the fund. Shares of mutual funds cannot be purchased from other investors on a secondary market, such as the NYSE or NASDAQ. The price that investors pay for mutual fund shares is the fund’s approximate net asset value (NAV) per share plus any fees that the fund may charge at purchase, such as sales charges, also known as sales loads.

ii. Closed-End: Shares are not continuously available for sale. Rather, a fixed number of shares are sold at one time (initial public offering), after which the shares trade on a secondary market, such as the NYSE or NASDAQ. The price is determined by the market and may be greater or less than the shares’ NAV, with a commission paid when purchased and sold. The procedures for buying/selling CEFs are the same for buying/selling stocks, and there are no minimums on purchases or sales. Information on market prices of closed-end funds is publicly available, and information on the NAV can be obtained from the issuer and from certain third-party sources / publications.

iii. Unit Investment Trust: A UIT typically will make a one-time "public offering" of only a specific, fixed number of units (like closed-end funds). Many UIT sponsors, however, will maintain a secondary market, which allows owners of UIT units to sell them back to the sponsors and allows other investors to buy UIT units from the sponsors.

b. Redeemable / Non-Redeemable: (The term redeemable focuses on whether the fund will reacquire the shares from the holder at the investor’s request.)

i. Mutual Fund: Redeemable - When mutual fund investors want to sell their fund shares, they sell them back to the fund, or to a broker acting for the fund, at the current NAV per share, minus any fees the fund may charge, such as deferred sales loads or redemption fees.

ii. Closed-End: Not redeemable - A closed-end fund is not required to buy shares back from investors upon request. However, closed-end funds may offer to repurchase shares at specified intervals (interval funds). As noted above, CEFs are traded on an exchange and can be liquidated at the current market price. (As the holder cannot redeem these investments directly with the fund, this issue paper proposes to require a fair value measurement for CEF, whereas investments that can be redeemed directly with a fund for net asset value (NAV) would be permitted to be reported at NAV.)
iii. **Unit Investment Trust**: Redeemable - Issues redeemable securities (or "units"), like a mutual fund, which means that the UIT will buy back an investor’s "units," at the investor’s request, at the approximate NAV.

c. Management / Registration and Liquid / Illiquid Investments

i. **Mutual Funds**: The investment portfolios of mutual funds are typically managed by separate entities (investment advisers) that are registered with the SEC. In addition, mutual funds themselves are registered with the SEC and subject to SEC regulation.

ii. **Closed-End**: Managed by separate entities (investment advisors) that are registered with the SEC. CEFs funds are permitted to invest in a greater amount of “illiquid” securities than are mutual funds. (An illiquid security generally is considered to be a security that cannot be sold within seven days at the approximate price used by the fund in determining NAV.)

iii. **Unit Investment Trust**: A UIT will have a termination date (a date when the UIT will terminate and dissolve) that is established when the UIT is created (although some may terminate more than fifty years after they are created). In the case of a UIT investing in bonds, for example, the termination date may be determined by the maturity date of the bond investments. When a UIT terminates, any remaining investment portfolio securities are sold and the proceeds are paid to the investors. A UIT does not actively trade its investment portfolio. That is, a UIT buys a relatively fixed portfolio of securities (for example, five, ten, or twenty specific stocks or bonds), and holds them with little or no change for the life of the UIT. Because the investment portfolio of a UIT generally is fixed, investors generally know what they are investing in for the duration of their investment. Investors will find the portfolio securities held by the UIT listed in its prospectus. A UIT does not have a board of directors, corporate officers, or an investment adviser to render advice during the life of the trust.

14. In researching to determine if there was an explicit reason for the prior exclusion of CEFs and UITs from SSAP No. 30, NAIC staff did not find any documented information detailing why “mutual funds” (open-end investment companies) were captured within SSAP No. 30, and the other SEC registered investment companies (CEF and UITs) were not identified within scope of SSAP No. 30. NAIC staff believes a correlation may have been previously made between “closed-end funds” and “partnerships” captured in scope of SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies. In reviewing current documentation regarding CEFs, NAIC staff does not believe that CEFs should be considered similar to non-SEC registered partnerships. Rather, the following characteristics seems to support the inclusion of registered CEF within scope of SSAP No. 30, similar to mutual funds:

a. CEFs are subject to laws and oversight by the SEC and the exchanges where they are listed.
b. CEFs must provide a written prospectus containing complete disclosure about the fund when the shares are initially offered to the public (IPO). Following the IPO, other disclosure documents, including annual and semiannual reports and the proxy statement provide info to the investors.

c. After an IPO, CEFs trade on a stock exchange or over-the-counter market at market prices.

d. CEFs are designed to reflect “bond CEFs” (representing 61% of the CEF market) or “equity CEFs” (representing 39% of the CEF market).

e. Info on CEFs, including NAV, market price and discounts/premiums are found in stock market tables and on major financial websites.

f. Investment returns are received from share price appreciation/depreciation or distributions. Distributions can occur from ordinary dividends (interest and dividend income from securities in the portfolio), capital gains (profits from selling securities held in the portfolio) and from return of capital. Although the “return of capital” may seem similar to a non-SEC registered partnership structure, for CEFs, this occurs when the fund is acting as a pass-through and one of the underlying holdings has a return of capital. (This was noted when the CEF was holding master limited partnerships and the CEF merely passes this payment to the shareholders.) (MLP are also captured in SSAP No. 30 if trading as common stock.) It was also noted that a CEF may have a managed distribution policy when they “return capital” to maintain a stable regular distribution over the long-term so the fund’s distributions are matched to its total return.

15. The proposal in this issue paper to capture CEFs and UITs in scope of SSAP No. 30, is specific to these SEC registered “investment company” structures. This limits the proposal to only investments that are registered under the Investment Company Act of 1940. This proposal purposely continues the exclusion of private funds from the scope of SSAP No. 30. Pursuant to the SEC, “private funds” are pooled investment vehicles that are excluded from the definition of investment company under the Investment Company Act by Section 3(c)1 or 3(c)7 of that Act. The term “private fund” generally includes funds commonly known as hedge funds and private equity funds. With the proposal detailed in this issue paper, private fund investments, if held by reporting entities, would continue to be excluded from the scope of SSAP No. 30.

a. Private fund advisors are often required to register with the SEC and are required to comply with applicable provisions of the Investment Advisors Act of 1940. (These provisions provide the SEC with information on private funds they manage - including size, leverage, liquidity and types of investors.) The “investment advisor” registration is not synonymous with registration of an investment vehicle as an investment company under the Investment Company Act of 1940. A private fund advisor that registers with SEC under the advisors act would not impact the reporting of private equity / hedge funds managed by the investment advisor. Hence, even if the investment advisor was registered with the SEC, funds issued by the registered investor would continue to be excluded from SSAP No. 30 unless the fund was an SEC registered investment.

Scope of SSAP No. 30 – Nonpublic Stock Warrants

16. Comments received from interested parties noted that SSAP No. 30 should be expanded to include stock warrants on non-public common stock. These comments noted that interested parties have wondered why only publicly traded stock warrants are included in SSAP No. 30.
17. From a review of Issue Paper No. 30—Investments in Common Stock, (excluding investments in common stock of subsidiary, controlled or affiliated entities) (finalized March 1998), The exclusion of nonpublic stock warrants seems to have been incorporated from historical guidance included in the Purposes and Procedures Manual of the NAIC Securities Valuation Office when SSAP No. 30 was first adopted. Pursuant to Issue Paper No. 30, paragraph 30: (Applicable Excerpts Only – bolded for emphasis)

18. The Purposes and Procedures Manual of the NAIC Securities Valuation Office - Section 5 - Procedures for Valuing Common Stocks and Stock Warrants contains the following guidance:

(A) Common Stocks of Companies Not Classified as Being Subsidiaries, Controlled or Affiliated, Under Section 5(B).

(a) Association values for publicly traded common stocks and warrants, including, where permitted by law or regulation of an insurer's state of domicile, shares against which exchange traded call options are outstanding, and where the requirements of Section 5(C)(1) are met, shall be equal to market value at date of statement, excepting that, where permitted by law or regulation of an insurer's state of domicile, shares loaned to others shall be valued at the market value at date of statement if the Acceptable Collateral, as hereinafter defined, is pledged as security for the loan and except as set forth in the following sentence, the Acceptable Collateral pledged as security is, at the inception of the loan, in an amount equal to 102% of the market value of the loaned shares. In event that foreign shares are the subject of the loan and the denomination of the currency of the Acceptable Collateral is other than the denomination of the currency of the loaned foreign shares, the amount of Acceptable Collateral which shall be pledged shall be an amount equal to 105% of the market value of the loaned shares. A decline in value of the Acceptable Collateral or an increase in the value of the loaned shares during the term of the loan shall not result in disqualification from valuation in accordance with the above if, during the term the loan is outstanding, additional Acceptable Collateral is posted any time the amount of Acceptable Collateral declines to 100% of the market value of the loaned shares (or 102% of the market value or the loaned shares if Acceptable Collateral in an amount equal to 105% was required to be posted at the inception of the loan) in an amount equal to the difference between the 102% or 105% initially required to be posted and 100% or 102%, respectively. For purpose of this provision, Acceptable Collateral shall mean cash and cash equivalents and shall include securities issued by the U.S. Government or its agencies. Any shortfall in the amount of the actual Acceptable Collateral posted and the required 102% or 105%, as applicable, shall be deducted from the otherwise determined statement value.

(C) Stock Warrants.

(1) Stock Warrants.

All warrants which are exercisable on the date of the Statement shall be valued at Association Value as defined below whether or not physically attached to any other security (See (D), hereunder, for the valuation of warrants exercisable into securities which are restricted as to transferability.)
(a) For publicly traded warrants (other than exchange traded) the Association Value shall be equal to market value.

(b) The Association Value for a warrant having no public market which is currently exercisable into shares of common stock which have no public market shall be the difference resulting from the subtraction from the analytically determined Association Value of the stock of the exercise price for the warrant.

(c) The Association Value for a warrant having no public market which is currently exercisable into shares of common stock which have a counterpart public market but which are themselves restricted shall be the difference resulting from the subtraction from the value of the common shares as determined under the procedures of Section 5(D) below of the exercise price for the warrant.

(d) Warrants having no public market and for which the first exercise date is subsequent to the date of the statement shall have no value for statement purposes.

(D) Common Stocks Having a Public Market Which Are Issued Under an Investment Letter or Are Otherwise Restricted as to Transferability.

Restricted common stocks (which for purposes of this section, are defined as restricted shares of an unaffiliated issuer held for a period of less than three years prior to the date of valuation) shall be valued by insurers in their Annual Statements on a basis which they are prepared to justify to the SVO staff. (Restrictions shall be considered to have expired for common stocks held at least three years prior to the date of valuation, and the regular valuation basis shall apply.) Such values shall be reviewed by the SVO staff as to the reasonableness of the valuation basis used. The results of the SVO staff’s review will be made available to insurance departments and upon request to insurers holding said restricted common stocks.

Warrants exercisable into such restricted common stocks will be valued on the same special basis.

All restricted common stocks and warrants exercisable into the same should be appropriately noted in the Annual Statement, as required, in Schedule D- Part 2- Section 2.

Market values, where used in the determination of Association Values carried in the SVO manual, are not intended for use in valuing restricted common stocks, warrants as described in this section. Values for such restricted common stocks, warrants will not be carried in the SVO publication.

18. A stock warrant is a security that entitles the holder to buy the underlying stock of the issuing company at a fixed price (exercise price) until the warrant’s expiration date. Key characteristics:

a. Warrants are generally long-term, and can have expiration dates that expire several years in the future.
b. When a warrant is exercised, the shares are issued directly by the company at the exercise price. (The warrant holder would turn the warrant into the issuing company with payment for the exercise price and receive the common stock directly from the company.)

c. Whether a warrant is exercised depends on whether the exercise price is less than the current stock price. (For example, if the warrant’s exercise price is $20, and the common stock price is only $10, the warrant holder would not choose to exercise the warrant.)

d. A warrant is profitable if the stock price exceeds the cost of the warrant plus the exercise price. (For example, if a warrant cost $2 and the exercise price is $20, the warrant would only be profitable if the common stock shares were trading above $22.)

e. If a warrant is not exercised before the expiration date, perhaps because the stock price was less than the exercise price, then the warrant would expire worthless, and the holder of the warrant would lose any investment to acquire the warrant.

19. NAIC staff believes that publicly-traded stock warrants were permitted as the trading value (fair value) would reflect market expectations of the future value of the warrant. Although a warrant may not be likely to be exercised, if publicly traded, the holder would have a verifiable value, as well as the ability to liquidate the warrant (at the current public trading value) if the holder did not think it would become profitable before the exercise date.

20. It is noted there is greater liquidity risk in permitting non-publicly traded stock warrants in scope of SSAP No. 30, as the insurer does not have the same ability to sell the warrant if they do not believe it will become profitable before the exercise date. Furthermore, if the warrant is not publicly traded, the fair value (reporting value) of the warrant would not be clearly known or verifiable. There is also concern with the reporting of assets on the statutory financial statements that may not actually “materialize” into assets available for policyholder claims. As detailed, stock warrants expire worthless if they are not exercised before the expiration date, and unless the warrant’s exercise price is less than the current stock price, a stock warrant is not likely to be exercised.

21. Guidance for warrants, other than publicly-traded stock warrants captured in SSAP No. 30, is reflected in SSAP No. 86—Derivatives. Warrants meet the definition of a derivative and are defined in SSAP No. 86 as follows:

“Warrants” are instruments that give the holder the right to purchase an underlying financial instrument at a given price and time or at a series of prices and times outlined in the warrant agreement. Warrants may be issued alone or in connection with the sale of other securities, for example, as part of a merger or recapitalization agreement, or to facilitate divestiture of the securities of another business entity.

Drafting Note: With the discussion above, this issue paper has not proposed revisions to capture nonpublicly traded stock warrants within scope of SSAP No. 30. However, the Working Group welcomes additional comments and information from industry for further discussion.

NAIC staff also requests comments from regulators on whether publicly traded stock warrants should continue to be reported as common stock within scope of SSAP No. 30. NAIC is unaware of how prevalent stock warrants are in the statutory financial statements, and whether it is common practice for the warrants to expire unexercised before being liquidated in the public market. NAIC staff welcomes comments from industry to provide information on the use of these items.
22. The following information for stock warrants is currently in the P&P Manual, in Part 5 – Section 1: Pricing of Unaffiliated Investments. This section pertains to SVO Valuation Methodologies and does not impact how an investment is reported (e.g., underlying SSAP or admitted) under the AP&P Manual:

Drafting Note: The guidance below is specific to warrants where a fair value cannot be obtained from a public source. The Working Group may consider a referral to the VOSTF to review the valuation methodology in accordance with Statutory Accounting guidance, particularly for warrants in scope of SSAP No. 86.

(c) SVO Valuation Methodologies

(iii) Analytical Determinations of Fair Value

Where a fair value cannot be obtained from a public source, the SVO shall attempt to determine a fair value analytically in accordance with the procedures discussed below.

(H) Stock Warrants

The fair value of a warrant convertible into private common stock for the year in which the warrant has been purchased by the reporting insurance company shall be the cost of the warrant to such reporting insurance company.

For any subsequent year, the fair value of a warrant convertible into private common stock shall be the difference between the Association Value of the common stock as determined pursuant to either Paragraph (E) or (G) of this section, as applicable, and the exercise price. The result is then discounted for illiquidity.

The fair value for a warrant with no public market, exercisable into shares of common stock that do have a public market, shall be the difference between the value of the common stock and the exercise price of the warrant. In the case of a warrant exercisable into restricted common stock, the fair value shall be the difference between the common stock share price determined pursuant to paragraph (I) below and the exercise price.

Warrants for which the first exercise date is subsequent to the date of the NAIC Financial Statement Blank shall have no value unless a publicly available price can be obtained for NAIC Financial Statement Blank purposes.

23. After considering non-public stock warrants, the Working Group agreed to retain public stock warrants in scope of SSAP No. 30, and include non-public stock warrants in scope of SSAP No. 86. Minor revisions will be captured in SSAP No. 86 to clarify the statutory accounting guidance:

"Warrants" are instruments that give the holder the right to purchase an underlying financial instrument at a given price and time or at a series of prices and times outlined in the warrant agreement. Warrants may be issued alone or in connection with the sale of other securities, for example, as part of a merger or recapitalization agreement, or to facilitate divestiture of the securities of another business entity. Publicly traded stock warrants are captured in scope of SSAP No. 30. All other warrants, including non-publicly traded stock warrants, shall be captured in scope of SSAP No. 86.

Reporting Enhancements for SSAP No. 30 Securities

23-24. The guidance in this issue paper supports the prior Working Group decisions to not include more equity/fund investments in SSAP No. 26R—Bonds (such as mutual funds or exchange-traded funds) beyond what is currently permitted. As detailed in SSAP No. 26R, paragraph 4, only specific SVO-Identified investments are captured within scope of SSAP No. 26R:
4. The definition of a bond, per paragraph 3, does not include equity/fund investments, such as mutual funds or exchange-traded funds. However, the following types of SVO-identified investments are provided special statutory accounting treatment and are included within the scope of this statement. These investments shall follow the guidance within this statement, as if they were bonds, unless different treatment is specifically identified in paragraphs 23-29.

   a. Exchange traded funds (ETFs), which qualify for bond treatment, as identified in Part Six, Section 2 of the Purposes and Procedures Manual of the NAIC Investment Analysis Office. (SVO-identified ETFs are reported on Schedule D – Part 1.)

   b. Bond mutual funds which qualify for the Bond List, as identified in Part Six, Section 2 of the Purposes and Procedures Manual of the NAIC Investment Analysis Office. (SVO-identified bond mutual funds are reported on Schedule D – Part 1.)

24-25. Although this issue paper does not propose revisions to reclassify additional mutual funds as SSAP No. 26R securities (reported as long-term bonds on Schedule D-1), this issue paper does support the consideration of reporting revisions to permit NAIC designations for mutual funds reported in scope of SSAP No. 30 (on Schedule D-2-2) based on the underlying holdings of the fund. As noted by interested parties, this reporting revision would have the potential to combine sound financial reporting standards with the flexibility for a more risk-sensitive RBC regime further reflective of underlying fund holdings. Although this issue paper supports the inclusion of NAIC designations on D-2-2 for funds, this issue paper does not propose any measurement method revisions, or changes in admittance requirements, for funds captured within scope of SSAP No. 30 based on the reported NAIC designation.

25-26. Although this issue paper supports the inclusion of NAIC designations on Schedule D-2-2, the Statutory Accounting Principles (E) Working Group does not have the ability to incorporate the reporting and RBC changes. Rather, if the Working Group supports the concept to report NAIC designations on Schedule D-2-2, the changes necessary to incorporate these revisions will need to be considered and adopted by the Blanks (E) Working Group, the Valuation of Securities (E) Task Force and the Capital Adequacy (E) Task Force.

26-27. During the 2018 Spring National Meeting, the Working Group considered comments from Vanguard requesting that more bond mutual funds be captured in scope of SSAP No. 26R. These comments identified that only bond mutual funds that hold 100% government securities qualify to be on the SVO-Identified Bond Mutual Fund listing, and Vanguard suggested that bond funds with other holdings (non U.S. government) should be considered for inclusion, and allowed in scope of SSAP No. 26R. The Vanguard comments noted that there is inconsistency in reporting by requiring non U.S. government bond fund investments to be in scope SSAP No. 30, and indicated that all investment-grade bond mutual funds should be eligible for bond-like treatment consistent with the current treatment of SVO-Identified Bond ETFs. Vanguard also noted that revising the methodology would not require substantive changes, but that only modest revisions would be needed.

27-28. After considering the comments received from Vanguard, the Working Group agreed not to consider expanding the provisions in SSAP No. 26R to allow additional bond mutual funds within scope of that standard. The following was captured in support of this decision:

   a. In accordance with prior Working Group comments from the discussion of SSAP No. 26R, equity / fund investments do not fit in SSAP No. 26R. These investments are not bonds and do not represent a creditor relationship whereby there is a fixed scheduled for one or more future payments. The inclusion of the specifically noted SVO-Identified
investments are specific exceptions, and there is no current Working Group member support to expand the equity / fund investments in scope of SSAP No. 26R.

b. The long-term bond schedule (Schedule D-1) is not conducive to the reporting of funds, and questions often arise on the proper completion of Schedule D-1 for the SVO-Identified ETFs and Bond Mutual Funds captured in SSAP No. 26R and reported on that schedule. (For example, several columns on Schedule D-1 are not applicable for funds - e.g., interest rate, par value, maturity date, etc.) If there was a desire for mutual funds to be reported similarly to SVO-Identified ETFs, rather than expanding the listing of funds permitted to be reported on Schedule D-1, further exacerbating these reporting issues, it would be recommended that all funds (including the SVO-Identified ETFs and Bond Mutual Funds captured in SSAP No. 26R) be captured within SSAP No. 30. (ETFs not on the SVO-Listing are already captured in SSAP No. 30.) If this approach was taken, it would allow similar investments to be reported on the same schedule and would eliminate the reporting issues. If consideration was to be given to this approach, revisions could be incorporated to move the specific measurement value permitted for the SVO-Identified funds (systematic value) from SSAP No. 26R to SSAP No. 30. With the proposal to capture NAIC designations on Schedule D-2-2, if the funds captured in SSAP No. 26R were moved to SSAP No. 30, it is expected that corresponding revisions would be considered by the Capital Adequacy (E) Task Force to revise the RBC accordingly for the investments that were previously on D-1.

c. The existing guidance that allows SVO-Identified funds to be reported in scope of SSAP No. 26R, on Schedule D-1, has historically resulted with inconsistent reporting across companies for similar investments. This is because some reporting entities did not identify that specific ETFs or bond mutual funds were on the SVO-Identified listings. As such, funds that qualified for SSAP No. 26R have continued to be reported by some companies as if they were in scope of SSAP No. 30, on Schedule D-2-2. It is anticipated that if specific mutual funds were noted as qualifying for SSAP No. 26R, then inconsistencies in reporting would be expanded as some reporting entities would continue to report the fund on Schedule D-2-2.

d. The Working Group noted that the proposal to allow NAIC designations on Schedule D-2-2 could provide the same benefits noted by commenters without requiring a reclassification of certain securities from SSAP No. 30 to SSAP No. 26R. With this proposed designation reporting change, mutual funds could be reported with an NAIC designation based on their underlying holdings, creating consistency in reporting which would allow the Capital Adequacy (E) Task Force to adjust risk-based capital charges if deemed appropriate.

Effective Date

The adoption of this issue paper by the Statutory Accounting Principles (E) Working Group, and the substantively-revised statement of statutory accounting principles (SSAP) occurred on _______. The substantive revisions to SSAP No. 30R are detailed in Exhibit A of this issue paper, and reflected in the substantively-revised SSAP No. 30R—Unaffiliated Common Stock. The effective date of the guidance is will be identified in the SSAP. Users of the Accounting Practices & Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC.
RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

- SSAP No. 30—Unaffiliated Common Stock
EXHIBIT A – Substantive Revisions to SSAP No. 30R—Unaffiliated Common Stock

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for common stocks.

2. Investments in common stock of subsidiaries, controlled or affiliated entities (investments in affiliates) are not within the scope of this statement. They are addressed in SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities (SSAP No. 97).

SUMMARY CONCLUSION

3. Common stocks (excluding investments in affiliates) are securities which represent a residual/subordinate ownership in a corporation. This definition includes and shall include:

   a. Publicly traded common stocks;

   b. Common stocks that are not publicly traded;

   c. Common stocks restricted as to transfer of ownership.

4. In addition, the following equity investments are captured within scope of this statement:

   a. Master limited partnerships trading as common stock and American deposit receipts only if the security is traded on the New York, American, or NASDAQ exchanges;

   b. Publicly traded common stock warrants;

   Staff Comment – This statement does not propose to include non-public stock warrants, and comments are requested on whether publicly traded stock warrants should be retained in the scope of SSAP No. 30 or moved to SSAP No. 86 with other warrants.

   c. Shares of SEC registered Investment Companies captured under the Investment Company Act of 1940 (open-end investment companies, closed-end funds and unit investment trusts), regardless of the types or mix of securities owned by the fund (e.g., bonds, stocks, money market instruments), except for Bond Mutual Funds which qualify for bond treatment, as identified in Part Six, Section 2, of the Purposes and Procedures Manual of the NAIC Investment Analysis Office;

---

1 Restricted stock shall be defined as a security for which sale is restricted by governmental or contractual requirement (other than in connection with being pledged as collateral), except where that requirement terminates within one year or if the holder has the power by contract or otherwise to cause the requirement to be met within one year. Any portion of the security that can be reasonably expected to qualify for sale within one year is not considered restricted. Regardless of redemption timeframe, FHLB capital stock is considered restricted stock until actual redemption by the FHLB.

2 Unless as specifically noted, the equity investments identified within scope are subject to the provisions of this standard as if they were common stock investments.

3 Non-SEC registered investment companies (e.g., private investment companies or hedge funds) are excluded from the scope of this statement.

4 Money market mutual funds are considered cash equivalents under SSAP No. 2R.
Common Stock

i. Money Market Mutual Funds on the U.S. Direct Obligations/Full Faith and Credit Exempt List, as identified in Part Six, Section 2, of the Purposes and Procedures Manual of the NAIC Investment Analysis Office; and

b-d. Exchange Traded Funds, except for those identified for bond or preferred stock treatment, as identified in Part Six, Section 2, of the Purposes and Procedures Manual of the NAIC Investment Analysis Office; and

c-e. Common stocks that are not publicly traded, including equity interests in certified capital companies in accordance with INT 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO); and

d. Common stocks that are restricted as to transfer of ownership. Restricted stock shall be defined as a security for which sale is restricted by governmental or contractual requirement (other than in connection with being pledged as collateral), except where that requirement terminates within one year or if the holder has the power by contract or otherwise to cause the requirement to be met within one year. Any portion of the security that can be reasonably expected to qualify for sale within one year is not considered restricted. Regardless of redemption timeframe, FHLB capital stock is considered restricted stock until actual redemption by the FHLB.

4.5. Common stocks investments within scope of this statement meet the definition of assets as defined in SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement.

Acquisitions and Sales

5-6. At acquisition, common stocks shall be reported at their cost, including brokerage and other related fees. Common stock acquisitions and dispositions shall be recorded on the trade date. Private placement stock transactions shall be recorded on the funding date. A reporting entity may become qualified for use of equity method accounting by an increase in the level of ownership. In this situation, the reporting entity shall add the cost of acquiring additional interest in the investee to the current basis of the previously held interest and shall apply the equity method, as prescribed in SSAP No. 97, prospectively, as of the date the investment becomes qualified for equity method accounting.

6.7. A reporting entity can subscribe for the purchase of stock, but not be required to make payment until a later time. Transactions of this nature are common in the formation of corporations. Common stock acquired under a subscription represents a conditional transaction in a security authorized for issuance but not yet actually issued. Such transactions are settled if and when the actual security is issued and the exchange or National Association of Securities Dealers (NASD) rules that the transactions are to be settled. Common stock acquired under a subscription shall be recorded as an admitted asset when the reporting entity or its designated custodian or transfer agent takes delivery of the security and the security is recorded in the name of the reporting entity or its nominee (i.e., the accounting for such common stock acquisitions shall be on the settlement date).

5 Pursuant to SSAP No. 2R, effective December 31, 2017, money market mutual funds shall be reported as cash equivalents and valued at fair value (net asset value allowed as a practical expedient).
Balance Sheet Amount

7.8. Investments in scope of this standard unaffiliated common stocks shall be valued reported at fair value. For FHLB capital stock, which is only redeemable at par, the fair value shall be presumed to be par, unless considered other-than-temporarily impaired. Mutual funds, unit-investment funds and exchange traded funds, without a readily determinable fair value, are permitted to be reported at net asset value if permitted as a practical expedient pursuant to the guidance in SSAP No. 100R. Closed-end funds are not permitted to be reported at net asset value and shall be reported at fair value. Changes in fair value (or net asset value, as permitted) shall be recorded as unrealized gains or losses.

8.9. For reporting entities required to maintain an Asset Valuation Reserve (AVR), the accounting for unrealized capital gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve (SSAP No. 7). For reporting entities not required to maintain an AVR, unrealized capital gains and losses shall be recorded as a direct credit or charge to surplus.

Impairment

9.10. For any decline in the fair value of a common stock which is determined to be other than temporary (INT 06-07) the common stock shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. For those reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with SSAP No. 7. Subsequent fluctuations in fair value shall be recorded as unrealized gains or losses. Future declines in fair value which are determined to be other than temporary shall be recorded as realized losses. A decline in fair value which is other than temporary includes situations where a reporting entity has made a decision to sell a security at an amount below its carrying value.

Income

10.11. Dividends on common stock shall be recorded as investment income on the ex-dividend date with a corresponding receivable to be extinguished upon receipt of cash (i.e., dividend income shall be recorded on stocks declared to be ex-dividends on or prior to the statement date).

11.12. For reporting entities required to maintain an AVR, the accounting for realized capital gains and losses on sales of common stock shall be in accordance with SSAP No. 7. For reporting entities not required to maintain an AVR, realized gains and losses on sales of common stock shall be reported as realized gains/losses in the statement of operations.

Stock Splits, Stock Dividends, Payment in Kind Dividends, and Stock Exchanges

12.13. Stock splits, stock dividends, payment in kind dividends, and stock exchanges shall be accounted for in accordance with SSAP No. 95—Nonmonetary Transactions (SSAP No. 95).
FHLB Capital Stock

13.14. FHLB capital stock is held by reporting entities that are members of an FHLB. Each reporting entity must acquire FHLB capital stock for membership and maintain capital stock holding sufficient to support its business activity (borrowings⁶) in accordance with the respective FHLB’s capital plan. The price of FHLB capital stock cannot fluctuate, and all FHLB capital stock must be purchased, repurchased or transferred at its par value. FHLB capital stock is restricted for redemption in accordance with the FHLB capital plan and shall be coded as restricted within the financial statements (e.g., investment schedules and general interrogatories).

14.15. Acquisition of FHLB capital stock allows members to conduct business activity (borrowings) from an FHLB. The amount of capital stock acquired determines the reporting entity’s eligible borrowing amount. At a minimum, all borrowings from an FHLB (regardless of structure) must also be fully collateralized in accordance with the FHLB capital plan, which determines the amount of collateral required by type of pledged instrument. Collateral pledged to an FHLB shall be coded as restricted within the financial statements (e.g., investments schedules and general interrogatories). Collateral pledged to an FHLB is considered an admitted asset if all of the following conditions are met:

a. the asset would have been admitted under SSAP No. 4;

b. the pledging insurer continues to receive the income on the pledged collateral;

c. the pledging insurer can remove and substitute other securities with little or advance notice to the FHLB as long as the insurer complies with related investment quality and market value provisions; and

d. there has been no uncured default or event to indicate an impairment or loss contingency for the pledged assets.

Disclosures

15.16. The following disclosures regarding common stocks shall be made in the financial statements:

a. Basis at which the common stocks are stated; and

b. A description, as well as the amount, of common stock that is restricted outside of FHLB agreements and the nature of the restriction. (Disclosures of FHLB capital stock are captured in paragraph 16.)

c. For each balance sheet presented, all common stocks in an unrealized loss position for which other-than-temporary declines in value have not been recognized,

⁶ Membership in an FHLB allows reporting entities to take advances / borrow from the FHLB. These borrowings can be structured in a variety of ways, for example: debt, funding agreements, repurchase agreements, securities lending, etc. Borrowings from an FHLB shall be reflected in the financial statements in accordance with the SSAP that addresses the substance of the agreement.
i. The aggregate amount of unrealized losses (that is, the amount by which cost or amortized cost exceeds fair value) and

ii. The aggregate related fair value of common stocks with unrealized losses.

d. The disclosures in (i) and (ii) above should be segregated by those common stocks that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with SSAP No. 100R—Fair Value.

e. As of the most recent balance sheet presented, additional information should be included describing the general categories of information that the investor considered in reaching the conclusion that the impairments are not other-than-temporary.

f. When it is not practicable to estimate fair value, the investor should disclose the following additional information, if applicable, as of each date for which a statement of financial position is presented in its annual financial statements:

i. The aggregate carrying value of the investments not evaluated for impairment, and

ii. The circumstances that may have a significant adverse effect on the fair value.

FHLB Disclosures

46.17. For FHLB agreements, the following information shall be disclosed in the financial statements for current and prior year and between general account and separate account activity. The information in the disclosures shall be presented gross even if a right to offset per SSAP No. 64 exists.

a. General description of FHLB agreements, with information on the nature of the agreement, type of borrowing (advances, lines of credit, borrowed money, etc.) and use of the funding.

b. Amount of FHLB capital stock held, in aggregate, and classified as follows: i) membership stock (separated by Class A and Class B); ii) Activity Stock; and iii) Excess Stock. For membership stock, report the amount of FHLB capital stock eligible for redemption\(^7\) and the anticipated timeframe for redemption: i) less than 6 months, ii) 6 months to 1 year, iii) 1 year to 3 years, and iv) 3 to 5 years.

c. Amount (fair value and carrying value) of collateral pledged to the FHLB as of the reporting date. In addition, report the maximum amount of collateral pledged to the FHLB at any time during the current reporting period. (Maximum shall be determined on the basis of carrying value, but with fair value also reported)

d. Aggregate amount of borrowings at the reporting date from the FHLB, reflecting compilation of all advances, loans, funding agreements, repurchase agreements, securities lending, etc., outstanding with the FHLB, and classify whether the borrowing is in substance: i) debt (SSAP No. 15—Debt and Holding Company Obligations), ii) a funding agreement (SSAP No. 52—Deposit-Type Contracts), or iii) Other. For funding

\(^7\) For FHLB membership stock to be eligible for redemption, written notification must have been provided to the FHLB prior to the reporting date.
agreements, report the total reserves established. Report the maximum amount of aggregate borrowings from an FHLB at any time during the current reporting period, the actual or estimated maximum borrowing capacity as determined by the insurer, with a description of how the borrowing capacity was determined, and whether current borrowings are subject to prepayment penalties.

47.18. The disclosures in paragraphs 15.c. through 15.f. shall be included in the annual audited statutory financial reports only. The FHLB disclosures in paragraph 16 are required in all interim and annual financial statements regardless if the activity is materially different from the activity reported during the prior reporting period. Refer to the Preamble for further discussion regarding disclosure requirements.

**Relevant Literature**

48.19. This statement adopts ASU 2016-07, Investments - Equity Method and Joint Ventures, modified to reflect statutory terms including the definition of control and statutory reporting concepts. This statement rejects ASU 2016-01, Financial Instruments – Overall and FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities.

**Effective Date and Transition**

49.20. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors. Revisions adopted to this statement in October 2013 amending SSAP No. 15 and SSAP No. 52 to incorporate FHLB disclosure information are initially effective for interim and annual reporting periods after January 1, 2014. Revisions adopted to this statement in , incorporating closed-end funds and unit investment trusts within scope, are initially effective January 1, 2019.

**REFERENCES**

**Other**

- Purposes and Procedures Manual of the NAIC Investment Analysis Office
- NAIC Valuation of Securities product prepared by the Securities Valuation Office

**Relevant Issue Papers**

- Issue Paper No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)
Issue: Structured Settlements

Check (applicable entity):

<table>
<thead>
<tr>
<th>Modification of existing SSAP</th>
<th>P/C</th>
<th>Life</th>
<th>Health</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Issue or SSAP</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interpretation</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Description of Issue:
This agenda item has been drafted to consider statutory accounting and reporting guidance for an insurance reporting entity that acquires (directly or indirectly) structured settlement payment rights as a result of a structured settlement factoring transaction. This item is specific for transactions that only provide a reporting entity the right to receive payments under a structured settlement and does not address situations in which the reporting entity has acquired an insurance product (e.g., life settlement, annuity, etc). This item has been drafted in response to questions on the appropriate accounting and reporting for acquired structured settlement income streams, and whether these acquired income streams qualify as admitted assets.

Overview of Structured Settlements:
Generally, structured settlements are settlements of tort claims involving physical injuries or physical sickness and workers’ compensation claims, under which settlement proceeds take the form of periodic payments, including scheduled lump sum payments. Structured settlements are often funded by single-premium annuity contracts purchased by the obligor / defendant contractually obligated to make the future settlement payments. In these situations, the original recipient of the structured settlement payments does not own the insurance product (annuity); rather the recipient only has the contractual right to the future cash streams. Structured settlement cash flow streams, by design, include the time value of money, therefore the interest rate is embedded in the payment stream - (they do not pay separate interest). Structured settlement payments to the original recipient are tax-free, and may have tax advantages to subsequent holders.

Structured settlement payments are designed in accordance with the financial needs of the original recipient. As such, the amounts and timing of structured settlement income streams are situation specific, and can vary significantly from other structured settlements. As basic examples, cash flow streams can result with monthly payments for a set period of time, or can be designed to provide large cash payments every few years to match anticipated predetermined costs for the injured person. Once the terms of the structured settlement are set, original recipients do not have the ability to renegotiate the settlement terms. Although they have different payment terms, structured settlements are broadly classified in two buckets:

- Period Certain / Guaranteed Payments – These structured settlement payments are owed regardless whether the recipient is living at the time the payment is owed. As such, any subsequent purchaser of the income stream can expect to receive a set amount of future cash flow payments.

- Life Contingent Payments – These structured settlement payments are owed only if the original recipient is living at the time the payment is owed. As such, the extent to which future cash payments will be required under the terms of the structured settlement is uncertain.

Original recipients of structured settlements may decide to sell their legal rights to future cash flows in exchange for lump sum payments on the secondary market through factoring companies. (These elections can include the entire future cash flows of the structured settlement, or partial amounts of future cash flows. As an example, if an
original beneficiary had legal rights to 36 monthly structured settlement payments, they could elect to only sell one year of their cash flow payments (12 months) to the secondary market and retain the remaining 24 payments.)

Factoring companies sell the rights to future cash flows as “investment” products to unrelated third parties, either as individual items or as an interest in a securitized pool of structured settlements. As the original recipient receives a discounted lump sum payment from the acquiring factoring company, the ultimate holder of the future income stream may receive an attractive yield. For period certain structured settlements, the income streams are often considered low risk as they are generally backed by single-premium annuity products purchased by the original obligor from well-capitalized insurance companies that fund / administer the future income stream. (When the original obligor purchases an annuity to fund the payments, the obligor is released from future obligation, and the annuity insurer, which makes the payments as set forth in the structured settlement arrangement, assumes the liability to the beneficiary.)

Structured Settlement Transfer Requirements:
In order to protect the original recipients of structured settlements from exploitation, state and federal laws have strict requirements on the transfer of structured settlement cash flows and provide tax penalties if the provisions are not followed. Although states have varying additional restrictions (e.g., some prohibit the factoring of worker’s compensation structured settlement benefits), all transfers are subject to the following provisions under the federal Structured Settlement Protection Act (SSPA) and IRS code:

- All structured settlements must comply with the specific state’s SSPA version, including the rule that the transfer had to be in the seller’s best interest and the best interest of that person’s family or dependents.

- A 40% excise tax is to be applied to any transfer that was not court-approved. Absent an appropriate court or administrative authoritative order, a party acquiring structured settlement payment rights must pay, up front, a tax equal to 40% of its expected gross profit on the transaction. (This is the difference between the total undiscounted amount of future payments and the amount paid to acquire the cash flow stream.)

Risks to acquirers of structured settlement income streams include:

- Future structured settlement income streams are illiquid and may be difficult to sell. If a subsequent holder needs to sell, it may be difficult to do so, and may result with the holder incurring a loss.

- Acquirers of income streams that are not court approved and properly assigned may not be legal, and the acquirer may not be able to legally obtain the future income streams.

Existing Authoritative Literature:
Existing statutory Accounting guidance for structured settlements is not intended to address insurer acquirers of structured settlement income streams as investments. Rather, existing SAP guidance addresses situations in which the insurer is the holder of an annuity that provides future structured settlement payments to the designated recipients. The existing SAP guidance, as it pertains to the use of annuities to fund structured settlements satisfying claim liabilities of the insurer, is adopted from U.S. GAAP. Under the existing statutory accounting guidance, these annuities are reported as “other than invested assets” outside of the investment schedules. As these items are reported as “other than invested assets,” they are excluded from RBC charges and may be outside of state investment limitations.

SSAP No. 21—Other Admitted Assets

Cash Value of Structured Settlements

5. The reporting of the present value of structured settlement annuities where the reporting entity is the owner and payee as described in SSAP No. 65, paragraph 17.a. shall account for the annuity an
admitted asset at its net present realizable value. The annuity described is reported as an other-than-invested asset. Income from the annuities shall be recorded as miscellaneous income. The present value of the annuity and the related amortization schedule shall be obtained from the issuing life insurance company at the time the annuity is purchased. When the reporting entity is the owner and payee, no reduction shall be made to loss reserves.

**SSAP No. 65—Property and Casualty Contracts**

**Structured Settlements**

17. Structured settlements are periodic fixed payments to a claimant for a determinable period, or for life, for the settlement of a claim. Frequently a reporting entity will purchase an annuity to fund the future payments. Reporting entities may purchase an annuity in which the entity is the owner and payee, or an annuity in which the claimant is the payee. When annuities are purchased to fund periodic fixed payments, they shall be accounted for as follows:

   a. When the reporting entity is the owner and payee, no reduction shall be made to loss reserves. The annuity shall be recorded at its present value and reported as an other-than-invested asset. Income from the annuities shall be recorded as miscellaneous income. The present value of the annuity and the related amortization schedule shall be obtained from the issuing life insurance company at the time the annuity is purchased; and

   b. When the claimant is the payee, loss reserves shall be reduced to the extent that the annuity provides for funding of future payments. The cost of the annuities shall be recorded as paid losses.

18. Statutory accounting and Generally Accepted Accounting Principles (GAAP) are consistent for the accounting of structured settlement annuities where the reporting entity is the owner and payee, and where the claimant is the owner and payee and the reporting entity has been released from its obligation. GAAP distinguishes structured settlement annuities where the owner is the claimant and a legally enforceable release from the reporting entity's liability is obtained from those where the claimant is the owner and payee but the reporting entity has not been released from its obligation. GAAP requires the deferral of any gain resulting from the purchase of a structured settlement annuity where the claimant is the owner and payee yet the reporting entity has not been released from its obligation. Statutory accounting treats these settlements as completed transactions and considers the earnings process complete, thereby allowing for immediate gain recognition.

19. The following information regarding structured settlements shall be disclosed in the financial statements:

   a. The amount of reserves no longer carried by the reporting entity because it has purchased annuities with the claimant as payee, and the extent to which the reporting entity is contingently liable for such amounts should the issuers of the annuities fail to perform under the terms of the annuities; and

   b. The name, location, and aggregate statement value of annuities due from any life insurer to the extent that the aggregate value of those annuities equal or exceed 1% of policyholders' surplus. This disclosure shall only include those annuities for which the reporting entity has not obtained a release of liability from the claimant as a result of the purchase of an annuity. The reporting entity shall also disclose whether the life insurers are licensed in the reporting entity's state of domicile.

20. Refer to the Preamble for further discussion regarding disclosure requirements.

**Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups):** None
Information or issues (included in Description of Issue) not previously contemplated by the Working Group: None

Convergence with International Financial Reporting Standards (IFRS): None

Staff Recommendation:
NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose this agenda item with proposed revisions to incorporate accounting and reporting guidance for structured settlement income streams acquired by insurers as investments. Specific guidance is needed for these investments as structured settlements acquired by insurers as a form of an investment should not be captured in the existing SSAP No. 21 guidance and reported as an “other than invested assets” outside of RBC and state investment provisions.

The proposed accounting and reporting guidance reflects the following concepts:

1. Structured settlement income streams acquired by insurance reporting entities, when the reporting entity is not the owner or payee of a corresponding annuity, through acquisition of an interest in a securitized pool that meets the scope requirements of SSAP No. 43R—Loan-backed and Structured Securities shall follow the accounting and reporting guidance of that SSAP. (This is not a change from existing guidance.)

2. Period certain (non-life contingent) structured settlement income streams acquired by insurance reporting entities, when the reporting entity is not the owner or payee of a corresponding annuity, as individual investments (not as securitizations), are considered other long-term investments, captured on Schedule BA, and permitted as admitted assets when the structured settlement income stream has been legally acquired in accordance with all state and federal requirements. These acquisition requirements include court-approval of the income stream transfer from the original beneficiary. If a structured settlement income stream has not been legally transferred from the original beneficiary to the insurer acquirer, the structured settlement shall be fully nonadmitted by the insurance reporting entity. (Unless there is legal transfer, nonadmittance is required as the acquirer may not be entitled to receive the future income streams.) In addition to nonadmittance, the insurer acquirer must also appropriately report the excise tax required under the IRS code.

3. Life contingent structured settlement income streams acquired by insurance reporting entities, when the reporting entity is not the owner or payee of a corresponding annuity, as individual investments (not as securitizations), are considered other long-term investments, captured on Schedule BA, and shall be fully nonadmitted. (With life contingent income streams, nonadmittance is required as it is uncertain whether any future income streams will be received. As such, these items should not be considered admitted assets available for policyholder claims under SSAP No. 4—Assets and Nonadmitted Assets.)

4. As this agenda item is focusing on structured settlements, the guidance should not be inferred to “life settlement” acquisitions. Life settlements are not structured settlements. A life settlement transaction is when an investor purchases an insurance policy from an insured and continues to pay the premium payments so that when the insured event occurs (e.g., death of the insured), the investor receives the death benefit. In life settlements, the investor often pays the insured an amount greater than the cash surrender value of the insurance policy, with an expectation that the insured event will occur in a timeframe that the death benefit received is greater than the cost of the purchase price and the future premium payments to keep the policy active. As detailed in this agenda item, a structured settlement is the legal right to future cash flows, and does not reflect the acquisition of an insurance policy. Unlike life settlements, there is no cash surrender value to structured settlements, and payments under the structured settlement are not renegotiable once set.
The following concepts shall be followed when reporting structured settlement income streams as other long-term invested assets on Schedule BA:

- Structured settlement income streams shall be separately reported on Schedule BA, unless they can be aggregated with other structured settlements with similar terms and payout streams.

- Structured settlement income streams may be submitted for a credit analysis to the SVO and reported on Schedule BA with an NAIC designation as a “fixed or variable interest rate investment that has the underlying characteristics of a bond, mortgage loans or other fixed income instrument.” (These individual structured settlement income streams may not be reported with a CRP rating as filing exempt.)

- Structured settlement income streams shall be initially reported at cost. This cost generally reflects the net present value of the future payment streams with an embedded fixed-rate yield. As the structured settlement income streams are received, reporting entities shall reduce the BACV to reflect the receipt of the income stream (partial payment on Schedule BA, Part 3) as well as corresponding investment income for the fixed rate spread.

Proposed Revisions to SSAP No. 21—Other Admitted Assets:

**Cash Value of Structured Settlements – Reporting Entity Owner and Payee of Annuity**

5. The reporting of the present value of structured settlement annuities where the reporting entity is the owner and payee as described in SSAP No. 65, paragraph 17.a. shall account for the annuity as an admitted asset at its net present realizable value. The annuity described is reported as an other-than-invested asset. Income from the annuities shall be recorded as miscellaneous income. The present value of the annuity and the related amortization schedule shall be obtained from the issuing life insurance company at the time the annuity is purchased. When the reporting entity is the owner and payee, no reduction shall be made to loss reserves.

**Structured Settlements – Reporting Entity Acquires Legal Right to Receive Payments**

6. A reporting entity that acquires (directly or indirectly) structured settlement payment rights through a factoring company, excluding securitizations captured in SSAP No. 43R, shall report the acquisition as follows:

   a. Period-certain (non-life contingent) structured settlement income streams shall be reported as other long-term invested assets, and are admitted assets if the rights to the future payments from a structured settlement has been legally acquired in accordance with all state and federal requirements. If the structured settlement has not met all legal requirements, including the court-approved transfer from the original recipient, then the reporting entity shall recognize the appropriate excise tax obligation and the structured settlement shall be nonadmitted.

   b. Life contingent structured settlement income streams shall be reported as other long-term invested assets on Schedule BA and shall be nonadmitted. (Nonadmittance is required regardless if the right to future payments has been legally transferred.)

New Footnote 1: This guidance is specific to acquired structured settlement income streams (legal right to receive future payments from a structured settlement) and does not capture accounting and reporting guidance for the acquisition of any insurance product (e.g., life settlement, annuities, etc.).

New Footnote 2: Reporting entities that hold qualifying structured settlement payment rights shall report the security on Schedule BA either as an “any other class of asset” or as a “fixed or variable interest rate investment with underlying characteristics of other fixed income instruments”
if the structured settlement payment right qualifies for reporting within that reporting line (e.g., NAIC designation).

7. Structured settlement income streams shall be initially reported at cost, including brokerage and other related fees. The cost generally reflects the net present value of the future payment streams with an embedded fixed-rate yield. Structured settlements income streams shall always be acquired at a discount, meaning the amount to be received shall be greater than the acquisition cost. As the structured settlement payments are earned, reporting entities shall reduce the book adjusted carrying value (BACV) to reflect the accrual of the income stream (proportionate payment of original cost on Schedule BA, Part 3) as well as corresponding investment income for the fixed rate spread. (For example, if a reporting entity acquires a structured settlement that equates to three payments, as each payment is received, the BACV would be decreased proportionately, with the pay-down recognized as a disposal.)

a. Impairment—Determination as to the impairment of a structured settlement income stream shall be based on current information and events. When a reporting entity does not expect to receive a structured settlement payment, the structured settlement shall be considered impaired. Once a structured settlement income stream is impaired, the entire amount of the reported structured settlement investment (including subsequent rights to cash flows related to the impaired structured settlement) shall be written off in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets. If the structured settlement payment is not expected to be received due to the credit quality of the issuer (e.g., the insurer / obligor making structured settlement payments), all structured settlement income streams expected from that obligor shall also be deemed impaired and written off in accordance with SSAP No. 5R. (For example, if a reporting entity acquired the rights to receive three structured settlement payments in a single brokerage transaction, when the first payment is not expected to be received, then all three structured settlement payments related to this acquisition shall be written off. If the reason for the impairment is due to the obligor, and the reporting entity had acquired other structured settlement income streams that are due from that obligor, all structured settlement income streams due from that obligor shall also be written off as impaired.)

b. Investment Income – The discount on acquired structured settlements shall be recognized as an adjustment of yield over the period of time until the cash payments under the structured settlements are received to produce a constant effective yield each year.

(Remaining paragraphs to be renumbered accordingly.)

Staff Review Completed by:
Julie Gann - NAIC Staff: April 2018

Status:
On August 4, 2018, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 21—Other Admitted Assets, as detailed above, to incorporate accounting guidance for structured settlement income streams acquired by insurers as investments. Comments were requested on whether this item should be considered a substantive or nonsubstantive revision.

© 2018 National Association of Insurance Commissioners 6
MEMORANDUM

TO: Dale Bruggeman, Chair Statutory Accounting Principles (E) Working Group

FROM: Kevin Fry, Chair Valuation of Securities (E) Task Force

CC: Bob Carcano, Senior Counsel, NAIC Investment Analysis Office
Julie Gann, Senior Manager, NAIC Financial Regulatory Division

DATE: October 24, 2018

RE: Referral on Structured Settlements

1. Introduction – The Valuation of Securities (E) Task Force (VOS TF) discussed the captioned referral from the Statutory Accounting Principles (E) Working Group (Working Group) on October 11. The referral advises that the Working Group is developing statutory accounting and reporting guidance for investments in cash streams due under structured settlements. The proposed guidance would provide that a properly structured and transferred, period certain investment acquired by an insurance company (other than the annuity insurer) would follow SSAP No. 43R—Loan-backed and Structured Securities in the case of a securitization or would follow SSAP No. 21– Other Admitted Assets as other long-term invested asset on Schedule BA if an individual investment.

2. Response – Purchases of cash streams via assignment of the right to payments due under a structured settlement have been filed with and designated for credit quality by the SVO for several decades. We have been aware that despite this, existing statutory accounting guidance for structured settlements does not discuss these investments. The VOS TF and the IAO express full support for this effort. The adoption by the Working Group of the proposed guidance will provide a needed framework and will also permit the SVO to modernize analytical guidance in the P&P Manual for this investment activity. During our discussion on October 11, we released the referral for a 30 day comment period. We will forward to the Working Group any comments we may receive.

Please let me know if you need anything else from me and feel free to contact Bob Carcano of the IAO should you require further technical input.

G:\FRS\DATA\Stat Acctg\3. National Meetings\A. National Meeting Materials\2018\Fall\Hearing\17 - VOSTF to SAPWG on Structured Settlements.docx
This page intentionally left blank.
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Structured Notes

Check (applicable entity):
- [ ] Modification of existing SSAP
- [ ] New Issue or SSAP
- [ ] Interpretation

<table>
<thead>
<tr>
<th>P/C</th>
<th>Life</th>
<th>Health</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Description of Issue:
This agenda item has been drafted to revisit the accounting and reporting of structured notes and other similar investment products, including buffered return-enhanced notes, reverse convertibles, revertible notes, leveraged notes and reverse-exchangeable securities. (These sorts of products may be marketed under a variety of names.) Although there can be differences in the underlying products, the focus of this agenda item is on instruments that combine characteristics of a debt instrument with a derivative component. More specifically, this agenda item is focused on investment products, structured to resemble debt instruments, where the investor assumes a risk of principal loss based on an underlying component unrelated to the credit risk of the issuer. The intent of this agenda item is to determine the appropriate accounting and reporting for these investments.

Information about structured notes from the SEC, FINRA, government sponsored enterprises and U.S. GAAP is provided below:

SEC Excerpts – Structured Note:

- Structured Notes are securities issued by financial institutions whose returns are based on, among other things, equity indexes, a single equity security, a basket of equity securities, interest rates, commodities, and/or foreign currencies. Thus, the return is “linked” to the performance of a reference asset or index. Structured notes have a fixed maturity and include two components – a bond component and an embedded derivative.

- Some structured notes provide for the repayment of principal at maturity, which is often referred to as “principal protection.” (Such protection may be limited to a portion of the original principal (e.g., 10%) and may be contingent on specific factors.) Many structured notes do not offer this feature. For structured notes that do not offer full principal protection, the performance of the linked asset or index may cause the holder to lose some, or all, of their principal. (Note: Principal protection focuses on the risk of principal loss from the embedded derivative and not risk of loss from default by the issuer.)

- Ability to trade structured notes in a secondary market is often very limited as structured notes (other than exchange-traded notes known as ETNs) are not listed for trading on securities exchanges. As a result, the only potential buyer may be the issuing financial institution’s broker-dealer affiliate or the broker-dealer distributor of the structured note. In addition, issuers often specifically disclaim their intent to repurchase or make markets in the notes they issue. Holders should be prepared to hold a structured note to its maturity date or risk selling the note at a discount to its value at the time of sale.

- Structured notes have complicated payoff structures that can make it difficult to accurately assess the value, risk and potential for growth through the term of the structured note. Determining the performance of the note can be complex and the calculation can vary significantly from note to note. Payoff structures can be leveraged, inverse, or inverse-leveraged, which may result in larger returns or losses for the holder. For example, the payoff on structured notes can depend on:
Participation Rates: Some structured notes provide a minimum payoff of the principal invested plus an additional payoff based on multiplying any increase in the reference asset or index by a fixed percentage. This percentage is called the participation rate. For example, if the participation rate is 50 percent, and the reference asset or index increased 20 percent, then the return paid would be 10 percent (50% of 20%).

Capped Maximum Returns: Some structured notes may provide payments linked to a reference asset or index with a leveraged or enhanced participation rate, but only up to a capped, maximum amount. Once the maximum payoff is reached, the holder does not participate in any additional increases in the reference asset or index.

Knock-in Feature: Some structured notes may specify that if the reference asset or index falls below a pre-specified level during the term of the note, the holder may lose some or all of the principal investment at maturity and also could lose coupon payments scheduled throughout the term of the note. This pre-specified level may be called a barrier, trigger or knock-in. When this level is breached, the payout return changes on the note. For example, if the reference asset or index falls below the knock-in level and its value is lower than on the date of issuance, instead of receiving a return of principal, the holder may receive an amount that reflects the decline in value of the reference asset or index. For certain types of structured notes, the holder may actually receive the reference asset that has declined in value during the term of the note.

- In addition to risk of the underlying variable, structured notes are unsecured debt obligations. Hence, they are also subject to the risk of issuer default.

- Some structured notes have “call provisions” that allow the issuer, at its sole discretion, to redeem the note before it matures at a price that may be above, below or equal to the face value of the structured note.

Structured Note - NAIC Designation / CRP Rating:

- Any CRP rating / NAIC designation reported for these investments may not address the risk of principal loss related to the underlying variable. If a CRP rating / NAIC designation is reported, it may only be reflective on the credit risk of the issuer, not the actual risk of the investment.

Structured Note Example Prospectus:
The following is language taken from a long-term structured note (maturing 2023) (names / rates changed):

These “Securities” are unsecured and unsubordinated debt securities issued by ABC (NAIC 1) and fully and unconditionally guaranteed by ABC with returns linked to the performance of the EURO XX Index (the “Underlying”). If the Underlying Return is greater than zero, ABC will pay the Principal Amount at maturity plus a return equal to the product of (i) the Principal Amount multiplied by (ii) the Underlying Return multiplied by (iii) the Upside Gearing of 2.75. If the Underlying Return is less than or equal to zero, ABC will either pay the full Principal Amount at maturity, or, if the Final Level is less than the Downside Threshold, ABC will pay significantly less than the full Principal Amount at maturity, if anything, resulting in a loss of principal that is proportionate to the negative Underlying Return. These long-dated Securities are for investors who seek an equity index-based return and who are willing to risk a loss on their principal and forgo current income in exchange for the Upside Gearing feature and the contingent repayment of principal, which applies only if the Final Level is not less than the Downside Threshold, each as applicable at maturity. Investing in the Securities involves significant risks. You will not receive interest or dividend payments during the term of the Securities. You may lose some or all of your Principal Amount. The contingent repayment of principal applies only if you hold the Securities to maturity.

The securities are significantly riskier than conventional debt instruments. The terms of the securities may not obligate us to repay the full principal amount of the securities. The securities can have downside...
market risk similar to the underlying, which can result in a loss of a significant portion or all of your investment at maturity. This market risk is in addition to the credit risk inherent in purchasing our debt obligations.

FINRA Excerpts: Investor Alert: Reverse Convertibles – Complex Investment Vehicles

- Reverse convertibles are debt obligations of the issuer that are tied to the performance of an unrelated security or basket of securities. Although often described as debt instruments, they are far more complex than a traditional bond and involve elements of option trading.

- A reverse convertible is a structured product that generally consists of a high-yield, short-term note of the issuer that is linked to the performance of an unrelated reference asset – often a single stock, but sometimes a basket of stocks, an index or some other asset. The product typically has two components:
  - A debt instrument – Usually a note (called the “wrapper”) that pays an above-market coupon (on a monthly or quarterly basis).
  - A derivative – A put option, that gives the issuer the right to repay the principal to the investor in the form of a set amount of the underlying asset, rather than cash, if the price of the underlying asset dips below a predetermined price (often referred to as the “knock-in” level).

- The purchase of a reverse convertible gives the holder a yield-enhanced bond. The holder does not own, and does not get to participate in any upside appreciation of, the underlying asset. Instead, in exchange for higher coupon payments during the life of the note, the holder gives the issuer a put option on the underlying asset.

- The purchaser / holder is betting that the value of the underlying asset will remain stable or go up, while the issuer is betting that the price will fall.
  - Holder Best Case – The value of the underlying asset stays above the knock-in level or rises, resulting in the holder receiving a return of principal and a high coupon over the life of the investment.
  - Holder Worst Case – The value of the underlying asset drops below the knock-in level, in which case, the issuer can pay back principal in the form of the depreciated asset. This means that the holder loses some, or all, of the principal (offset only partially by the monthly or quarterly interest received and the ownership of the shares of the devaluated asset).

- The initial investment for most reverse convertibles is $1,000 per security, and most have maturity dates ranging from 3 months to one year. The interest or “coupon” rate on the note is usually higher than the yield on a conventional debt instrument of the issuer, or an issuer with a comparable debt rating.
  - FINRA identified reverse convertibles with annualized coupon rates of up to 30%. A high yield reflects the risk that instead of full return of principal at maturity, the investor could receive less than the full return of principal if the value of the unrelated reference assets falls below the knock-in level the issuer sets.
  - Depending on how the underlying asset performs, the holder either receives the principal back in cash or a predetermined amount of shares of the underlying stock or asset (or cash equivalent), which amounts to less than the original investment (because the asset’s price has dropped).
In some cases, return of the full principal depends on the price of the reference asset at the maturity date, whereas in other cases, the breach of the knock-in level at any time during the period will result in the holder receiving less than the original principal.

- Reverse convertibles have risks similar to fixed-income products (issuer default and inflation), but also have risks attributed to the underlying asset. **Even if the issuer meets its obligation on the note, holders could end up with shares of a depreciated – or worthless – asset.**

- **While the note component may reflect the issuer’s credit rating, that rating does not reflect the risk that the price of the unrelated underlying asset will fall below the knock-in level, and result in a loss of principal.** A reverse convertible packaged by a highly rated issuer could be linked to a poorly rated company, or to a highly rated company with poor performing stock.

- Some reverse convertibles have call provisions that allow the issuer, at its sole discretion, to redeem the investment before it matures. If this is the case, the holder does not receive any subsequent coupon payments, and the holder would immediately receive principal in either cash or stock.

- Reverse convertibles do not offer principal protection. The only principal protection offered is the conditional downside protection of the knock-in price.

**Reverse Convertibles - NAIC Designation / CRP Rating:**

- As reverse convertibles are short-term investments, these items are not reported with any NAIC designation or CRP rating. Rather, a holder would allocate these items on Schedule D - Part 1A based on their assessment of the underlying credit risk. It is assumed that holders of these investments would allocate these items based on the credit quality of the issuer. **However, similar to Structured Notes, the credit risk of the issuer does not address the risk of principal loss related to the underlying variable.**

**Reverse Convertible Example Prospectus:**

The following is an excerpt from a reverse convertible (offering both 3-month and 6-month notes):

Payment at Maturity (if held to maturity): For each $1,000 principal amount of the Notes, the investor will receive $1,000 plus any accrued and unpaid interest at maturity unless: (i) the Final Stock Price is less than the Initial Stock Price; and (ii) (a) for notes subject to Intra-Day Monitoring, at any time during the Monitoring Period, the trading price of the Reference Stock is less than the Barrier Price, or (b) for notes subject to Close of Trading Day Monitoring, on any day during the Monitoring Period, the closing price of the Reference Stock is less than the Barrier Price.

If the conditions described in (i) and (ii) are both satisfied, then at maturity the investor will receive, instead of the principal amount of the Notes, in addition to any accrued and unpaid interest, the number of shares of the Reference Stock equal to the Physical Delivery Amount, or at our election, the cash value thereof. If we elect to deliver shares of the Reference Stock, fractional shares will be paid in cash. **Investors in these Notes could lose some or all of their investment at maturity if there has been a decline in the trading price of the Reference Stock.**

The following is another excerpt from a reverse convertible:

**Principal Payment at Maturity**

A $1,000 investment in the Notes will pay $1,000 at maturity unless: (a) the final price of the linked share is lower than the initial price of the linked share; and (b) between the initial valuation date and the final valuation date, inclusive, the closing price of the linked share on any day is below the protection price.
If the conditions described in (a) and (b) are both true, at maturity you will receive, at our election, instead of the full principal amount of your Notes, either (i) the physical delivery amount (fractional shares to be paid in cash in an amount equal to the fractional shares multiplied by the final price), or (ii) a cash amount equal to the principal amount of your Notes reduced by the percentage decrease in the price of the linked share from the initial price to the final price.

If you receive shares of the linked share in lieu of the principal amount of your Notes at maturity, the value of your investment will approximately equal the market value of the shares of the linked share you receive, which could be substantially less than the value of your original investment. You may lose some or all of your principal if you invest in the Notes.

**Government-Sponsored Enterprises (GSE) – Credit Risk Transfer (CRT) Transactions**

GSE CRT securities are “debt” notes issued by Freddie Mac or Fannie Mae designed to transfer the credit risk from the mortgages in a specified reference pool to the investors that purchase the debt securities. The structure of these securities originated in 2012 in response to a Federal Housing Finance Agency (FHFA) strategic plan of credit risk transfer to reduce Fannie Mae’s and Freddie Mac’s overall risk. (The original issuances under the strategic plan were Structured Agency Credit Risk (STACR) for Freddie Mac and Connecticut Avenue Securities (CAS) for Fannie Mae.)

- Issued CRT security is tied to a reference pool of mortgages. As loans in the referenced pool default, the securities incur principal write-downs. The principal write-downs are allocated to designated tranches.

- CRT securities are different from mortgage-backed securities (MBS). Investing in a MBS allows investors to receive a portion of the principal and interest that the GSE receives from the borrowers of the underlying mortgages. The GSE guarantees timely payment of interest and principal on MBS by charging a guarantee fee to the lender, which is passed on to the borrower through the interest rate changed to the mortgage. (With this structure the GSEs retain the credit risk of the mortgage borrowers.) As an investor in a CRT, the credit risk in the referenced mortgages is transferred to the investors.

- Each CRT transaction includes several tranches that cover a range of cash flows, credit risk and potential return profiles. Those holding the lowest level tranche take on the highest credit risk, as they incur losses first. Those holding higher level tranches take on the lowest credit risk. The GSE generally maintains the highest tranche, which incurs the last level of loss.

- The FHFA 2012 summary characterize these transactions as synthetic notes or derivatives:

  The STACR and CAS securities account for about 90 percent of credit risk transfers to date. These securities are issued as Enterprise debt and do not constitute the sale of mortgage loans or their cash flows. Instead, **STACR and CAS are considered to be synthetic notes or derivatives because their cash flows track to the credit risk performance of a notional reference pool of mortgage loans.**

- As identified the Freddie Mac STACR summary:
  
  - STACR debt notes are unsecured and unguaranteed bonds whose principal payments are determined by the delinquency and principal payment experience on a STACR Reference Pool. Freddie Mac transfers credit risk from the mortgages in the reference pool to credit investors who invest in the STACR debt notes.
  
  - Freddie Mac makes periodic payments of principal and interest on the notes and is compensated through a reduction in note balance for defined credit events on the Reference Pool.
STACR debt investors may not receive their full principal and will receive periodic payments of principal as well as interest.

Periodic and ultimate principal payments on STACR debt are influenced by the delinquency and principal payment experience on a STACR reference pool, in addition to predetermined principal rules. Debt coupon yields will likely be established at higher levels than standard Freddie Mac debt offerings.

GSE / CRT (Mortgage Referenced Securities) - NAIC Designation / CRP Rating:

- Mortgage referenced securities issued by Fannie Mae and Freddie Mac are reviewed under existing methodologies of the NAIC Securities Valuation Office (SVO) and the NAIC Structured Securities Group (SSG). This methodology considers both the credit risk of the issuer (Fannie / Freddie) as well as the credit risk of the borrowers in the referenced mortgage loans. This analysis is possible as the underlying risk is credit risk, and not the risk of any other variable (e.g., equity index, etc.).

STACR Example Prospectus:

The Notes will not constitute “mortgage related securities” for purposes of SMMEA, and the Notes may be regarded as high-risk, derivative, risk-linked or otherwise complex securities. The Notes should not be purchased by prospective investors who are prohibited from acquiring securities having the foregoing characteristics.

The performance of the Notes will be affected by the Credit Event experience of the Reference Obligations. The Notes are not backed by the Reference Obligations and payments on the Reference Obligations will not be available to make payments on the Notes. However, each Class of Notes will have credit exposure to the Reference Obligations, and the yield to maturity on the Notes will be directly related to the amount and timing of Credit Events on the Reference Obligations.

As described in this offering circular, the notes are linked to the credit and principal payment risk of a certain pool of residential mortgage loans but are not backed or secured by such mortgage loans. The occurrence of 180-day or more delinquencies on these mortgage loans as well as the occurrence of other credit events thereon as described in this offering circular, could result in write-downs of the class principal balances of the notes. Interest and principal payable on the notes will be solely the unsecured obligation of Freddie Mae.

CAS Example Prospectus:

The Notes will not constitute “mortgage related securities” for purposes of SMMEA, and the Notes may be regarded as high-risk, derivative, risk-linked or otherwise complex securities. The Notes should not be purchased by prospective investors who are prohibited from acquiring securities having the foregoing characteristics.

As described in this prospectus, the notes are linked to the credit and principal payment risk of certain residential mortgage loans but are not backed or secured by such mortgage loans. The occurrence of certain credit events or modification events on these mortgage loans, as described in this prospectus, will result in write-downs of the class principal balances of the notes to the extent losses are realized on such mortgage loans as a result of these events. In addition, the interest entitlement of the notes will be subject to reduction based on the occurrence of modification events on these mortgage loans to the extent losses are realized with respect thereto, as further described herein under “description of the notes—hypothetical structure and calculations with respect to the reference tranches—allocation of modification loss amount.” interest and principal payable on the notes will be solely the unsecured obligation of Fannie Mae.

U.S. GAAP Guidance
The U.S. GAAP guidance for structured notes was originally reflected in EITF 96-12, Recognition of Interest Income and Balance Sheet Classification of Structured Notes. This guidance was rejected for statutory accounting in SSAP No. 43R. Some of the conclusions in EITF 96-12 were subsequently revised with the issuance of FAS 133, Accounting for Derivative Instruments and Hedging Activities and FAS 155, Accounting for Certain Hybrid Financial Instruments. The revisions from FAS 133 and FAS 155 were driven from the “clear and closely related” separation guidance for embedded derivatives. Pursuant to the changes from FAS 133 and FAS 155, if an entity cannot reliably identify the embedded derivative for separation, the entire contract shall be measured at fair value. Additionally, the changes incorporated a fair value measurement election for certain hybrid financial instruments with embedded derivatives. For those items, an entity could elect to account for the contract entirely at fair value.

Current U.S. GAAP guidance for structured notes is captured in FASB Codification Topic 320, Investments – Debt and Equity Securities. The current GAAP guidance differentiates accounting based on whether the contract terms suggests that is reasonably possible that the entity could lose all or substantially all of its original investment amount for other than failure of the borrower to pay the contractual amounts due. For those structured notes, the GAAP guidance requires measurement at fair value, with all changes in fair value reported in earnings. For other structured notes in which the contractual amount of principal or original investment amount is at risk, entities are required to use a retrospective interest method. With this approach, if a note was to trigger a reduction in principal repayment, the entity would recognize a negative yield adjustment.

Key excerpts from U.S. GAAP:

**Structured Note Definition:** A debt instrument whose cash flows are linked to the movement in one or more indexes, interest rates, foreign exchange rates, commodities prices, prepayment rates, or other market variables. Structured notes are issued by U.S. government-sponsored enterprises, multilateral development banks, municipalities, and private entities. The notes typically contain embedded (but not separable or detachable) forward components or option components such as caps, calls, and floors. Contractual cash flows for principal, interest, or both can vary in amount and timing throughout the life of the note based on nontraditional indexes or nontraditional uses of traditional interest rates or indexes.

**Income Recognition for Certain Structured Notes**

320-10-35-38 This guidance addresses the accounting for certain structured notes that are in the form of debt securities, but does not apply to any of the following:

a. Mortgage loans or other similar debt instruments that do not meet the definition of a security under this Subtopic

b. Traditional convertible bonds that are convertible into the stock of the issuer

c. Multicurrency debt securities

d. Debt securities classified as trading

e. [Subparagraph not used]

f. Debt securities participating directly in the results of an issuer's operations (for example, participating mortgages or similar instruments)

g. Reverse mortgages

h. Structured note securities that, by their terms, suggest that it is reasonably possible that the entity could lose all or substantially all of its original investment amount (for other
than failure of the borrower to pay the contractual amounts due). (Such securities shall be subsequently measured at fair value with all changes in fair value reported in earnings.)

320-10-35-40 Entities shall use the retrospective interest method for recognizing income on structured note securities that are classified as available-for-sale or held-to-maturity debt securities and that meet any of the following conditions:

a. **Either the contractual principal amount of the note to be paid at maturity or the original investment amount is at risk** (for other than failure of the borrower to pay the contractual amounts due). Examples include principal-indexed notes that base principal repayment on movements in the Standard & Poor's S&P 500 Index or notes that base principal repayment on the occurrence of certain events or circumstances.

b. The note's return on investment is subject to variability (other than due to credit rating changes of the borrower) because of either of the following:

1. There is no stated coupon rate or the stated coupon is not fixed or prespecified, and the variation in the return on investment or coupon rate is not a constant percentage of, or in the same direction as, changes in market-based interest rates or interest rate index, for example, the London Interbank Offered Rate (LIBOR) or the U.S. Treasury Bill Index.

2. The variable or fixed coupon rate is below market rates of interest for traditional notes of comparable maturity and a portion of the potential yield (for example, upside potential for principal) is based on the occurrence of future events or circumstances. (Examples of instruments that meet this condition include inverse floating-rate notes, dual-index floating notes, and equity-linked bear notes.)

c. The contractual maturity of the bond is based on a specific index or on the occurrence of specific events or circumstances outside the control of the parties to the transaction, excluding the passage of time or events that result in normal covenant violations. Examples of instruments that meet this condition include index amortizing notes and notes that base contractual maturity on the price of oil.

320-10-35-41 Under the retrospective interest method, the income recognized for a reporting period would be measured as the difference between the amortized cost of the security at the end of the period and the amortized cost at the beginning of the period, plus any cash received during the period. The amortized cost would be calculated as the present value of estimated future cash flows using an effective yield, which is the yield that equates all past actual and current estimated future cash flow streams to the initial investment. If the effective yield is negative (that is, the sum of the newly estimated undiscounted cash flows is less than the security's amortized cost), the amortized cost would be calculated using a zero percent effective yield.

320-10-35-42 For purposes of determining the effective yield at which income will be recognized, all estimates of future cash flows shall be based on quoted forward market rates or prices in active markets, when available; otherwise, they shall be based on current spot rates or prices as of the reporting date.

Existing Authoritative Literature:

**SSAP No. 86—Derivatives:**

4. “Derivative instrument” means an agreement, option, instrument or a series or combination thereof:

a. To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or
b. That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.

11. An “underlying” is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under contract). An underlying may be a price or rate of an asset or liability but is not the asset or liability itself.

SSAP No. 26R—Bonds

3. Bonds shall be defined as any securities representing a creditor relationship, whereby there is a fixed schedule for one or more future payments. This definition includes:

a. U.S. Treasury securities;

b. U.S. government agency securities;

c. Municipal securities;

d. Corporate bonds, including Yankee bonds and zero-coupon bonds;

e. Convertible bonds, including mandatory convertible bonds as defined in paragraph 11.b;

f. Fixed-income instruments specifically identified:

i. Certifications of deposit that have a fixed schedule of payments and a maturity date in excess of one year from the date of acquisition;

ii. Bank loans issued directly by a reporting entity or acquired through a participation, syndication or assignment;

iii. Hybrid securities, excluding: surplus notes, subordinated debt issues which have no coupon deferral features, and traditional preferred stocks.

iv. Debt instruments in a certified capital company (CAPCO)

Although “structured notes” are not explicitly named in the SSAP No. 26R scope, they are referenced in a disclosure adopted per a referral from the Valuation of Securities (E) Task Force:

30.l Separately identify structured notes, on a CUSIP basis, with information by CUSIP for actual cost, fair value, book/adjusted carrying value, and whether the structured note is a mortgage-referenced security.

1 This statement adopts the GAAP definition of a security as it is used in FASB Codification Topic 320 and 860.

2 Security: A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.

b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.

c. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests or obligations.
As noted in the footnote to paragraph 30.1., the definition of a structured note subject to this disclosure is in accordance with the definition in the Purposes and Procedures Manual of the NAIC Investment Analysis Office:

Structured Note Definition from P&P Manual:

A Structured Note’s is a direct debt issuance by a corporation, municipality, or government entity, ranking pari-passu with the issuer’s other debt issuance of equal seniority where either:

- The coupon and/or principal payments are linked, in whole or in part, to prices of, payment streams from, index or indices, or assets deriving their value from other than the issuer’s credit quality, or
- The coupon and/or principal payments are leveraged by a formula that is different from either a fixed coupon, or a non-leveraged floating rate coupon linked to an interest rate index including by not limited to LIBOR or prime rate.

Analytically, a Structured Note can be divided into the issuer’s debt issue and an embedded derivative.

Securities with certain embedded securities are not considered Structured Notes, including but not limited to bonds with standard call or put options.

When the issuer is a trust, the source of payments on the security is the assets in the trust, and investors’ recourse is limited to the assets in that trust, the security is not a Structured Note.


Mortgage Referenced Security is a category of a Structured Note, as defined above in Part Three, Section 3 (b) (vi) of this Manual. In addition to the Structured Note definition, the following are characteristics of a Mortgage Referenced Security:

A Mortgage Referenced Security’s coupon and/or principal payments are linked, in whole or in part, to prices of, or payment streams from, real estate, index or indices related to real estate, or assets deriving their value from instruments related to real estate, including, but not limited to, mortgage loans.

(B) Not Filing Exempt
A Mortgage Referenced Security is not eligible for the filing exemption in Part Two, Section 4 (c) (ii) or the filing exemption in Section 4 (d) of this Manual, but is subject to the filing requirement indicated in Part Two, Section 2 (a) of this Manual.

(C) NAIC Risk Assessment
In determining the NAIC designation of a Mortgage Referenced Security, the SSG may use the financial modeling methodology discussed in this Part Seven, Section 6(a), adjusted to the specific reporting and accounting requirements applicable to Mortgage Referenced Securities.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): In 2014, in response to a request from the Valuation of Securities (E) Task Force, the Statutory Accounting Principles (E) Working Group incorporated a disclosure for structured notes in SSAP No. 26R. As detailed in that agenda item (agenda item 2014-02), the disclosure was requested by the Investment Asset (E) Working Group in order to assess the volume and activity of these notes, and so that subsequent consideration could occur for accounting or reporting revisions. This disclosure was requested before assessments for valuation and risk-based capital for these investments. The definition of a structured note was adopted in December 2013 by the

---

2 Determination of a “structured note” and “mortgage-referenced security” for this disclosure shall follow the definitions adopted within the Purposes and Procedures Manual of the NAIC Investment Analysis Office.
VOSTF, noting that these investments are different from structured securities subject to SSAP No. 43R, as these securities are not backed by a trust holding assets to back the cash flows.

**Information or issues (included in Description of Issue) not previously contemplated by the Working Group:** NAIC staff ran a report of the structured note disclosure captured in the year-end 2017 financial statements. The disclosure captured limited information regarding CUSIP, actual cost, fair value, BACV and whether the item is a mortgage-referenced security. The following summarizes key data from that report:

- **Population as of year-end 2017:** 3,933 securities reported by 476 entities
  - 28 securities reported by 4 fraternals
  - 1,290 securities reported by 123 life companies
  - 2,255 securities reported by 294 property / casualty companies
  - 360 reported by 55 health entities

- **Reported Value in the Disclosure**
  - BACV = $25,508,476,578
  - FV = $27,114,386,508
  - Cost = $25,095,837,931

- **Mortgage Reference Security**
  - No = 3,134
  - Yes = 788

- **Number of CUSIPS = 1,777**

  Instances where multiple companies held the same CUSIP seemed to mostly reflect U.S. TIPS (Treasury Inflation-Indexed Securities) or other items described as Treasury Securities. From review of the data, 859 of structured notes reported were identified as US Tips or other US Treasury securities. (All of these items were reported with an NAIC 1.)

  Note: NAIC staff does not consider Treasury Securities or TIPS to be structured notes within the scope of this agenda item. Structured notes, for purposes of this agenda item, represent securities where there is the potential for loss based on an underlying variable unrelated to the credit risk of the issuer. Treasury inflation-indexed securities (TIPS) are direct obligations of the U.S. government, and are backed by the full faith and credit of the government. The principal is protected against inflation and can grow as inflation rises. Although subsequent deflation could cause the principal to decline, the Treasury will pay at maturity an amount that is no less than the par amount as of the date the security was first issued. Hence, with these securities there is no risk of “principal loss” to the reporting entity.

After removing the 859 US Treasury items, 3,009 investments were captured in the structured note disclosure. The following reflects the reported NAIC designation for these items:

<table>
<thead>
<tr>
<th></th>
<th>Standard</th>
<th>FE</th>
<th>FM</th>
<th>AM</th>
<th>Z</th>
<th>S</th>
<th>*</th>
<th>PS</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>NAIC 1</td>
<td>621</td>
<td>948</td>
<td>259</td>
<td>11</td>
<td>30</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>1,870</td>
</tr>
<tr>
<td>NAIC 2</td>
<td>14</td>
<td>671</td>
<td>2</td>
<td>34</td>
<td>16</td>
<td>4</td>
<td>0</td>
<td>7</td>
<td>748</td>
</tr>
<tr>
<td>NAIC 3</td>
<td>18</td>
<td>239</td>
<td>2</td>
<td>7</td>
<td>1</td>
<td>2</td>
<td>0</td>
<td>1</td>
<td>270</td>
</tr>
<tr>
<td>NAIC 4</td>
<td>19</td>
<td>40</td>
<td>0</td>
<td>3</td>
<td>3</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>65</td>
</tr>
<tr>
<td>NAIC 5</td>
<td>3</td>
<td>10</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>8</td>
<td>0</td>
<td>24</td>
</tr>
<tr>
<td>NAIC 6</td>
<td>5</td>
<td>8</td>
<td>1</td>
<td>4</td>
<td>1</td>
<td>4</td>
<td>4</td>
<td>5</td>
<td>32</td>
</tr>
<tr>
<td>Totals</td>
<td>680</td>
<td>1,916</td>
<td>265</td>
<td>60</td>
<td>52</td>
<td>11</td>
<td>12</td>
<td>13</td>
<td>3,009</td>
</tr>
</tbody>
</table>
Summary of items noted:

NAIC 1 = Items reported with a “standard” NAIC 1 appear to mostly reflect the mortgage-referenced structured notes. The descriptions for these items reference FNMA, FHLMC, FHLB, Federal National Mortgage Association, Fannie Mae, Connecticut Avenue Securities—CAS, STACR, and GNMA. (As discussed within this agenda item, these agencies pass on the risk of the underlying mortgage to the security holder.) Per discussion with the NAIC Securities Valuation Office (SVO) and the NAIC Structured Securities Group (SSG), the NAIC has a methodology to review the STACR and CAS investments, and that methodology includes both the issuer’s credit assessment, as well as the credit assessment of the borrowers reflected in the referenced mortgage loan pool.

FE Items = Items reported with an “FE” are presumably reported based on the issuer’s CRP rating. As detailed within this agenda item, although the issuer is responsible for remitting the note obligation at maturity, the underlying risk of the security is not limited to the issuer obligation. Rather, there is additional risk for the performance of the underlying variable. (Although NAIC staff has not verified use of the FE designation for items reported as structured notes, the P&P Manual prohibits use of the “FE” symbol with mortgage referenced securities.)

FM / AM Items = NAIC staff is uncertain why securities that have been financially modeled, or that are modified filing exempt, would be captured within the structured note disclosure. Per discussion with the SVO and the SSG, although STACRs and CAS are reviewed for NAIC designations by the SSG, these securities are not considered “modeled” and are not captured in the financial modeling or modified filing exempt guidance in SSAP No. 43R. As such, it is not appropriate for these securities to be reported with these symbols.

Z Designation = A Z designation is used to identify an insurer-designated security that is in transition in reporting or filing status because it is newly purchased, not yet submitted to the SVO, in transition from a FE status to another, or has been dropped recently by AVR+ and the insurer has filed the security.

S Symbol = The designation is used to identify additional or other non-payment risk. The “S” symbol is not a symbol that insurers can self-designate. The SVO adds the “S” symbol to NAIC designations as a signal to the regulator that there is additional risk in the security not related to the credit risk of the issuer.

“*” = Security has been self-assigned by the insurer.

PS = This security was on the preferred stock schedule with preferred stock identifiers.

Convergence with International Financial Reporting Standards (IFRS): N/A

Staff Recommendation: NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose this agenda item with a request for comments. This agenda item proposes to revise statutory accounting and reporting to indicate that structured notes, for which the contractual principal amount to be paid at maturity or the original investment amount is at risk for other than failure of the borrower to pay the contractual amount due, shall be reported as a derivative in scope of SSAP No. 86. This guidance proposes a specific exception for mortgage-referenced government sponsored enterprises, with those securities captured in scope of SSAP No. 43R. Other instruments, which meet the definition of a bond, that may be considered a form of a “structured note” under U.S. GAAP terminology but for which the principal amount or original investment is not at risk for other than credit risk, (for example, an inflation bond or other structures where the interest rate varies, but original principal is not at risk), shall continue to be reported as bonds in scope of SSAP No. 26R. This agenda item also proposes to clarify that all derivatives, regardless of maturity date, shall be captured as derivatives and not as cash equivalents or short-term investments.
The proposed accounting and reporting proposed within this agenda item is consistent with statutory accounting concepts, primarily the recognition concept, which focuses on the ability to meet policyholder obligations with the existence of readily marketable assets available when both current and future obligations are due. Consistent with that concept, an instrument for which original principal may not be returned in accordance with the terms of the agreement, should be captured on an annual statement reporting schedule that is more consistent with the substance of the transaction. Reporting these instruments as a derivative is consistent with the definition of a derivative in SSAP No. 86, and reflects the substance of the instrument (rather than the form). With reporting as a derivative, these instruments would be reported at fair value, which would be consistent with U.S. GAAP for situations in which the terms of the instrument suggests that it is reasonably possible that an entity could lose all or substantially all of its original investment amount for other than the failure of the borrower to pay the contractual amounts due.

NAIC staff also highlights that the substance of the structured notes in scope of this agenda item (excluding the mortgage referenced securities), may be considered “speculative derivatives.” NAIC staff understands that certain state investment limitations may prohibit insurers from holding speculative derivative instruments. As such, by properly classifying these items based on the substance of the transaction, the financial statements provide a better representation of the investments held by a reporting entity.

Speculation is the act of buying or selling an asset in hopes of generating a profit from the asset's price fluctuations. Stock options, which are derivative securities, could be used to speculate on prices of underlying assets.

Ultimately, if the revisions proposed in this agenda item are supported, the Working Group will need to make a referral to the Valuation of Securities (E) Task Force to make corresponding revisions to their definition of a “structured note.”

Key elements / discussion points in determining the NAIC staff recommendation:

- Structured Notes, excluding mortgage-referenced securities, in which the terms of the security does not obligate the issuer to repay the full principal, (as principal repayment is determined in accordance with the performance of an underlying variable), which can result in a loss of principal, other than by default, is a derivative instrument subject to the provisions of SSAP No. 86—Derivatives.
  - A structured note incorporates risk of an underlying variable in addition to the credit-risk of the issuer. With the focus of structured notes captured in this agenda item, the substance of the structure is the derivative element, which determines the amount owed under the terms of the agreement. The reporting of these structures as derivatives is consistent with the overall substance of the item. Although these structures are designed to resemble a debt instrument (with an issuer obligation), as the issuer obligation is contingent on the derivative element, the substance of the transaction (derivative element) should drive the accounting. (Reporting these instruments as bonds reflects the “form” of the investment and is not reflective of the underlying risk of the investment.) The direction for classification as a derivative instrument is not contradictory to SSAP No. 86, paragraph 16, which indicates that embedded derivatives should not be separated from the host contract and accounted for separately. As detailed in this agenda item, there is no separation from the host contract of the derivative; rather the entire instrument shall be classified as a derivative, which is in substance the nature of the transaction.
  - Identification, and the designated accounting and reporting of a structured note for statutory accounting purposes are focused on principal repayment per the terms of the security (which includes the performance of the underlying variable). For statutory accounting purposes, this
classification does not intend to capture debt instruments for which the principal repayment is only subject to the credit risk of the issuer. (As noted in the proposed revisions to SSAP No. 26R, bond instruments that may be considered “structured notes” under U.S. GAAP, but for which the original principal or investment is not at risk will be captured in scope of SSAP No. 26R. Examples include TIPS and other floating / variable rate interest instruments.

- Classification as a structured note, for statutory accounting, is focused on the potential for loss of principal per the terms of the security (other than by default). This classification excludes inflation-indexed securities in which the principal repayment may increase, as long as the security will pay at maturity no less than the par stated as of the date the security was issued.

- A structured note for which the original principal or investment is at risk shall be accounted for under SSAP No. 86 regardless if the maturity date of the instrument is short term or long term. As such, reverse convertibles (or similar structures) shall be accounted and reported in accordance with SSAP No. 86. The guidance for cash equivalents / short-term investment classification is predicated on the concept that the risk of interest rate changes until maturity is insignificant. However, as the risk of loss for the structured notes addressed in this agenda item is contingent on equity / derivative factors, these instruments should not be captured as cash equivalents or short-term investments. Revisions have also been proposed to clarify that derivatives, regardless of maturity date, should never be reported as cash equivalents or short-term investments. (NAIC staff notes that there is no dedicated reporting line for derivatives as either short-term assets or cash equivalents, and if previously captured in these reporting lines, they would have simply been noted as “other.”)

- With the clarification that structured notes for which there is a risk of principal loss outside of default risk are derivatives, the structured note disclosure will be deleted from SSAP No. 26. Consideration could be given on whether additional information shall be captured for these securities in SSAP No. 86.

- Government sponsored enterprises (GSE) credit risk transfer instruments (CRT) (known as mortgage-referenced securities - MRS) meet the statutory classification as a structured note (as the holder could lose principal with the performance of the referenced security), however, separate accounting and reporting consideration is given as the underlying referenced variable also pertains to credit-risk, which can be assessed by existing methodologies of the NAIC Securities Valuation Office and/or the NAIC Structured Securities Group (SSG). These securities encompass both the credit risk of the issuer (e.g., Fannie Mae or Freddie Mac), as well as the credit risk of mortgage loan borrowers.

- As the “referenced variable” in a MRS is credit risk, which can be assessed for NAIC designations, an exception to the structured note classification / derivative reporting is proposed. For MRS, it is recommended that these items be specifically identified in scope of SSAP No. 43R with explicit guidance in that SSAP for the accounting and reporting for these securities.

  - The inclusion of these securities in SSAP No. 43R would be an exception to the definition of a loan-backed or structured security, because MRS are not backed by assets held in trust. Although these items do not meet the standard definition of a SSAP No. 43R security, inclusion of these securities is considered more appropriate than capturing these securities in scope of SSAP No. 26R. This is because the principal repayment and interest income received by the holder ultimately depends on the cash flows attributed to the underlying variable (referenced pool of mortgages), even if the underlying variables are not held in “trust” and do not directly collateralize the MRS.
The explicit accounting and reporting in SSAP No. 43R for MRS is proposed to include the following concepts:

- Identification of MRS included in scope of SSAP No. 43R. (This will explicitly reference the government agencies that could issue these securities.) Structured notes, for which there is a risk of principal loss beyond default risk, that are not MRS will be reported as derivatives under SSAP No. 86.
- Guidance that MRS will be considered an “other” security in determining NAIC designation (NAIC 1-6) and will not be subject to the SSAP No. 43R financial modeling or the modified filing exempt process. With this distinction, the guidance in SSAP No. 43R, paragraph 25 would apply in determining the measurement method as either amortized cost or lower of amortized cost of fair value. (Under the provisions of the P&P Manual, these securities will not qualify for filing exempt; therefore they would be required to be filed with the NAIC SVO/SSG for the NAIC designation.)
- Guidance that MRS securities should recognize an other-than-temporary impairment when it is known that a referenced mortgage has incurred a default that will impact the principal repayment of the debt instrument. This guidance would be in addition to standard guidance for OTTI recognition based on the credit assessment of the issuer.

If the SSAP No. 43R approach is supported for MRS, a referral will be sent to the Blanks (E) Working Group to capture these securities on Schedule D-1 as a specific line in the “U.S. Special Revenue and Special Assessment Obligations and All Non-Guaranteed Obligations of Agencies and Authorities of Governments and Their Political Subdivisions” category. (As the MRS are only permitted from the designated government agencies, there should be no reporting of these securities in any of the other categories on Schedule D-1.)

If the SSAP No. 43R approach is not supported for MRS, NAIC staff offers the following two other options:

- Capture MRS in scope of SSAP No. 86 as derivatives. This classification would be consistent with the treatment of other structured notes subject to the risk of loss beyond default risk. (As noted, the FHFA and prospectus’ identify these securities as derivatives as they are based on the performance of an underlying variable.)
- Include explicit guidance in SSAP No. 26 for these securities. (The accounting and reporting, including the NAIC designation would likely be similar to what is proposed if captured under SSAP No. 43R.)

**Proposed Revisions pursuant to the NAIC Staff Recommendations**

**SSAP No. 2—Cash, Cash Equivalents, Drafts and Short-Term Investments**

*Revisions exclude derivative instruments from being reported as cash equivalents or short-term investments.*

**Cash Equivalents**

6. Cash equivalents are short-term, highly liquid investments that are both (a) readily convertible to known amounts of cash, and (b) so near their maturity that they present insignificant risk of
changes in value because of changes in interest rates. Only investments with original maturities\(^3\) of three months or less qualify under this definition, with the exception of money market mutual funds, as detailed in paragraph 7. Regardless of maturity date, derivative instruments shall not be reported as cash equivalents and shall be reported as derivatives on Schedule DB. Securities with terms that are reset at predefined dates (e.g., an auction-rate security that has a long-term maturity and an interest rate that is regularly reset through a Dutch auction) or have other features an investor may believe results in a different term than the related contractual maturity shall be accounted for based on the contractual maturity at the date of acquisition, except where other specific rules within the statutory accounting framework currently exist.

Short-Term Investments

12. All investments with remaining maturities (or repurchase dates under repurchase agreements) of one year or less at the time of acquisition (excluding derivatives and those investments classified as cash equivalents as defined in this statement) shall be considered short-term investments. Short-term investments include, but are not limited to, bonds, commercial paper, repurchase agreements, and collateral and mortgage loans which meet the noted criteria. Short-term investments shall not include certificates of deposit. Regardless of maturity date, derivative instruments shall not be reported as short-term investments and shall be reported as derivatives on Schedule DB.

SSAP No. 26R—Bonds

(Revisions clarify the scope inclusions / exclusions for structured notes as well as remove the structured note disclosure.)

1. This statement establishes statutory accounting principles for bonds, specific fixed-income investments, and particular funds identified by the Securities Valuation Office (SVO) as qualifying for bond treatment as identified in this statement.

2. This statement excludes:

a. Loan-backed and structured securities addressed in SSAP No. 43R—Loan-Backed and Structured Securities.

b. Securities that meet the definition in paragraph 3 with a maturity date of one year or less from date of acquisition, which qualify as cash equivalents or short-term investments. These investments are addressed in SSAP No. 2R—Cash, Cash Equivalents, Drafts and Short-Term Investments.

c. Securities that meet the definition in paragraph 3, but for which the contractual amount of the instrument to be paid at maturity (or the original investment) is at risk for other than failure of the borrower to pay the contractual amount due. These investments, although in the form of a debt instrument, incorporate risk of an underlying variable in the terms of the agreement, and the issuer obligation to return the full principal is contingent on the performance of the underlying variable\(^\text{FN}\). These investments are addressed in SSAP No. 86—Derivatives, unless the investment is a mortgage-referenced security addressed in SSAP No. 43R.

New Footnote: The exclusion in paragraph 2c is specific to instruments in which the terms of the agreement make it possible that the reporting entity could lose all or a portion of its principal amount due / original investment amount (for other than failure of

\(^3\) Original maturity means original maturity to the entity holding the investment. For example, both a three-month U.S. Treasury bill and a three-year Treasury note purchased three months from maturity qualify as cash equivalents. However, a Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months.
the issuer to pay the contractual amounts due). These instruments incorporate both the credit risk of the issuer, as well as the risk of an underlying variable (such as the performance of an equity index or the performance of an unrelated security). Securities that are labeled “principal-protected notes” are captured within this exclusion if the “principal protection” involves only a portion of the principal / original investment amount and/or if the protection requires the reporting entity to meet qualifying conditions in order to be safeguarded from the risk of loss from the underlying linked variable. Securities that may have changing interest rates in response to a linked underlying variable, or that have the potential for increased principal repayments in response to a linked variable (such as U.S. Treasury Inflation-Indexed Securities) that do not incorporate risk of original investment / principal loss (outside of default risk) are not captured in this exclusion.

Mortgage loans and other real estate lending activities made in the ordinary course of business. These investments are addressed in SSAP No. 37—Mortgage Loans and SSAP No. 39—Reverse Mortgages.

30. The financial statements shall include the following disclosures:

- Separately identify structured notes, on a CUSIP basis, with information by CUSIP for actual cost, fair value, book/adjusted carrying value, and whether the structured note is a mortgage-referenced security.

SSAP No. 43R—Loan-backed and Structured Securities
(Revisions clarify the scope inclusions for MRS.)

1. This statement establishes statutory accounting principles for investments in loan-backed securities and structured securities and mortgage referenced securities. In accordance with SSAP No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. 103R), retained beneficial interests from the sale of loan-backed securities and structured securities are accounted for in accordance with this statement. Items captured in scope of this statement loan-backed securities and structured securities are collectively referred to as loan-backed securities.

SUMMARY CONCLUSION

2. Loan-backed securities are defined as securitized assets not included in structured securities, as defined below, for which the payment of interest and/or principal is directly proportional to the payments received by the issuer from the underlying assets, including but not limited to pass-through securities, lease-backed securities, and equipment trust certificates.

3. Structured securities are defined as loan-backed securities which have been divided into two or more classes for which the payment of interest and/or principal of any class of securities has been allocated in a manner which is not proportional to payments received by the issuer from the underlying assets.

4. Loan-backed securities are issued by special-purpose corporations or trusts (issuer) established by a sponsoring organization. The assets securing the loan-backed obligation are acquired by the issuer and pledged to an independent trustee until the issuer’s obligation has been fully satisfied. The investor only has direct recourse to the issuer’s assets, but may have secondary recourse to third parties through insurance or guarantee for repayment of the obligation. As a result, the sponsor and its other affiliates may have no financial obligation under the instrument, although one of those entities may retain the responsibility for servicing the underlying assets. Some sponsors do guarantee the performance of the underlying assets.

---

4 Determination of a “structured note” and “mortgage referenced security” for this disclosure shall follow the definitions adopted within the Purposes and Procedures Manual of the NAIC Investment Analysis Office.
4.5. Mortgage referenced securities do not meet the definition of a loan-backed or structured security, but are explicitly captured in scope of this statement. In order to qualify as a mortgage referenced security, the security must be issued by a government sponsored enterprise in the form of a “credit risk transfer” in which the issued security is tied to a referenced pool of mortgages. These securities do not qualify as “loan-backed securities” as the pool of mortgages are not held in trust and the amounts due under the investment are not backed or secured by the mortgage loans. Rather, these items reflect instruments in which the payments received are linked to the credit and principal payment risk of the underlying mortgage loan borrowers captured in the referenced pool of mortgages. For these instruments, reporting entity holders may not receive a return of their full principal as principal repayment is contingent on repayment by the mortgage loan borrowers in the referenced pool of mortgages. Unless specifically noted, the provisions for loan-backed securities within this standard apply to mortgage referenced securities.

(Remaining paragraphs renumbered accordingly.)

New Footnote – Currently, only Fannie Mae and Freddie Mac are the government sponsored entities that issue qualifying mortgage referenced securities. However, this guidance would apply to mortgage referenced securities issued by any other government sponsored entity that subsequently engages in the transfer of residential mortgage credit risk.

Reporting Guidance for All Loan-Backed and Structured Securities

2625. Loan-backed and structured securities shall be valued and reported in accordance with this statement, the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*, and the designation assigned in the *NAIC Valuations of Securities* product prepared by the NAIC Securities Valuation Office or equivalent specified procedure. The carrying value method shall be determined as follows:

a. For reporting entities that maintain an Asset Valuation Reserve (AVR), loan-backed and structured securities shall be reported at amortized cost, except for those with an NAIC designation of 6, which shall be reported at the lower of amortized cost or fair value.

b. For reporting entities that do not maintain an AVR, loan-backed and structured securities designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; loan-backed and structured securities that are designated medium quality, low quality, lowest quality and in or near default (NAIC designations 3 to 6, respectively) shall be reported at the lower of amortized cost or fair value.

Designation Guidance

2726. For securities within the scope of this statement, the initial NAIC designation used to determine the carrying value method and the final NAIC designation for reporting purposes is determined using a multi-step process. The *Purposes and Procedures Manual of the NAIC Investment Analysis Office* provides detailed guidance. A general description of the processes is as follows:

c. All Other Loan-Backed and Structured Securities: For loan-backed and structured securities not subject to paragraphs 26.a. (financial modeling) or 26.b. (modified filing exempt), follow the established designation procedures according to the appropriate section of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*. The NAIC designation shall be applicable for statutory accounting and reporting purposes (including determining the carrying value method and establishing the AVR charges). The carrying value method is established as described in paragraph 25. Examples of these securities include, but are not limited to, mortgage referenced securities, equipment trust certificates, credit tenant loans (CTL), 5*/6* securities, interest only (IO) securities, and loan-backed and structured securities with SVO assigned NAIC designations.

3433. If the entity does not expect to recover the entire amortized cost basis of the security, the entity would be unable to assert that it will recover its amortized cost basis even if it does not intend to
sell the security and the entity has the intent and ability to hold. Therefore, in those situations, an other-than-temporary impairment shall be considered to have occurred. (For mortgage-referenced securities, an OTTI is considered to have occurred when there has been a delinquency or other credit event in the referenced pool of mortgages.) In assessing whether the entire amortized cost basis of the security will be recovered, an entity shall compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. If present value of cash flows expected to be collected is less than the amortized cost basis of the security, the entire amortized cost basis of the security will not be recovered (that is, a non-interest related decline exists), and an other-than-temporary impairment shall be considered to have occurred. A decrease in cashflows expected to be collected on a loaned-backed or structured security that results from an increase in prepayments on the underlying assets shall be considered in the estimate of the present value of cashflows expected to be collected.

SSAP No. 86—Derivatives
(Revisions clarify the inclusion of securities when there is a contractual risk of loss in the terms of a debt instrument for an underlying variable other than the failure of the borrower to pay the contractual amount due.)

Definitions (for purposes of this statement)

4. “Derivative instrument” means an agreement, option, instrument or a series or combination thereof:
   a. To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or
   b. That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.

5. Derivative instruments include, but are not limited to; options, warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, forwards, futures, structured notes with risk of principal / original investment loss based on the terms of the agreement (in addition to default risk) and any other agreements or instruments substantially similar thereto or any series or combination thereof.
   a. “Caps” are option contracts in which the cap writer (seller), in return for a premium, agrees to limit, or cap, the cap holder’s (purchaser) risk associated with an increase in a reference rate or index. For example, in an interest rate cap, if rates go above a specified interest rate level (the strike price or the cap rate), the cap holder is entitled to receive cash payments equal to the excess of the market rate over the strike price multiplied by the notional principal amount. Because a cap is an option-based contract, the cap holder has the right but not the obligation to exercise the option. If rates move down, the cap holder has lost only the premium paid. A cap writer has virtually unlimited risk resulting from increases in interest rates above the cap rate;
   b. “Collar” means an agreement to receive payments as the buyer of an option, cap or floor and to make payments as the seller of a different option, cap or floor;
   c. “Floors” are option contracts in which the floor writer (seller), in return for a premium, agrees to limit the risk associated with a decline in a reference rate or index. For example, in an interest rate floor, if rates fall below an agreed rate, the floor holder

---

A non-interest related decline is a decline in value due to fundamental credit problems of the issuer. Fundamental credit problems exist with the issuer when there is evidence of financial difficulty that may result in the issuer being unable to pay principal or interest when due. An interest related decline in value may be due to both increases in the risk-free interest rate and general credit spread widening.
(purchaser) will receive cash payments from the floor writer equal to the difference between the market rate and an agreed rate multiplied by the notional principal amount;

d. “Forwards” are agreements (other than futures) between two parties that commit one party to purchase and the other to sell the instrument or commodity underlying the contract at a specified future date. Forward contracts fix the price, quantity, quality, and date of the purchase and sale. Some forward contracts involve the initial payment of cash and may be settled in cash instead of by physical delivery of the underlying instrument;

e. “Futures” are standardized forward contracts traded on organized exchanges. Each exchange specifies the standard terms of futures contracts it sponsors. Futures contracts are available for a wide variety of underlying instruments, including insurance, agricultural commodities, minerals, debt instruments (such as U.S. Treasury bonds and bills), composite stock indices, and foreign currencies;

f. “Options” are contracts that give the option holder (purchaser of the option rights) the right, but not the obligation, to enter into a transaction with the option writer (seller of the option rights) on terms specified in the contract. A call option allows the holder to buy the underlying instrument, while a put option allows the holder to sell the underlying instrument. Options are traded on exchanges and over the counter;

f.g. “Structured Notes” in scope of this statement are instruments (often in the form of a debt instruments), in which the amount of principal repayment or return of original investment is contingent on an underlying variable/interest & MD. Structured notes that are “mortgage referenced securities” are captured in SSAP No. 43R—Loan-backed and Structured Securities.

New Footnote: The "structured notes" captured within scope of this statement is specific to instruments in which the terms of the agreement make it possible that the reporting entity could lose all or a portion of its original investment amount (for other than failure of the issuer to pay the contractual amounts due). These instruments incorporate both the credit risk of the issuer, as well as the risk of an underlying variable/interest (such as the performance of an equity index or the performance of an unrelated security). Securities that are labeled "principal-protected notes" are captured within scope of this statement if the "principal protection" involves only a portion of the principal and/or if the principal protection requires the reporting entity to meet qualifying conditions in order to be safeguarded from the risk of loss from the underlying linked variable. Securities that may have changing interest rates in response to a linked underlying variable, or that have the potential for increased principal repayments in response to a linked variable (such as U.S. Treasury Inflation-Indexed Securities) that do not incorporate risk of original investment / principal loss (outside of default risk) are not captured in scope of this statement.

g.h. “Swaps” are contracts to exchange, for a period of time, the investment performance of one underlying instrument for the investment performance of another underlying instrument, typically, but not always, without exchanging the instruments themselves. Swaps can be viewed as a series of forward contracts that settle in cash and, in some instances, physical delivery. Swaps generally are negotiated over-the-counter directly between the dealer and the end user. Interest rate swaps are the most common form of swap contract. However, foreign currency, commodity, and credit default swaps also are common;

h.i. “Swaptions” are contracts granting the owner the right, but not the obligation, to enter into an underlying swap. Although options can be traded on a variety of swaps, the term “swaption” typically refers to options on interest rate swaps. A swaption hedges the buyer against downside risk, as well as lets the buyer take advantage of any upside benefits. That is, it gives the buyer the benefit of the agreed-upon rate if it is more favorable than the current market rate, with the flexibility of being able to enter into the current market
swap rate if it is preferable. Conversely, the seller of swaptions assumes the downside risk, but benefits from the amount paid for the swaption, regardless if it is exercised by the buyer and the swap is entered into.

“Warrants” are instruments that give the holder the right to purchase an underlying financial instrument at a given price and time or at a series of prices and times outlined in the warrant agreement. Warrants may be issued alone or in connection with the sale of other securities, for example, as part of a merger or recapitalization agreement, or to facilitate divestiture of the securities of another business entity.

Staff Review Completed by:
Julie Gann - NAIC Staff: April 2018

Status:
On August 4, 2018, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 2—Cash, Cash Equivalents, Drafts, and Short-Term Investments, SSAP No. 26R—Bonds, SSAP No. 43R—Loan-Backed and Structured Securities and SSAP No. 86—Derivatives to revise the guidance for structured notes when the reporting entity holder assumes a risk of principal loss based on an underlying component unrelated to the credit risk of the issuer.

The revisions, as shown above, are summarized as follows:

- **SSAP No. 2—Cash, Cash Equivalents, Drafts and Short-Term Investments**: Revisions clarify that derivative instruments shall not be reported as cash equivalents or short-term instruments regardless of their maturity date, and shall be reported as derivatives regardless of maturity.

- **SSAP No. 26R—Bonds**: Revisions remove securities from the bond definition when the contractual amount of the instrument to be paid at maturity is at risk for other than the failure of the borrower to pay the contractual amount due. This guidance identifies that the instrument may be in the form of a debt instrument, but the issuer obligation to return principal is contingent on the performance of an underlying variable (e.g., equity index or performance of an unrelated security.) The revisions also delete the structured note disclosure.

- **SSAP No. 43R—Loan-backed and Structured Securities**: Revisions explicitly capture mortgage-reference securities in scope. This is an explicit exception to the LBSS definition, as the items do not qualify as “loan-backed securities” as the pool of mortgages are not held in trust, and the amounts due under the investment are not backed by the referenced mortgages.

- **SSAP No. 86—Derivatives**: Revisions capture structured notes in scope when there is a risk of principal loss based on the terms of the agreement (in addition to default risk).
This page intentionally left blank.
Statutory Accounting Principles (E) Working Group  
Maintenance Agenda Submission Form  
Form A

**Issue:** SSAP No. 43R – Elimination of Modified Filing Exempt (MFE)

**Check (applicable entity):**

<table>
<thead>
<tr>
<th>Modification of existing SSAP</th>
<th>P/C</th>
<th>Life</th>
<th>Health</th>
</tr>
</thead>
<tbody>
<tr>
<td>✗</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>New Issue or SSAP</th>
<th>P/C</th>
<th>Life</th>
<th>Health</th>
</tr>
</thead>
<tbody>
<tr>
<td>✗</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Interpretation</th>
<th>P/C</th>
<th>Life</th>
<th>Health</th>
</tr>
</thead>
<tbody>
<tr>
<td>☐</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Description of Issue:** This agenda item has been drafted in response to a Valuation of Securities (E) Task Force referral requesting that the Working Group consider deletion of paragraph 26.b. of SSAP No. 43R and make other necessary changes to delete the modified filing exempt guidance (MFE) from SSAP No. 43R—Loan-backed and Structured Securities. Pursuant to the referral received from the Task Force:

In the period 2009-2010, insurers holding the highest quality tranches of securitizations found that securitizations that had experienced a $1 loss solely as a result of the application of NRSRO methodologies were being downgraded which resulted in the highest quality tranche of securities trading significantly below par value. The Task Force responded by adopting a financial modeling methodology to replace the use of credit ratings to produce NAIC Designations for RMBS and CMBS and by adopting a modified version of filing exemption (MFE) to produce NAIC Designations for other loan backed and structured securities (LBaSS). MFE is applied by insurers to LBaSS that are not subject to financial modeling and that are assigned NAIC CRP credit ratings. The objective of MFE was to permit insurers to select an NAIC Designation on the basis of the insurer’s carrying value for the security. The MFE procedure is housed in paragraph 26 (b) of SSAP No. 43R where it provides an alternative to the general rule for measuring the value of LBaSS in paragraph 25 of SSAP No. 43R. The Task Force has evaluated the impact of MFE from time to time since its adoption. As markets stabilized trading of most asset backed securities has moved backed to par value with the result that the use of carrying value in this normal market environment creates unusual results such as enhanced aggregate ratings. MFE would also negatively impact the implementation of the more granular risk-based capital (RBC) framework. On June 11, 2018, the Task Force requested NAIC staff to prepare an amendment to delete MFE from the Purposes and Procedures Manual and from SSAP 43R. On July, 12, the Task Force received and exposed a proposed amendment to delete Part Seven, Section 6 (iv) (A) and (C) of the Purposes and Procedures Manual which would delete MFE. The Task Force also moved to refer to the Working Group a request that they consider deletion of paragraph 26 (b) of SSAP No. 43R and make other necessary changes to delete MFE from the AP&PM.

Additional information regarding the MFE process:

Securities within scope of SSAP No. 43R that are not financially modeled, but have a credit rating from a credit rating provider (CRP) follow the MFE process. Under the MFE process, the amortized cost basis is used in conjunction with the CRP rating to determine the “final” NAIC designation statutory accounting and reporting purposes - including the assessment of AVR and for risk-based capital (RBC) purposes. As the MFE process utilizes the amortized cost for a particular security, under the process, identical securities purchased at different price points (acquired in different lots) may have differing final NAIC Designations.

The MFE process was initially adopted by the Valuation of Securities (E) Task Force and incorporated into SSAP No. 43R in 2011. Pursuant to the referral of the Task Force, this agenda item proposes to remove paragraph 26.b, along with other revisions necessary to eliminate MFE from SSAP No. 43R. If the MFE process is eliminated, all SSAP No. 43R securities that are not financially modeled (which is limited to qualifying RMBS or CMBS reviewed by the NAIC Structured Securities Group - SSG), will be subject to the “other” process in SSAP No. 43R. This process uses the NAIC designation, without adjustment, to determine the measurement method under
SSAP No. 43R and in determining the corresponding RBC charges. Hence, for securities that have a CRP rating that are not captured as financially modeled securities, the equivalent NAIC Designation would be utilized without adjustment for statutory accounting and reporting. All identical securities (excluding those financially modeled) will have identical NAIC designations, eliminating the issue of weighted-average designations for these securities.

**Existing Authoritative Literature:**

**SSAP No. 43R—Loan-backed and Structured Securities**

**Reporting Guidance for All Loan-Backed and Structured Securities**

25. Loan-backed and structured securities shall be valued and reported in accordance with this statement, the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*, and the designation assigned in the *NAIC Valuations of Securities* product prepared by the NAIC Securities Valuation Office or equivalent specified procedure. The carrying value method shall be determined as follows:

a. For reporting entities that maintain an Asset Valuation Reserve (AVR), loan-backed and structured securities shall be reported at amortized cost, except for those with an NAIC designation of 6, which shall be reported at the lower of amortized cost or fair value.

b. For reporting entities that do not maintain an AVR, loan-backed and structured securities designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; loan-backed and structured securities that are designated medium quality, low quality, lowest quality and in or near default (NAIC designations 3 to 6, respectively) shall be reported at the lower of amortized cost or fair value.

**Designation Guidance**

26. For securities within the scope of this statement, the initial NAIC designation used to determine the carrying value method and the final NAIC designation for reporting purposes is determined using a multi-step process. The *Purposes and Procedures Manual of the NAIC Investment Analysis Office* provides detailed guidance. A general description of the processes is as follows:

1. Financial Modeling: The NAIC identifies securities where financial modeling must be used to determine the NAIC designation. NAIC designation based on financial modeling incorporates the insurers’ carrying value for the security. For those securities that are financially modeled, the insurer must use NAIC CUSIP specific modeled breakpoints provided by the modelers in determining initial and final designation for these identified securities. Securities where modeling results in zero expected loss in all scenarios are automatically considered to have a final NAIC designation of NAIC 1, regardless of the carrying value. The three-step process for modeled securities is as follows:

   i. Step 1: Determine Initial Designation – The current amortized cost (divided by remaining par amount) of a loan-backed or structured security is compared to the modeled breakpoint values assigned to the six (6) NAIC designations for each CUSIP to establish the initial NAIC designation.

   ii. Step 2: Determine Carrying Value Method – The carrying value method, either the amortized cost method or the lower of amortized cost or fair value method, is then determined as described in paragraph 25 based upon the initial NAIC designation from Step 1.

   iii. Step 3: Determine Final Designation – The final NAIC designation that shall be used for investment schedule reporting is determined by comparing the carrying value (divided by remaining par amount) of a security (based on paragraph 26.a.ii.) to the NAIC CUSIP specific modeled breakpoint values assigned to the six (6) NAIC designations for each CUSIP. This final NAIC designation shall be applicable for statutory accounting and
reporting purposes (including establishing the AVR charges). The final designation is not used for establishing the appropriate carrying value method in Step 2 (paragraph 26.a.ii.).

2. Modified Filing Exempt Securities: The modified filing exempt method is for securities that are not subject to modeling under paragraph 26.a., and is further defined in the Purposes and Procedures Manual of the NAIC Investment Analysis Office and have a NAIC Credit Rating Provider (CRP) rating. The four-step process for these securities is similar to the three-step process described in paragraph 26.a.i. through 26.a.iii.

   i. Step 1: Translate ARO Rating – Translate CRP Rating to the NAIC Designation Equivalent in accordance with the Purposes and Procedures Manual of the NAIC Investment Analysis Office. If the result is NAIC 1 or NAIC 6, the remaining steps do not need to be performed; use the NAIC 1 or NAIC 6 to establish the appropriate carrying value methodology per paragraph 25 and report the NAIC 1 or NAIC 6 as the Final Designation. For NAIC 2 through NAIC 5, proceed to Step 2.

   ii. Step 2: Determine Initial Designation – Use the NAIC 2 through NAIC 5 from Step 1 to identify the appropriate breakpoints from the pricing matrix (see table, “NAIC Designations Breakpoints for Loan-Backed and Structured Securities” provided in Part Three Section 3 (c) (iv) (A) of the Purposes and Procedures Manual of the NAIC Investment Analysis Office) and compare to the amortized cost (divided by outstanding par) to determine the initial NAIC designation.

   iii. Step 3: Determine Carrying Value Method – The carrying value method, either the amortized cost method or the lower of amortized cost or fair value method, is then determined as described in paragraph 25 based upon the initial NAIC designation determined in Step 2.

   iv. Step 4: Determine Final Designation – If the appropriate carrying value methodology established in Step 3 results in the security being carried at amortized cost (including securities where the carrying value method is lower of amortized cost or fair value where the amortized cost is the lower value), then the final NAIC designation is the same as the initial NAIC designation. If the appropriate carrying value methodology established in Step 3 results in the security being carried at fair value (thus the carrying value method is lower of amortized cost and fair value, and the fair value is the lower value), use the converted ARO rating NAIC designation from Step 2 to identify the appropriate breakpoints from the pricing matrix and compare to the fair value (divided by outstanding par) to determine the final NAIC designation. This final NAIC designation shall be applicable for statutory accounting and reporting purposes (including establishing the AVR charges). The final NAIC designation is not used for establishing the appropriate carrying value method in Step 3 (paragraph 26.b.ii.).

3. All Other Loan-Backed and Structured Securities: For loan-backed and structured securities not subject to paragraphs 26.a. (financial modeling) or 26.b. (modified filing exempt), follow the established designation procedures according to the appropriate section of the Purposes and Procedures Manual of the NAIC Investment Analysis Office. The NAIC designation shall be applicable for statutory accounting and reporting purposes (including determining the carrying value method and establishing the AVR charges). The carrying value method is established as described in paragraph 25. Examples of these securities include, but are not limited to, equipment trust certificates, credit tenant loans (CTL), 5*/6* securities, interest only (IO) securities, and loan-backed and structured securities with SVO assigned NAIC designations.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): Agenda item 2018-03: Reporting NAIC Designations as Weighted Averages proposed revisions to SSAP No. 43R to clarify that if a loan-backed or structured security has different NAIC designations by lot, then the reporting entity shall report the entire investment on a single reporting line with the lowest applicable NAIC designation or report
separately by purchase lots aggregated by NAIC designation. (This agenda item was in response to adopted changes eliminating the reference to weighted averages in SSAP No. 43R.) In response to the exposure, interested parties provided comments disagreeing with the proposal for the following summarized reasons:

- The process to revise from CUSIP level reporting to “lot” level reporting may be onerous and costly, and the more detailed reporting may be more of a distraction than it is helpful.

- The option to report the entire security at the lowest NAIC designation (rather than aggregated by lots with different NAIC designations) is overly punitive and may not reflect the true risk of the portfolio.

- If there is a change to eliminate the MFE process, the system changes (and extensive work by companies) to eliminate average NAIC for MFE designations would have been unnecessary.

The comments from interested parties noted that at a minimum, agenda item 2018-03 should be deferred until a decision is reached on the potential elimination of the MFE approach.

**Information or issues (included in Description of Issue) not previously contemplated by the Working Group:** None

**Convergence with International Financial Reporting Standards (IFRS):** Not applicable.

**Staff Recommendation:**

NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose revisions to SSAP No. 43R—Loan-backed and Structured Securities to eliminate the modified filing exempt process in determining the final NAIC designation for CRP rated securities. Although this change is considered nonsubstantive, this change is recommended to be effective Jan. 1, 2019, with early application permitted. If electing early application, the approach must be applied to all applicable securities held at Dec. 31, 2018. (Early application means that a reporting entity would report the equivalent NAIC designation based on the CRP rating in the year-end 2018 financial statements without adjustment.) The Jan. 1, 2019 effective date has been proposed in case there are concerns with implementing this change so close to year-end, and to allow vendors time to update their systems. Comments are specifically requested on the proposed effective date, early adoption, and other transition issues that should be considered.

Although this change does not result in Blanks format structure changes, there will be several instructional revisions necessary to eliminate MFE from the reporting process. NAIC staff is recommending a concurrent exposure with the Blanks (E) Working Group to allow the reporting changes to be considered simultaneously with the SSAP revisions.

Although the Working Group is recommended to proceed with exposure on this agenda item and solicit comments for consideration, final action will not occur on this item until revisions eliminating the MFE process have been adopted by the Valuation of Securities (E) Task Force. (*Details of the exposed revisions to the Purposes and Procedures Manual of the NAIC Investment Analysis Office are captured in the Task Force referral.*) NAIC SAPWG staff will be working with the VOSTF staff to stay current on their discussion and action on this item.

**Additional elements to note:**

- As detailed in agenda item 2018-03: Reporting NAIC Designations as Weighted Averages, NAIC staff has proposed to defer discussion on the reporting of weighted average designations until the proposal to eliminate MFE has been addressed.
The change in NAIC designation is not expected to impact assessments to AVR or IMR. Under SSAP No. 43R the allocations to AVR and IMR are based on assessments of credit and interest factors, and not a change in NAIC designation. (Note – NAIC staff has identified that there are references in the Q/A regarding allocation to AVR/IMR based on NAIC designation, which are inconsistent with the guidance in paragraph 37 and the AVR/IMR annual statement instruction. Revisions have been proposed to update the Q/A guidance.)

The revisions to incorporate the financial modeling and MFE approach were considered nonsubstantive changes in 2011 and are not currently documented in an issue paper. As such, NAIC staff has assessed that the elimination of the MFE process would also be considered nonsubstantive. If preferred by the Working Group, NAIC Staff could develop an issue paper to document the inclusion of the financial modeling / MFE process in 2011 and the elimination of the MFE process for historical purposes.

Proposed Revisions to SSAP No. 43R—Loan-backed and Structured Securities

Reporting Guidance for All Loan-Backed and Structured Securities

25. Loan-backed and structured securities shall be valued and reported in accordance with this statement, the Purposes and Procedures Manual of the NAIC Investment Analysis Office, and the designation assigned in the NAIC Valuations of Securities product prepared by the NAIC Securities Valuation Office or equivalent specified procedure. The carrying value method shall be determined as follows:

a. For reporting entities that maintain an Asset Valuation Reserve (AVR), loan-backed and structured securities shall be reported at amortized cost, except for those with an NAIC designation of 6, which shall be reported at the lower of amortized cost or fair value.

b. For reporting entities that do not maintain an AVR, loan-backed and structured securities designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; loan-backed and structured securities that are designated medium quality, low quality, lowest quality and in or near default (NAIC designations 3 to 6, respectively) shall be reported at the lower of amortized cost or fair value.

Designation Guidance

26. For RMBS/CMBS securities within the scope of this statement, the initial NAIC designation used to determine the carrying value method and the final NAIC designation for reporting purposes is determined using a multi-step process. The Purposes and Procedures Manual of the NAIC Investment Analysis Office provides detailed guidance. A general description of the processes is as follows:

a. Financial Modeling: The NAIC identifies securities where financial modeling must be used to determine the NAIC designation. NAIC designation based on financial modeling incorporates the insurers’ carrying value for the security. For those securities that are financially modeled, the insurer must use NAIC CUSIP specific modeled breakpoints provided by the modelers in determining initial and final designation for these identified securities. Securities where modeling results in zero expected loss in all scenarios are automatically considered to have a final NAIC designation of NAIC 1, regardless of the carrying value. The three-step process for modeled securities is as follows:

i. Step 1: Determine Initial Designation – The current amortized cost (divided by remaining par amount) of a loan-backed or structured security is compared to the modeled breakpoint values assigned to the six (6) NAIC designations for each CUSIP to establish the initial NAIC designation.

ii. Step 2: Determine Carrying Value Method – The carrying value method, either the amortized cost method or the lower of amortized cost or fair value method, is then determined as described in paragraph 25 based upon the initial NAIC designation from Step 1.
iii. Step 3: Determine Final Designation – The final NAIC designation that shall be used for investment schedule reporting is determined by comparing the carrying value (divided by remaining par amount) of a security (based on paragraph 26.a.ii.) to the NAIC CUSIP specific modeled breakpoint values assigned to the six (6) NAIC designations for each CUSIP. This final NAIC designation shall be applicable for statutory accounting and reporting purposes (including establishing the AVR charges). The final designation is not used for establishing the appropriate carrying value method in Step 2 (paragraph 26.b.ii.).

b. Modified Filing Exempt Securities: The modified filing exempt method is for securities that are not subject to modeling under paragraph 26.a., and is further defined in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* and have a NAIC Credit Rating Provider (CRP) rating. The four-step process for these securities is similar to the three-step process described in paragraph 26.a.i. through 26.a.iii.

i. Step 1: Translate ARO Rating – Translate CRP Rating to the NAIC Designation Equivalent in accordance with the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*. If the result is NAIC 1 or NAIC 6, the remaining steps do not need to be performed; use the NAIC 1 or NAIC 6 to establish the appropriate carrying value methodology per paragraph 25 and report the NAIC 1 or NAIC 6 as the Final Designation. For NAIC 2 through NAIC 5, proceed to Step 2.

ii. Step 2: Determine Initial Designation – Use the NAIC 2 through NAIC 5 from Step 1 to identify the appropriate breakpoints from the pricing matrix (see table, “NAIC Designations Breakpoints for Loan-Backed and Structured Securities” provided in Part Three Section 3 (c) (iv) (A) of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*) and compare to the amortized cost (divided by outstanding par) to determine the initial NAIC designation.

iii. Step 3: Determine Carrying Value Method – The carrying value method, either the amortized cost method or the lower of amortized cost or fair value method, is then determined as described in paragraph 25 based upon the initial NAIC designation determined in Step 2.

iv. Step 4: Determine Final Designation – If the appropriate carrying value methodology established in Step 3 results in the security being carried at amortized cost (including securities where the carrying value method is lower of amortized cost or fair value where the amortized cost is the lower value), then the final NAIC designation is the same as the initial NAIC designation. If the appropriate carrying value methodology established in Step 3 results in the security being carried at fair value (thus the carrying value method is lower of amortized cost and fair value, and the fair value is the lower value), use the converted ARO rating NAIC designation from Step 2 to identify the appropriate breakpoints from the pricing matrix and compare to the fair value (divided by outstanding par) to determine the final NAIC designation. This final NAIC designation shall be applicable for statutory accounting and reporting purposes (including establishing the AVR charges). The final NAIC designation is not used for establishing the appropriate carrying value method in Step 3 (paragraph 26.b.ii.).

c.b. All Other Loan-Backed and Structured Securities: For loan-backed and structured securities not subject to paragraphs 26.a. (financial modeling) or 26.b. (modified filing exempt), follow the established designation procedures according to the appropriate section of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*. The NAIC designation shall be applicable for statutory accounting and reporting purposes (including determining the carrying value method and establishing the AVR charges). The carrying value method is established as described in paragraph 25. Examples of these securities include, but are not limited to, equipment trust certificates, credit tenant loans (CTL), 5*/6* securities, interest only (IO) securities, securities with CRP ratings (excluding RMBS/CMBS) and loan-backed and structured securities with SVO assigned NAIC designations.
**EXHIBIT A – Question and Answer Implementation Guide**

This exhibit addresses common questions regarding the valuation and impairment guidance detailed in SSAP No. 43R.

### Index to Questions

<table>
<thead>
<tr>
<th>No.</th>
<th>Question</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Are reporting entities permitted to establish an accounting policy to write down a SSAP No. 43R other-than-temporarily impaired security, for which a “non-interest” related decline exists, to fair-value regardless of whether the reporting entity intends to sell, or has the intent and ability to hold?</td>
</tr>
<tr>
<td>2</td>
<td>Can a reporting entity avoid completing a cash-flow assessment or testing for a specific other-than-temporarily impaired security when the entity believes there is a clear cash-flow shortage (i.e., non-interest related impairment) and elect to recognize a full impairment for the SSAP No. 43R security (no impairment bifurcation), with fair value becoming the new amortized cost basis, and recognition of the full other-than-temporary impairment as a realized loss?</td>
</tr>
<tr>
<td>3</td>
<td>Can reporting entities change their “intend to sell” or “unable to hold” assertions and recover previously recognized other-than-temporary impairments?</td>
</tr>
<tr>
<td>4</td>
<td>How do the regulators intend the phrase “intent and ability to hold” as used within SSAP No. 43R to be interpreted?</td>
</tr>
<tr>
<td>5</td>
<td>How do contractual prepayments affect the determination of credit losses?</td>
</tr>
<tr>
<td>6</td>
<td>Are the disclosure requirements within paragraphs 50.f. and 50.g. of SSAP No. 43R required to be completed for the current reporting quarter only, or as a year-to-date cumulative disclosures?</td>
</tr>
<tr>
<td>7</td>
<td>If an impairment loss is recognized based on the “present value of projected cash flows” in one period is the entity required to get new cash flows every reporting period subsequent or just in the periods where there has been a significant change in the actual cash flows from projected cash flows?</td>
</tr>
</tbody>
</table>

**Questions 8-10 are specific to securities subject to the financial modeling process. (This process is limited to qualifying RMBS/CMBS securities reviewed by the NAIC Structured Securities Group.) The guidance in paragraphs 8-10 shall not be inferred to other securities in scope of SSAP No. 43R.**

<table>
<thead>
<tr>
<th>No.</th>
<th>Question</th>
</tr>
</thead>
<tbody>
<tr>
<td>8</td>
<td>Do LBSS purchased in different lots result in a different NAIC designation for the same CUSIP? Can reporting entities use a weighted average method determined on a legal entity basis?</td>
</tr>
<tr>
<td>9</td>
<td>The NAIC Designation process for LBSS may incorporate loss expectations that differ from the reporting entity’s expectations related to OTTI conclusions. Should the reporting entities be required to incorporate recovery values obtained from data provided by the service provider used for the NAIC Designation process for impairment analysis as required by SSAP No. 43R?</td>
</tr>
<tr>
<td>10</td>
<td>For companies that have separate accounts, can the NAIC designation be assigned based upon the total legal entity or whether it needs to be calculated separately for the general account and the total separate account?</td>
</tr>
<tr>
<td>No.</td>
<td>Question</td>
</tr>
<tr>
<td>-----</td>
<td>----------</td>
</tr>
<tr>
<td>11</td>
<td>Should the initial or final rating be used to determine the AVR/IMR classification on sold securities? <strong>Staff Note – As detailed in paragraph 37 of SSAP No. 43R, all securities subject to SSAP No. 43R must bifurcate realized losses (whether from a sale or OTTI) between AVR and IMR depending on interest and non-interest factors in accordance with the analysis performed as of the date of the sale or OTTI. As such, this question is not relevant for SSAP No. 43R securities.</strong></td>
</tr>
<tr>
<td>12</td>
<td>Why is the final designation used for the AVR/IMR classification of realized gains and losses on sales? If the initial rating results in a NAIC 6 designation, and the final designation is higher, how does this impact reporting for AVR/IMR? <strong>Per discussion with the SSG, this issue was specific to MFE securities, and is not relevant for RMBS/CMBS that are financially modeled.</strong></td>
</tr>
</tbody>
</table>

Questions 8-10 are specific to securities subject to the financial modeling process. (This process is limited to qualifying RMBS/CMBS securities reviewed by the NAIC Structured Securities Group.) The guidance in paragraphs 8-10 shall not be inferred to other securities in scope of SSAP No. 43R.

8. **Question** – Do LBSS purchased in different lots result in a different NAIC designation for the same CUSIP? Can reporting entities use a weighted average method determined on a legal entity basis?

8.1 **Under the financial modeling process (applicable to qualifying RMBS/CMBS reviewed by the NAIC Structured Securities Group), the amortized cost of the security impacts the “final” NAIC designation used for reporting and RBC purposes. SSAP No. 43R and several other statements of statutory accounting principle require use of the scientific (constant yield) method of amortization. In addition to purchase price, the purchase date is an inherent part of this method and will typically result in different amortization values for different lots. Therefore, as such, securities subject to the financial modeling process acquired LBSS in different lots can result in a different NAIC designation for the same CUSIP. In accordance with the current instructions for calculating AVR and IMR, reporting entities are required to keep track of the different lots separately, which means reporting the different designations. To the extent that a different accounting method applies to a legal entity’s general and separate account, then the weighted average for each account should be calculated separately for the general account and separate account.**

**NAIC Staff Note – The guidance regarding weighted average designations will be considered in agenda item 2018-03 after this agenda item, which proposes to eliminate the MFE process, has been addressed. It is anticipated that the elimination of the MFE would significant reduce the occurrences for when identical securities have been acquired in differing lots with different NAIC designations.**

9. **Question** – The NAIC Designation process for LBSS subject to the financial modeling process may incorporate loss expectations that differ from the reporting entity’s expectations related to OTTI conclusions. Should the reporting entities be required to incorporate recovery values obtained from data provided by the service provider used for the NAIC Designation process for impairment analysis as required by SSAP No. 43R?

9.1 **In accordance with INT 06-07: Definition of Phrase “Other Than Temporary,” reporting entities are expected to “consider all available evidence” at their disposal, including the information that can be derived from the NAIC designation.**

10. **Question** - For companies that have separate accounts, can the NAIC designation be assigned based upon the total legal entity or whether it needs to be calculated separately for the general account and the total separate account?

10.1 **The financial modeling process for qualifying RMBS/CMBS securities is required for applicable securities held in either the general or separate account. The answer to this question is identical to the answer for question 8. SSAP No. 43R and several other statements of statutory accounting...**
principle require use of the scientific (constant yield) method of amortization. In addition to purchase price, the purchase date is an inherent part of this method and will typically result in different amortization values for different lots. Therefore, LBSS in different lots can result in a different NAIC designation for the same CUSIP. In accordance with the current instructions for calculating AVR and IMR, reporting entities are required to keep track of the different lots separately, which means reporting the different designations. To the extent that a different accounting method applies to a legal entity's general and separate account, then the weighted average for each account should be calculated separately for the general account and separate account.

11. **Question** — Should the initial or final designation be used to determine the AVR/IMR classification on sold securities?

11.1 The final designation should be utilized to determine the AVR/IMR classification on sold securities.

12. **Question** — Why is the final designation used for the AVR/IMR classification of realized gains and losses on sales? If the initial designation results in a NAIC 6 designation and the final designation is higher, how does this impact reporting for AVR/IMR?

12.1 With regards for AVR/IMR determination and other reporting purposes, the FINAL designation, after application of the multi-step method described in paragraph 26, shall be used. The initial designation, which is not used for any reporting purposes except for determining the carrying value method, is only an interim step in determining the (final) NAIC designation. However, as noted in paragraph 26, securities assigned an NAIC 6 designation are not modified by the carrying value; therefore the final designation is also an NAIC 6. The same is true for securities assigned an NAIC 1 designation by the SVO. As NAIC 1 securities are assumed to have zero expected loss, the initial designation is not modified by the carrying value; therefore the final designation is also an NAIC 1. (Please see paragraph 26 and related subparagraphs for additional information related to the multi-step method.)

**Staff Review Completed by:**

Julie Gann, NAIC Staff – July 2018

**Status:**

On August 4, 2018, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed proposed revisions, as shown above, to eliminate the modified filing exempt (MFE) process in determining the NAIC designation in accordance with the Valuation of Securities (E) Task Force referral. The exposure specifically requested comments on the effective date and transition issues that should be considered. It was noted that this exposure was concurrent with the Task Force project and adoption by the Working Group of the exposed revisions will be contingent on the actions of the Task Force regarding MFE. With this exposure, NAIC staff was directed to send notice to the Blanks (E) Working Group to allow consideration of the impact to the Annual Statement reporting instructions.
This page intentionally left blank.
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: Debt Forgiveness Between Related Parties

Check (applicable entity):

<table>
<thead>
<tr>
<th>Modification of existing SSAP</th>
<th>P/C</th>
<th>Life</th>
<th>Health</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Issue or SSAP</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interpretation</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Description of Issue: This agenda item has been drafted to clarify statutory accounting guidance for instances in which an amount due under a related party transaction involving a parent or stockholder has been forgiven. Particularly, it recommends clarifications regarding the treatment of forgiven debt involving a parent or other stockholder (related party issuer, parent/stockholder debtor) in SSAP No. 15—Debt and Holding Company Obligations to ensure the adopted GAAP guidance in SSAP No. 15 is applied correctly.

With the review of the related party guidance in SSAP No. 25—Affiliates and Other Related Parties, as well as recent questions regarding modifications of amounts charged and/or waivers to amounts owed under related party service agreements, this agenda item also references the general statutory accounting treatment for related party transactions. It also proposes clarifications to ensure reassessment of contract terms after service contract modifications, and to reference existing guidance in SSAP No. 72—Surplus and Quasi-Reorganizations.

Key elements in existing statutory accounting guidance:

- Accounting Principles Board Opinion No. 26, Early Extinguishment of Debt was adopted with modification to require gains and losses from extinguishment of debt by the obligor is to be reported as capital gains or losses and charged to operations. (SSAP No. 15, paragraph 25)

- Loans or advances made by a reporting entity to its parent or principal owner, and to all other related parties are required to be assessed periodically for collectability. If in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets, it is probable the amount is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made. (SSAP No. 25, paragraphs 8-9)

- Regulatory scrutiny of related party transactions where amounts charged for services do not meet the fair and reasonable criteria established by Appendix A-440 may result in (a) amounts charged being re-characterized as dividends or capital contributions, (b) transactions being reversed, (c) receivable balances being nonadmitted, or (d) other regulatory action. (SSAP No. 25, paragraph 18)

- Transactions involving the forgiveness of debt owed by a reporting entity to its parent shall be accounted for as contributed surplus. (SSAP No. 72—Paragraph 7)

- Transactions involving the forgiveness of any debt, surplus note, or other obligation owed to the reporting entity from its parent, or other stockholders, shall be accounted for as a dividend. (SSAP No. 72, paragraph 12.i.)

NAIC staff was contacted initially with a request to clarify statutory accounting guidance for debt transactions pursuant to the adoption, with modification, of Accounting Principles Board Opinion No. 26, Early Extinguishment of Debt (ABP 26). As detailed in SSAP No. 15, this APB, which includes guidance for related party transactions, was adopted with modification to require that gains and losses from extinguishment of debt be
reported as capital gains or losses and charged to operations. Although other statutory accounting guidance in SSAP No. 25—Affiliates and Other Related Parties and SSAP No. 72—Surplus and Quasi-Reorganizations provides guidance for related party transactions, the inquirer identified that the statutory adoption with modification of APB 26 was contradictory to the related party guidance, as SSAP No. 15 specifically requires capital gain and loss treatment for debt extinguishments. (Currently, there is no reference to SSAP No. 25 in SSAP No. 15.)

The guidance from APB 26 is now reflected in FASB Codification ASC 470-50-40:

470-50-40-2 A difference between the reacquisition price of debt and the net carrying amount of the extinguished debt shall be recognized currently in income of the period of extinguishment as losses or gains and identified as a separate item. Gains and losses shall not be amortized to future periods. If upon extinguishment of debt the parties also exchange unstated (or stated) rights or privileges, the portion of the consideration exchanged allocable to such unstated (or stated) rights or privileges shall be given appropriate accounting recognition. Moreover, extinguishment transactions between related entities may be in essence capital transactions.

Existing Authoritative Literature:

- **SSAP No. 15—Debt and Holding Company Arrangements** – This SSAP establishes statutory accounting principles for recording debt and related disclosure requirements. This guidance considers various GAAP guidance, but the pertinent adoption, with modification, of GAAP guidance is noted in paragraph 25:

  25. This statement adopts Accounting Principles Board Opinion No. 26, *Early Extinguishment of Debt* with modification to require that gains and losses from extinguishment of debt be reported as capital gains or losses, and charged to operations.

- **SSAP No. 25—Affiliates and Other Related Parties** – This SSAP establishes statutory accounting principles related party transactions, noting that related party transactions require specialized accounting rules and increased regulator scrutiny.

**Related Party Loans**

8. Loans or advances (including debt, public or private) made by a reporting entity to its parent or principal owner shall be admitted if approval for the transaction has been obtained from the domiciliary commissioner and the loan or advance is determined to be collectible based on the parent or principal owner’s independent payment ability. An affiliate’s ability to pay shall be determined after consideration of the liquid assets or revenues available from external sources (i.e., determination shall not include dividend paying ability of the subsidiary making the loan or advance) which are available to repay the balance and/or maintain its account on a current basis. Evaluation of the collectibility of loans or advances shall be made periodically. If, in accordance with SSAP No. 5R—Liabilities, *Contingencies and Impairments of Assets* (SSAP No. 5R), it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

9. Loans or advances by a reporting entity to all other related parties shall be evaluated by management and nonadmitted if they do not constitute arm’s-length transactions as defined in paragraph 12. Loans or advances made by a reporting entity to related parties (other than its parent or principal owner) that are economic transactions as defined in paragraph 12 shall be admitted. This includes financing arrangements with providers of health care services with whom the reporting entity contracts with from time to time. Such arrangements can include both loans and advances to these providers. Evaluation of the collectibility of loans or advances shall be made periodically. If, in accordance with SSAP No. 5R, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.
10. Any advances under capitation arrangements made directly to providers, or to intermediaries that represent providers, that exceed one month’s payment shall be nonadmitted assets.

11. Indirect loans are loans or extensions of credit to any person who is not an affiliate, where the reporting entity makes loans or extensions of credit with the agreement or understanding that the proceeds of the transactions, in whole or in substantial part, are to be used to make loans or extensions of credit to, to purchase assets of, or to make investments in, any affiliate of the reporting entity making the loans or extensions of credit. The admissibility of indirect loans made by a reporting entity for the benefit of its parent or principal owner shall be determined in accordance with the guidelines in paragraph 8. Indirect loans or advances made for the benefit of all other related parties shall be evaluated and accounted for consistent with loans or advances to related parties as described in paragraphs 9 and 10.

Transactions Involving the Exchange of Assets or Liabilities

12. An arm’s-length transaction is defined as a transaction in which willing parties, each being reasonably aware of all relevant facts and neither under compulsion to buy, sell, or loan, would be willing to participate. A transaction between related parties involving the exchange of assets or liabilities shall be designated as either an economic transaction or non-economic transaction. An economic transaction is defined as an arm’s-length transaction which results in the transfer of the risks and rewards of ownership and represents a consummated act thereof, i.e., “permanence.” The appearance of permanence is also an important criterion in assessing the economic substance of a transaction. In order for a transaction to have economic substance and thus warrant revenue (loss) recognition, it must appear unlikely to be reversed. If subsequent events or transactions reverse the effect of an earlier transaction prior to the issuance of the financial statements, the reversal shall be considered in determining whether economic substance existed in the case of the original transaction. Subsequent events are addressed in SSAP No. 9—Subsequent Events. An economic transaction must represent a bonafide business purpose demonstrable in measurable terms. A transaction which results in the mere inflation of surplus without any other demonstrable and measurable betterment is not an economic transaction. The statutory accounting shall follow the substance, not the form of the transaction.

13. In determining whether there has been a transfer of the risks and rewards of ownership in the transfer of assets or liabilities between related parties, the following—and any other relevant facts and circumstances related to the transaction—shall be considered:

   a. Whether the seller has a continuing involvement in the transaction or in the financial interest transferred, such as through the exercise of managerial authority to a degree usually associated with ownership;

   b. Whether there is an absence of significant financial investment by the buyer in the financial interest transferred, as evidenced, for example, by a token down payment or by a concurrent loan to the buyer;

   c. Whether repayment of debt that constitutes the principal consideration in the transaction is dependent on the generation of sufficient funds from the asset transferred;

   d. Whether limitations or restrictions exist on the buyer’s use of the financial interest transferred or on the profits arising from it;

   e. Whether there is retention of effective control of the financial interest by the seller.

14. A transaction between related parties may meet the criteria for treatment as an economic transaction at one level of financial reporting, but may not meet such criteria at another level of financial reporting. An example of such a transaction is a reporting entity purchasing securities at fair value from an affiliated reporting entity that carried the securities at amortized cost. This transaction meets the criteria of an economic transaction at this level of financial reporting, and therefore, the selling reporting entity would record a gain and the acquiring reporting entity would record the securities at their cost (fair value on the transaction date). At the common parent level of reporting, this transaction has resulted in the mere inflation of surplus, and therefore, is a non-economic transaction. The parent reporting entity
shall defer the net effects of any gain or increase in surplus resulting from such transactions by recording a deferred gain and an unrealized loss. The deferred gain shall not be recognized by the parent reporting entity unless and until arms-length transaction(s) with independent third parties give rise to appropriate recognition of the gain.

15. A non-economic transaction is defined as any transaction that does not meet the criteria of an economic transaction. Similar to the situation described in paragraph 14, transfers of assets from a parent reporting entity to a subsidiary, controlled or affiliated entity shall be treated as non-economic transactions at the parent reporting level because the parent has continuing indirect involvement in the assets.

16. When accounting for a specific transaction, reporting entities shall use the following valuation methods:

a. Economic transactions between related parties shall be recorded at fair value at the date of the transaction. To the extent that the related parties are affiliates under common control, the controlling reporting entity shall defer the effects of such transactions that result in gains or increases in surplus (see paragraph 14);

b. Non-economic transactions between reporting entities, which meet the definition of related parties above, shall be recorded at the lower of existing book values or fair values at the date of the transaction;

c. Non-economic transactions between a reporting entity and an entity that has no significant ongoing operations other than to hold assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates, shall be recorded at the fair value at the date of the transaction; however, to the extent that the transaction results in a gain, that gain shall be deferred until such time as permanence can be verified;

d. Transactions which are designed to avoid statutory accounting practices shall be reported as if the reporting entity continued to own the assets or to be obligated for a liability directly instead of through a subsidiary.

17. Examples of transactions deemed to be non-economic include security swaps of similar issues between or among affiliated companies, and swaps of dissimilar issues accompanied by exchanges of liabilities between or among affiliates.

Transactions Involving Services

18. Transactions involving services between related parties can take a variety of different forms. One of the significant factors as to whether these transactions will be deemed to be arm’s length is the amount charged for such services. In general, amounts charged for services are based either on current market rates or on allocations of costs. Determining market rates for services is difficult because the circumstances surrounding each transaction are unique. Unlike transactions involving the exchange of assets and liabilities between related parties, transactions for services create income on one party’s books and expense on the second party’s books, and therefore, do not lend themselves to the mere inflation of surplus. These arrangements are generally subject to regulatory approval.

19. Transactions involving services provided between related parties shall be recorded at the amount charged. Regulatory scrutiny of related party transactions where amounts charged for services do not meet the fair and reasonable standard established by Appendix A-440, may result in (a) amounts charged being recharacterized as dividends or capital contributions, (b) transactions being reversed, (c) receivable balances being nonadmitted, or (d) other regulatory action. Expenses that result from cost allocations shall be allocated subject to the same fair and reasonable standards, and the books and records of each party shall disclose clearly and accurately the precise nature and details of the transaction. See SSAP No 70—Allocation of Expenses for additional discussion regarding the allocation of expenses.
Gross Paid-in and Contributed Surplus

7. Gross paid-in and contributed surplus is the amount of capital received in excess of the par value of the stock issued. Changes in the par value of a reporting entity’s capital stock shall be reflected as a reclassification between the capital stock account and gross paid-in and contributed surplus. Forgiveness of a reporting entity’s obligations to its parent or other stockholders shall be accounted for as contributed surplus.

Unassigned Funds (Surplus)

12. Unassigned funds (surplus) represents the undistributed and unappropriated amount of surplus at the balance sheet date. Certain components of unassigned funds (surplus) are addressed in more detail in other issue papers. Unassigned funds (surplus) is comprised of the cumulative effect of:

i. Dividends to Stockholders

Dividends declared are charged directly to unassigned funds (surplus) on the declaration date and are carried as a liability until paid. The amount of the dividend is the cash paid if it is a cash dividend, the fair value of the assets distributed if it is a property dividend, or the par value of the company’s stock if it is a stock dividend. A stock dividend is recorded as a transfer from unassigned funds (surplus) to capital stock. Stock dividends have no effect on total capital and surplus while other forms of dividends reduce surplus. Forgiveness by a reporting entity of any debt, surplus note or other obligation of its parent or other stockholders shall be accounted for as a dividend. Dividends paid to related parties are subject to the requirements of SSAP No. 25—Affiliates and Other Related Parties;

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): None

Information or issues (included in Description of Issue) not previously contemplated by the Working Group: None


Staff Recommendation:

NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose minor revisions to SSAP No. 15—Debt and Holding Company Obligations to reference the applicable guidance in SSAP No. 25 and SSAP No. 72. Additionally, NAIC staff recommends minor revisions in SSAP No. 25 to reference SSAP No. 72 when there has been forgiveness of an amount owed. SSAP No. 25 applies to all related party transactions, but the recommended revisions will assist users in applying the debt guidance and prevent potential misperceptions. (Depending on the nature of the transaction and the forgiving party, the guidance in SSAP No. 72 directs either recognition as a capital contribution or as a dividend.)

Exposure Question 1 - Should uncollectibility of an amount loaned or advanced to a parent be considered a dividend, instead of a write-off to income? Is it clear when an amount owed from a parent has been deemed uncollectible instead of when debt has been forgiven?

Exposure Question 2 – Should additional guidance for the recording of related party service transactions be captured? NAIC staff is aware of instances in which intercompany service costs have been forgiven and not recorded. Generally, the intercompany transaction (and service cost expense / payable) should be recognized at the onset of the contract. Then, if the amount owed is forgiven, the offset to the payable should be to contributed capital. However, if a company does not record the initial entry, then expense recognition is not shown in the F/S.

Initial Entry for service contract:
Debit - Service Expense / Credit - Payable

If the payable was forgiven, then the entry would be:

Debit – Payable / Credit - Contributed Capital

This would ensure both the expense entry and the impact to contributed capital were recognized.

**Proposed revisions to SSAP No. 15:**

2. Debt shall be reported as a liability unless (a) it is debt on real estate in accordance with SSAP No. 40R—Real Estate Investments (i.e., reported as a reduction in the carrying value of real estate), (b) it is offset against another asset in accordance with SSAP No. 64—Offsetting and Netting of Assets and Liabilities, or (c) other treatment is specified elsewhere within the Accounting Practices and Procedures Manual. Instruments that meet the requirements to be recorded as surplus as specified in SSAP No. 72—Surplus and Quasi-Reorganizations are not considered debt. SSAP No. 25—Affiliates and Other Related Parties also provides specific guidance for debt obligations owed to related parties.

25. This statement adopts Accounting Principles Board Opinion No. 26, Early Extinguishment of Debt with modification to require that gains and losses from extinguishment of debt be reported as capital gains or losses, and charged to operations unless the extinguishment reflects the forgiveness of a reporting entity’s obligation to its parent or other stockholders. Forgiveness of a reporting entity’s obligation to its parent or other stockholder shall be accounted for as contributed surplus under SSAP No. 72—Surplus and Quasi-Reorganization.

**Proposed Revisions to SSAP No. 25:**

8. Loans or advances (including debt, public or private) made by a reporting entity to its parent or principal owner shall be admitted if approval for the transaction has been obtained from the domiciliary commissioner and the loan or advance is determined to be collectible based on the parent or principal owner’s independent payment ability. An affiliate’s ability to pay shall be determined after consideration of the liquid assets or revenues available from external sources (i.e., determination shall not include dividend paying ability of the subsidiary making the loan or advance) which are available to repay the balance and/or maintain its account on a current basis. Evaluation of the collectibility of loans or advances shall be made periodically. If, in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets (SSAP No. 5R), it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made. Pursuant to SSAP No. 72, forgiveness by a reporting entity of any debt, surplus note or other obligation of its parent or other stockholder shall be accounted for as a dividend.

**Transactions Involving Services**

17. Transactions involving services between related parties can take a variety of different forms. One of the significant factors as to whether these transactions will be deemed to be arm’s length is the amount charged for such services. In general, amounts charged for services are based either on current market rates or on allocations of costs. Determining market rates for services is difficult because the circumstances surrounding each transaction are unique. Unlike transactions involving the exchange of assets and liabilities between related parties, transactions for services create income on one party’s books and expense on the second party’s books, and therefore, do not lend themselves to the mere inflation of surplus. These arrangements are generally subject to regulatory approval.

18. Transactions involving services provided between related parties shall be recorded at the amount charged. Regulatory scrutiny of related party transactions where amounts charged for services do not meet the fair and reasonable standard established by Appendix A-440, may result in (a) amounts charged being recharacterized as dividends or capital contributions, (b) transactions being reversed, (c) receivable balances being nonadmitted, or (d) other regulatory action. Expenses that result from cost allocations shall be allocated subject to the same fair and reasonable standards, and the books and records of each party shall disclose clearly and accurately the precise nature and details of the transaction. See SSAP No 70—Allocation of Expenses for additional discussion regarding the allocation of expenses.
New Footnote – The amount charged shall be reviewed when there are any modifications or waivers subsequent to the establishment of the contract terms. If waivers or modifications to amounts charged occur, the related party transaction shall be reassessed to determine whether the contract continues to reflect fair and reasonable standards. If the transaction was with a parent or other stockholder, and the charge for services has been fully waived, then the guidance in SSAP No. 72 for recognition as contributed capital (forgiveness of reporting entity obligation) or as a dividend (forgiveness of amount owed to the reporting entity) shall apply.

Staff Review Completed by:
Julie Gann, NAIC Staff – May 2018

Status:
On August 4, 2018, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed proposed revisions to SSAP No. 15—Debt and Holding Company Obligation and SSAP No. 25—Affiliates and Other Related Parties, as shown above, to reference existing guidance when there has been a forgiveness of an amount owed. With exposure, information was requested on the following questions:

- **Exposure Question 1** - Should uncollectibility of an amount loaned or advanced to a parent be considered a dividend, instead of a write-off to income? Is it clear when an amount owed from a parent has been deemed uncollectible instead of when debt has been forgiven?

- **Exposure Question 2** – Should additional guidance for the recording of related party service transactions be captured? NAIC staff is aware of instances in which intercompany service costs have been forgiven and not recorded. Generally, the intercompany transaction (and service cost expense / payable) should be recognized at the onset of the contract. Then, if the amount owed is forgiven, the offset to the payable should be to contributed capital. However, if a company does not record the initial entry, then expense recognition is not shown in the F/S. Initial Entry for service contract:

  Debit - Service Expense / Credit - Payable

If the payable was forgiven, then the entry would be:

  Debit – Payable / Credit - Contributed Capital

This would ensure both the expense entry and the impact to contributed capital were recognized.
This page intentionally left blank.
**Statutory Accounting Principles (E) Working Group**  
**Maintenance Agenda Submission Form**  
**Form A**

**Issue:** SSAP No. 72 Distributions

**Check (applicable entity):**

<table>
<thead>
<tr>
<th>Modification of existing SSAP</th>
<th>P/C</th>
<th>Life</th>
<th>Health</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Issue or SSAP</td>
<td>☒</td>
<td>☒</td>
<td>☒</td>
</tr>
<tr>
<td>Interpretation</td>
<td>☒</td>
<td>☒</td>
<td>☒</td>
</tr>
</tbody>
</table>

**Description of Issue:** This agenda item has been drafted to clarify statutory accounting guidance for distributions captured within the scope of SSAP No. 72—Surplus and Quasi-Reorganization. Specifically, this agenda item intends to clarify the difference between a dividend and other distribution to a parent or shareholders and incorporate appropriate statutory accounting and reporting guidance.

Current statutory accounting guidance does not address non-dividend capital distributions. This issue has been identified as questions have been received on “dividends” (distributions) when the reporting entity has negative unassigned funds. In response to these past inquiries, there have been different state responses on how these distributions should be reported:

- Some have noted a preference to follow the guidance in accordance with SSAP No. 72 for dividends, with a charge to unassigned funds. With this accounting, the gross paid-in and contributed surplus line is not impacted, but unassigned funds go further negative.

- Some have noted a preference to deduct the distribution from gross paid in and contributed surplus, but have noted that this guidance is contrary to the dividend guidance in SSAP No. 72, which indicates that dividends should be charged directly to unassigned funds.

A key element in this agenda item is to distinguish between dividends and distributions. Under tax rules, if a distribution is made that does not come from the company’s profits, then the distribution is not a dividend, but is considered a return of capital. If a shareholder was to receive nondividend distributions after their stock basis had been reduced to zero, the distribution would be a taxable capital gain. Excerpt from IRS Topic 404 – Dividends:

**Return of Capital**

**Distributions that qualify as a return of capital aren't dividends. A return of capital is a return of some or all of your investment in the stock of the company. A return of capital reduces the adjusted cost basis of your stock.** For information on basis of assets, refer to Topic No. 703. A distribution generally qualifies as a return of capital if the corporation making the distribution doesn't have any accumulated or current year earnings and profits. **Once the adjusted cost basis of your stock has been reduced to zero, any further nondividend distribution is a taxable capital gain** that you report on Form 8949, Sales and Other Dispositions of Capital Assets, and Form 1040, Schedule D, Capital Gains and Losses.

Similar terminology is also captured in **Model 440, Insurance Holding Company System Regulatory Act**, as the Model often references **“dividends and other distributions to shareholders.”** (Excerpts Below)

**Section 4 – Registration of Insurers**

E. Reporting of Dividends to Shareholders. Subject to Section 5B, each registered insurer shall report to the commissioner all **dividends and other distributions to shareholders** within fifteen (15) business days following the declaration thereof.

© 2018 National Association of Insurance Commissioners
Section 5 – Standards and Management of an Insurer Within an Insurance Holding Company System

A. Transactions Within an Insurance Holding Company System

(f) The insurer’s surplus as regards policyholders following any dividends or distributions to shareholder affiliates shall be reasonable in relation to the insurer’s outstanding liabilities and adequate to meet its financial needs.

B. Dividends and other Distributions

No domestic insurer shall pay any extraordinary dividend or make any other extraordinary distribution to its shareholders until thirty (30) days after the commissioner has received notice of the declaration thereof and has not within that period disapproved the payment, or until the commissioner has approved the payment within the thirty-day period.

For purposes of this section, an extraordinary dividend or distribution includes any dividend or distribution of cash or other property, whose fair market value together with that of other dividends or distributions made within the preceding twelve (12) months exceeds the lesser of:

1. Ten percent (10%) of the insurer's surplus as regards policyholders as of the 31st day of December next preceding; or

2. The net gain from operations of the insurer, if the insurer is a life insurer, or the net income, if the insurer is not a life insurer, not including realized capital gains, for the twelve-month period ending the 31st day of December next preceding, but shall not include pro rata distributions of any class of the insurer's own securities.

In determining whether a dividend or distribution is extraordinary, an insurer other than a life insurer may carry forward net income from the previous two (2) calendar years that has not already been paid out as dividends. This carry-forward shall be computed by taking the net income from the second and third preceding calendar years, not including realized capital gains, less dividends paid in the second and immediate preceding calendar years.

Notwithstanding any other provision of law, an insurer may declare an extraordinary dividend or distribution which is conditional upon the commissioner’s approval, and the declaration shall confer no rights upon shareholders until (1) the commissioner has approved the payment of the dividend or distribution or (2) the commissioner has not disapproved payment within the thirty-day period referred to above.

In review of the U.S. GAAP provisions, there is limited guidance on reporting distributions as return of capital. The guidance that was available under U.S. GAAP was from APB 18, The Equity Method of Accounting for Investments in Common Stock, but that guidance was superseded with the issuance of ASU 2016-01, Financial Instruments – Overall.

325-20-35-1 Under the cost method of accounting for investments in common stock, dividends are the basis for recognition by an investor of earnings from an investment. An investor recognizes as income dividends received that are distributed from net accumulated earnings of the investee since the date of acquisition by the investor. The net accumulated earnings of an investee subsequent to the date of investment are recognized by the investor only to the extent distributed by the investee as dividends. Dividends received in excess of earnings subsequent to the date of investment are considered a return of investment and are recorded as reductions of cost of the investment.

325-20-35-3 As discussed in paragraph 323-10-35-36, an investment in voting stock of an investee entity may fall below the level of ownership described in paragraph 323-10-15-3 from sale of a portion of an investment by the investor, sale of additional stock by an investee, or other transactions, and the investor may thereby lose the ability to influence policy (see paragraphs 323-10-15-6 through 15-11 for guidance in determining significant influence). That paragraph requires that an investor discontinue
accruing its share of the earnings or losses of the investee for an investment that no longer qualifies for the equity method. That paragraph also requires that the earnings or losses that relate to the stock retained by the investor and that were previously accrued shall remain as a part of the carrying amount of the investment. However, dividends received by the investor in subsequent periods that exceed the investor’s share of earnings for such periods shall be applied in reduction of the carrying amount of the investment (see paragraph 325-20-35-1).

Existing Authoritative Literature:

**SSAP No. 72—Surplus and Quasi-Reorganizations**

**Gross Paid-in and Contributed Surplus**

7. **Gross paid-in and contributed surplus is the amount of capital received in excess of the par value of the stock issued.** Changes in the par value of a reporting entity’s capital stock shall be reflected as a reclassification between the capital stock account and gross paid-in and contributed surplus. Forgiveness of a reporting entity’s obligations to its parent or other stockholders shall be accounted for as contributed surplus.

8. Notes or other receivables received as additional capital contributions satisfied by receipt of cash or readily marketable securities prior to the filing of the statutory financial statement shall be treated as a Type I subsequent event in accordance with SSAP No. 9 and as such shall be considered an admitted asset based on the evidence of collection and approval of the domiciliary commissioner. To the extent that the notes or other receivables are not satisfied, they shall be nonadmitted.

9. Real estate or other assets received as additional capital contributions are nonreciprocal transfers as defined in SSAP No. 95—Nonmonetary Transactions (SSAP No. 95).

10. Stock purchase warrants issued in return for cash shall be credited to gross paid-in and contributed surplus. When debt instruments are issued with conversion features, no value shall be assigned to the conversion features unless the conversion feature is clearly separable from the debt obligation in the form of a detachable stock purchase warrant. In such instances the relative fair value of the detachable stock purchase warrant at time of issue shall be credited to gross paid-in and contributed surplus. For instances in which a reporting entity has issued puttable warrants or mandatorily redeemable warrants, such items shall be reflected as liabilities as the warrants obligate the reporting entity to ultimately transfer cash or other assets to the holder in order to repurchase the shares.

**Unassigned Funds (Surplus)**

12. **Unassigned funds (surplus) represents the undistributed and unappropriated amount of surplus at the balance sheet date.** Certain components of unassigned funds (surplus) are addressed in more detail in other issue papers. Unassigned funds (surplus) is comprised of the cumulative effect of:

i. **Dividends to Stockholders**

Dividends declared are charged directly to unassigned funds (surplus) on the declaration date and are carried as a liability until paid. The amount of the dividend is the cash paid if it is a cash dividend, the fair value of the assets distributed if it is a property dividend, or the par value of the company’s stock if it is a stock dividend. A stock dividend is recorded as a transfer from unassigned funds (surplus) to capital stock. Stock dividends have no effect on total capital and surplus while other forms of dividends reduce surplus. Forgiveness by a reporting entity of any debt, surplus note or other obligation of its parent or other stockholders shall be accounted for as a dividend. Dividends paid to related parties are subject to the requirements of SSAP No. 25—Affiliates and Other Related Parties;
SSAP No. 97—Investments in Subsidiary, Controlled Affiliated Entities is for holders of investments, but the adjustments for equity method accounting (quoted below) make a distinction in the equity method accounting treatment for amounts in excess of the undistributed earnings of the investee. (bolding added)

11. For investments in entities recorded on an equity method (paragraph 8.b.i. through 8.b.iv.) after the date of acquisition, the investment amount shall be 1) adjusted for the amortization of statutory goodwill as defined in SSAP No. 68, and 2) adjusted, with a corresponding unrealized gain or loss, for the reporting entity's share of undistributed earnings and losses of the investee (net of dividends declared). (This results in a reduction of the investment amount when dividends declared are in excess of the undistributed accumulated earnings attributable to the investee.) The following additional adjustment, based on the equity method applied for the investment, shall also be made: (subparagraphs excluded to save space.)

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): None

Information or issues (included in Description of Issue) not previously contemplated by the Working Group: None


Staff Recommendation:

NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose revisions to SSAP No. 72 to provide guidance for when a reporting entity provides a distribution that is a return of capital.

Proposed revisions to SSAP No. 72:

Gross Paid-in and Contributed Surplus

7. Gross paid-in and contributed surplus is the amount of capital received in excess of the par value of the stock issued. Changes in the par value of a reporting entity's capital stock shall be reflected as a reclassification between the capital stock account and gross paid-in and contributed surplus. Forgiveness of a reporting entity's obligations to its parent or other stockholders shall be accounted for as contributed surplus.

8. Notes or other receivables received as additional capital contributions satisfied by receipt of cash or readily marketable securities prior to the filing of the statutory financial statement shall be treated as a Type I subsequent event in accordance with SSAP No. 9 and as such shall be considered an admitted asset based on the evidence of collection and approval of the domiciliary commissioner. To the extent that the notes or other receivables are not satisfied, they shall be nonadmitted.

9. Real estate or other assets received as additional capital contributions are nonreciprocal transfers as defined in SSAP No. 95—Nonmonetary Transactions (SSAP No. 95).

10. Stock purchase warrants issued in return for cash shall be credited to gross paid-in and contributed surplus. When debt instruments are issued with conversion features, no value shall be assigned to the conversion features unless the conversion feature is clearly separable from the debt obligation in the form of a detachable stock purchase warrant. In such instances the relative fair value of the detachable stock purchase warrant at time of issue shall be credited to gross paid-in and contributed surplus. For instances in which a reporting entity has issued puttable warrants or mandatorily redeemable warrants, such items shall be reflected as liabilities.
as the warrants obligate the reporting entity to ultimately transfer cash or other assets to the holder in order to repurchase the shares.

11. Reporting entities shall receive domiciliary state approval before providing a return of capital to a parent or other stockholder. Distributions that reflect a return of capital shall be charged directly to the gross paid in and contributed surplus. (A return of capital will reduce the adjusted cost basis of the parent/stockholder in the reporting entity.)

(Remaining paragraphs renumbered accordingly.)

Unassigned Funds (Surplus)

4213. Unassigned funds (surplus) represents the undistributed and unappropriated amount of surplus at the balance sheet date. Certain components of unassigned funds (surplus) are addressed in more detail in other issue papers. Unassigned funds (surplus) is comprised of the cumulative effect of:

i. Dividends to Stockholders

Dividends declared are charged directly to unassigned funds (surplus) on the declaration date and are carried as a liability until paid. The amount of the dividend is the cash paid if it is a cash dividend, the fair value of the assets distributed if it is a property dividend, or the par value of the company’s stock if it is a stock dividend. A stock dividend is recorded as a transfer from unassigned funds (surplus) to capital stock. Stock dividends have no effect on total capital and surplus while other forms of dividends reduce surplus. Forgiveness by a reporting entity of any debt, surplus note or other obligation of its parent or other stockholders shall be accounted for as a dividend. Dividends paid to related parties are subject to the requirements of SSAP No. 25—Affiliates and Other Related Parties;

New Footnote: As a dividend represents the distribution of earnings, in any event in which unassigned funds is negative, or goes below zero as a result of a distribution to a parent or stockholder, the distribution (or portion thereof that does not reflect undistributed accumulated earnings in unassigned funds) shall be considered a return of capital and captured in paragraph 11. Determining whether a distribution is a dividend or a return of capital does not impact consideration of whether the distribution is “extraordinary” as both dividends and other distributions (e.g., return of capital) are subject to that assessment. (Reporting entities with positive unassigned funds may choose to make return of capital distributions. Those distributions are also captured in paragraph 11.)

Staff Review Completed by:
Julie Gann, NAIC Staff – May 2018

Status:
On August 4, 2018, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed proposed revisions to SSAP No. 72—Surplus and Quasi-Reorganizations, as shown above, to incorporate accounting guidance for when a reporting entity provides a distribution that represents a return of capital.
Statutory Accounting Principles (E) Working Group  
Maintenance Agenda Submission Form  
Form A

**Issue:** SSAP No. 37 – Participation Agreement in a Mortgage Loan

**Check (applicable entity):**

<table>
<thead>
<tr>
<th>Modification of existing SSAP</th>
<th>P/C</th>
<th>Life</th>
<th>Health</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Issue or SSAP</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interpretation</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Description of Issue:** This agenda item has been drafted to clarify statutory accounting guidance for a participation agreement in a mortgage loan. The guidance permitting a “participation agreement” was adopted in 2017 and intended to allow ownership in a single mortgage loan agreement with a sole borrower when the insurer is not named on the original mortgage loan agreement. With a participation agreement, the insurer would acquire the mortgage loan via an assignment or participation agreement between the selling lender and any co-lenders.

This guidance for acquiring mortgages through a “participation agreement” was adopted at the same time as the revisions to identify “participants” in mortgage loans. (A participant in a mortgage is defined when there is more than one lender identified on the loan documents as providing funds to a sole borrower.) Although the guidance for a “participant” in a mortgage loan is explicit that the guidance pertains to mortgages issued to a “sole borrower,” and there is explicit guidance in SAP No. 37 that identifies that investments that reflect involvement in a “mortgage loan fund” are not considered mortgage loans, it appears that the “participation agreement” language is being used as a reference to incorporate ownership interests in pool / funds of mortgages as SSAP No. 37 (Schedule B) mortgage loans.

This agenda item incorporates minimal revisions to the “participant agreement” language to expressly indicate that the participation agreement must pertain to a sole borrower in a single mortgage loan agreement. Consistent with existing guidance in SSAP No. 37, investments that reflect ownership in a mortgage loan fund is not in scope of SSAP No. 37. Investments in a “pool of mortgages” shall be reported on Schedule BA.

**Existing Authoritative Literature:**

**SSAP No. 37–Mortgage Loans**

2. A mortgage loan is defined as a debt obligation that is not a security, which is secured by a mortgage on real estate. In addition to mortgage loans directly originated, a mortgage loan also includes mortgages acquired through assignment, syndication or participation¹. Investments that

----

¹ Examples of agreements intended to be captured within this statement:

a. Reporting entity is a “participant” in a single mortgage loan agreement that identifies more than one lender (which includes the reporting entity) providing funds to a sole borrower with the real estate collateral securing all lenders identified in the agreement. For these agreements, each lender is incorporated directly into the loan documents. The key differentiating characteristic of a mortgage loan provided under a group “mortgage loan participation agreement” rather than a solely-owned mortgage loan is that no one lender of the lending group may unilaterally foreclose on the mortgage. With these agreements, the lenders must foreclose on the mortgage loan as a group.

b. Reporting entity has a “participation agreement” to invest in mortgages issued by another entity. Although the reporting entity is not named on the original mortgage loan agreement, the original issuer sells a portion of the mortgage loan to an incoming participant lender (co-lender) and the sale is documented by an assignment or participation agreement between the selling lender and the co-lender. With these agreements, the co-lender acquires an undivided participation interest in the loan and will receive direct interest in the amount of their participation in the right to repayment of the loan and the collateral...
Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): Agenda item 2016-39 expanded the scope of SSAP No. 37, with the intent to clarify that mortgage loans would include co-lending agreements when the insurer is directly named on the loan documentation (as a “participant”) and when they are not named on the loan documents, but acquire the interest through a sale (in a “participation agreement”). Although the guidance in SSAP No. 37 is explicit that investments that reflect “mortgage loan funds” are not intended to be in scope, it seems that some are referencing the guidance for a “participation agreement” to captured interests in mortgage loan funds / pools of mortgages.

Information or issues (included in Description of Issue) not previously contemplated by the Working Group: None


Staff Recommendation:

NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive, and expose minimal revisions to SSAP No. 37—Mortgage Loans to further clarify that a mortgage loan acquired through “participation agreement” is limited to a single mortgage loan agreement with a sole borrower.

SSAP No. 37—Mortgage Loans

2. A mortgage loan is defined as a debt obligation that is not a security, which is secured by a mortgage on real estate. In addition to mortgage loans directly originated, a mortgage loan also includes mortgages acquired through assignment, syndication or participation. Investments that

given to secure the loan. The financial rights and obligations of the lenders in these agreements shall be similar to those in a direct loan.

2 Examples of agreements intended to be captured within this statement:

a. Reporting entity is a “participant” in a single mortgage loan agreement that identifies more than one lender (which includes the reporting entity) providing funds to a sole borrower with the real estate collateral securing all lenders identified in the agreement. For these agreements, each lender is incorporated directly into the loan documents. The key differentiating characteristic of a mortgage loan provided under a group “mortgage loan participation agreement” rather than a solely-owned mortgage loan is that no one lender of the lending group may unilaterally foreclose on the mortgage. With these agreements, the lenders must foreclose on the mortgage loan as a group.
reflect “participating mortgages,” “mortgage loan fund,” or the “securitization of assets” are not considered mortgage loans within scope of this SSAP.

a. A security is a share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

i. It is either represented by an instrument issued in bearer or registered form, or if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.

ii. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.

iii. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

Staff Review Completed by:
Julie Gann, NAIC Staff – June 2018

Status:
On August 4, 2018, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed proposed revisions to SSAP No. 37—Mortgage Loans, as detailed above, to clarify that a mortgage loan acquired through a mortgage loan participation agreement is limited to a single mortgage loan agreement with a sole borrower.

b. Reporting entity has a “participation agreement” to invest in a single mortgage agreement mortgage(sole borrower) originally issued by another entity. Although the reporting entity is not named on the original mortgage loan agreement, the original issuer sells a portion of the mortgage loan to an incoming participant lender (co-lender) and the sale is documented by an assignment or participation agreement between the selling lender and the co-lender. With these agreements, the co-lender acquires an undivided participation interest in the loan and will receive direct interest in the amount of their participation in the right to repayment of the loan and the collateral given to secure the loan. The financial rights and obligations of the lenders in these agreements shall be similar to those in a direct loan.
Statutory Accounting Principles (E) Working Group
Maintenance Agenda Submission Form
Form A

Issue: SCA Loss Tracking – Accounting Guidance

Check (applicable entity):

<table>
<thead>
<tr>
<th></th>
<th>P/C</th>
<th>Life</th>
<th>Health</th>
</tr>
</thead>
<tbody>
<tr>
<td>Modification of existing SSAP</td>
<td>☒</td>
<td>☒</td>
<td>☒</td>
</tr>
<tr>
<td>New Issue or SSAP</td>
<td>☒</td>
<td>☒</td>
<td>☒</td>
</tr>
<tr>
<td>Interpretation</td>
<td>☒</td>
<td>☒</td>
<td>☒</td>
</tr>
</tbody>
</table>

Description of Issue:
This agenda item has been drafted to clarify the accounting guidance for SCA losses that result in zero or negative equity in an SCA. Agenda item 2018-09 - SCA Loss Tracking clarified the reporting guidance for SCA losses that result in zero, or negative, equity in an SCA. When reviewing that agenda item, it was identified that there could be uncertainty on the existing provisions that require a negative SCA reporting amount (rather than a zero reporting value). The intent of this agenda item is to clarify the instances that require a negative SCA value and ensure the accounting guidance in SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities for these instances is clear.

Existing Authoritative Literature:

SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets

 Guarantees
16. A guarantee contract is a contract that contingently requires the guarantor to make payments (either in cash, financial instruments, other assets, shares of its stock, or provision of services) to the guaranteed party based on changes in the underlying that is related to an asset, a liability, or an equity security of the guaranteed party. Commercial letters of credit and loan commitments, by definition, are not considered guarantee contracts. Also excluded from the definition are indemnifications or guarantees of an entity’s own performance, subordination arrangements or a noncontingent forward contract. This definition could include contingent forward contracts if the characteristics of this paragraph are met.

19. With the exception of the provision for guarantees made to/or on behalf of a wholly-owned subsidiaries in paragraph 18.f. and “unlimited” guarantees in 18.g., this guidance does not exclude guarantees issued as intercompany transactions or between related parties from the initial liability recognition requirement. Thus, unless the guarantee is provided on behalf of a wholly-owned subsidiary or considered “unlimited,” guarantees issued between the following parties are subject to the initial recognition and disclosure requirements:

   a. Guarantee issued either between parents and their subsidiaries or between corporations under common control;

   b. A parent’s guarantee of its subsidiary’s debt to a third party; and

   c. A subsidiary’s guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent.

20. At the inception of a guarantee, the guarantor shall recognize in its statement of financial position a liability for that guarantee. Except as indicated in paragraph 22, the objective of the initial measurement of the liability is the fair value1 of the guarantee at its inception.

---

1 As practical expedients, when a guarantee is issued in a standalone arm’s-length transaction, the liability recognized at the inception of the guarantee should be the premium received or receivable by the guarantor. When a guarantee is issued as part of a transaction with multiple elements, the liability recognized at the inception of the guarantee should be an estimate of the guarantee’s fair value. In that
21. The issuance of a guarantee obligates the guarantor (the issuer) in two respects: (a) the guarantor undertakes an obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur (the noncontingent aspect) and (b) the guarantor undertakes a contingent obligation to make future payments if those triggering events or conditions occur (the contingent aspect). Because the issuance of a guarantee imposes a noncontingent obligation to stand ready to perform in the event that the specified triggering event occurs, the provisions of paragraph 8 should not be interpreted as prohibiting the guarantor from initially recognizing a liability for that guarantee even though it is not probable that payments will be required under that guarantee.

22. In the event that, at the inception of the guarantee, the guarantor is required to recognize a liability under paragraph 8 for the related contingent loss, the liability to be initially recognized for that guarantee shall be the greater of (a) the amount the satisfies the fair value objective as discussed in paragraph 20 or (b) the contingent liability amount required to be recognized at inception of the guarantee by paragraph 8. For many guarantors, it would be unusual for the contingent liability under (b) to exceed the amount that satisfies the fair value objective at the inception of the guarantee.

SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities

13. On at least a quarterly basis, the procedures set forth below shall be followed by a reporting entity in applying an equity method of accounting (as described in paragraphs 8.b.i. through 8.b.iv.), as applicable, to investments in SCA entities:

e. For entities subject to 8.b.i., 8.b.iii. and 8.b.iv. a reporting entity’s share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by an equity method plus advances made by the investor. The reporting entity shall discontinue applying an equity method when the investment (including advances) is reduced to zero and shall not provide for additional losses unless the reporting entity has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee (guaranteed obligations meeting the definition of liabilities in SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets shall be recorded as liabilities). If the investee subsequently reports net income, the reporting entity shall resume applying an equity method only after its share of that net income equals the share of net losses not recognized during the period that an equity method was suspended;

Disclosures

34. All SCA investments within the scope of this statement (except paragraph 8.b.i. entities) shall include disclosure of the SCA balance sheet value (admitted and nonadmitted) as well as information received from the NAIC in response to the SCA filing (e.g., date and type of filing, NAIC valuation amount, whether resubmission of filing is required). This disclosure shall include an aggregate total of all SCAs (except paragraph 8.b.i. entities) with detail of the aggregate gross value under this statement with the admitted and nonadmitted amounts reflected on the balance sheet. (As noted in paragraph 4, joint ventures, partnerships and limited liability companies are accounted for under the guidance in SSAP No. 48. As such, those entities are not subject to this disclosure.)

a. For all periods presented, a reporting entity whose shares of losses in an SCA exceeds its investment in the SCA shall disclose its share of losses. (This is required regardless of a guarantee or commitment of future financial support to the SCA.) This disclosure shall include the following:

circumstance, guarantors should consider what premium would be required by the guarantor to issue the same guarantee in a standalone arm’s-length transaction.

2 Refer to the additional guidance related to discontinuance of an equity method in paragraphs 15-17 and INT 00-24: EITF 98-13: Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee and EITF 99-10: Percentage Used to Determine the Amount of Equity Method Losses.
i. The reporting entity’s accumulated share of the SCA losses not recognized during the period that the equity method was suspended;

ii. The reporting entity’s share of the SCA’s equity, including negative equity;

iii. Whether a guaranteed obligation or commitment for financial support exists; and

iv. The SCA’s reported value.

This disclosure shall apply beginning in the period the SCA’s equity initially falls below zero and shall continue to be disclosed as long as the SCA investment is in a deficit position. Additionally, the reporting entity shall detail in a narrative disclosure whether losses in the SCA have impacted other investments as required by INT 00-24: EITF 98-13: Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee and EITF 99-10: Percentage Used to Determine the Amount of Equity Method Losses.

SCA Loss Tracking FN1

<table>
<thead>
<tr>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
</tr>
</thead>
<tbody>
<tr>
<td>SCA Entity</td>
<td>Reporting Entity’s Share of SCA Net Income (Loss)</td>
<td>Accumulated Share of SCA Net Income (Losses)</td>
<td>Reporting Entity’s Share of SCA’s Equity, Including Negative Equity</td>
<td>Guaranteed Obligation / Commitment for Financial Support (Yes / No)</td>
<td>SCA Reported Value FN2</td>
</tr>
<tr>
<td>...............................................</td>
<td>................</td>
<td>.............</td>
<td>................</td>
<td>................</td>
<td>................</td>
</tr>
<tr>
<td>...............................................</td>
<td>................</td>
<td>.............</td>
<td>................</td>
<td>................</td>
<td>................</td>
</tr>
<tr>
<td>...............................................</td>
<td>................</td>
<td>.............</td>
<td>................</td>
<td>................</td>
<td>................</td>
</tr>
<tr>
<td>...............................................</td>
<td>................</td>
<td>.............</td>
<td>................</td>
<td>................</td>
<td>................</td>
</tr>
<tr>
<td>...............................................</td>
<td>................</td>
<td>.............</td>
<td>................</td>
<td>................</td>
<td>................</td>
</tr>
<tr>
<td>...............................................</td>
<td>................</td>
<td>.............</td>
<td>................</td>
<td>................</td>
<td>................</td>
</tr>
<tr>
<td>...............................................</td>
<td>................</td>
<td>.............</td>
<td>................</td>
<td>................</td>
<td>................</td>
</tr>
<tr>
<td>...............................................</td>
<td>................</td>
<td>.............</td>
<td>................</td>
<td>................</td>
<td>................</td>
</tr>
<tr>
<td>...............................................</td>
<td>................</td>
<td>.............</td>
<td>................</td>
<td>................</td>
<td>................</td>
</tr>
<tr>
<td>...............................................</td>
<td>................</td>
<td>.............</td>
<td>................</td>
<td>................</td>
<td>................</td>
</tr>
</tbody>
</table>

NOTE: FN1 - This disclosure is only required for SCAs in which the reporting entity’s share of losses exceed the investment in an SCA, (the SCA investment is in a negative equity position). This disclosure shall apply beginning in the period the investment in the SCA equity initially falls below zero and shall continue to be disclosed as long as the SCA investment is in a negative equity position. The disclosure is required whenever an investment in an SCA entity is in a negative equity position, and in the first year subsequent to the negative equity position in which a positive equity position has been attained.

FN2 - For Column 6, as detailed in SSAP No. 97, (unless the entity is subject to statutory adjustments under paragraph 9), once the reporting entity’s share of losses equals or exceeds the investment in the SCA, the SCA shall be reported at zero, with discontinuation of the equity method, unless there is a guaranteed obligation or a commitment for future financial support. If there is a guaranteed obligation or a commitment for future financial support, the guarantee requirement shall be recognized pursuant to SSAP No. 5R, and the reporting entity shall report the investment in the SCA reflecting their share of losses as a contra-asset. (Disclosure of the guarantee or commitment would be captured in Note 14 and is not duplicated in this disclosure.)
7. **Q - Is it possible for an SCA investment valued using an equity method to be reported as a negative value?**

7.1 **A -** Yes, the equity method noninsurance SCA could have a negative equity. SSAP No. 97 paragraph 8.b.ii. relating to noninsurance SCA entities requires some assets to be reported as a negative value (nonadmitted) in paragraph 9. For example an 8.b.ii. SCA subsidiary that is only holding furniture, which is nonadmitted, would be reflected with negative equity to the extent the value of the nonadmitted asset(s) exceed(s) reported equity. It should be noted that although SSAP No. 97, paragraph 13.e. discusses some situations in which the equity method should be discontinued, this does not apply to SCA entities, which meet the requirements of paragraph 8.b.ii. In addition, SSAP No. 97, paragraph 13.e. lists some situations where the equity method would result in a valuation that is less than zero; examples are if reporting entity has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee, in these cases, the valuation of the investment in subsidiary could be a negative value.

8. **Q - Paragraph 13.e. of SSAP No. 97, lists some situations where the equity method should be discontinued. If the equity method is discontinued, does the reporting entity cease tracking equity losses?**

8.1 **A -** No, the reporting entity does not cease tracking losses related to the investment in the SCA if an equity method is discontinued. If the equity method is discontinued, follow the guidance in paragraphs 15-17 and INT 00-24: EITF 98-13: Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee and EITF 99-10: Percentage Used to Determine the Amount of Equity Method Losses (INT 00-24).

8.2 INT 00-24 lists situations that might require the reporting entity to write down other investments in the SCA subsidiary, such as loans, because of continuing losses in the SCA investment. Paragraphs 15-17 provides guidance to assist in determining whether prior losses are being funded if the reporting entity purchases additional stock, etc. after suspending the equity method. Paragraphs 15-17 in INT 00-24 note that even if the equity method is not being applied, the investment should be tracked to determine if additional losses have to be applied to other items and to determine if the investment in the SCA has a future recovery.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups):
The Statutory Accounting Principles (E) Working Group previously adopted agenda item 2018-09 – SCA Loss Tracking, which incorporated an additional disclosure to track an SCA’s losses.

Information or issues (included in Description of Issue) not previously contemplated by the Working Group: None

Convergence with International Financial Reporting Standards (IFRS): N/A

Staff Recommendation:
Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, as detailed below, to clarify the existing reporting requirements for an SCA in a loss position. Staff would also request comments from regulators and interested parties regarding additional situations that require negative reporting.

Proposed Revisions:

**SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities**

13. On at least a quarterly basis, the procedures set forth below shall be followed by a reporting entity in applying an equity method of accounting (as described in paragraphs 8.b.i. through 8.b.iv.), as applicable, to investments in SCA entities:
For entities subject to 8.b.i., 8.b.ii., 8.b.iii., and 8.b.iv. a reporting entity’s share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by an equity method plus advances made by the investor. The reporting entity shall discontinue applying an equity method when the investment (including advances) is reduced to zero\(^3\) and shall not provide for additional losses unless the situations in paragraph 13.e.i. or paragraph 13.e.ii. exist. If the investee subsequently reports net income, the reporting entity shall resume applying an equity method only after its share of that net income equals the share of net losses not recognized during the period that an equity method was suspended. In situations in which negative equity is reported (paragraph 13.e.i. and paragraph 13.e.ii.), the book adjusted carrying value for the investment in the SCA shall reflect the reporting entity’s negative equity value (reflecting the reporting entity’s share of the SCA losses). (This would be reported as a contra-asset.)

1. In all instances in which the limited statutory adjustments required by paragraph 9 results in a negative equity valuation of the investment. (This would apply to 8.b.ii and 8.b.iv entities.)

2. When the reporting entity has guaranteed obligations or committed further financial support to an SCA. Recognition of the negative equity in the SCA is in addition to the guarantee liability required under SSAP No. 5R. (This applies to all SCA entities.)

Staff Review Completed by:
Fatima Sediqzad - NAIC Staff
July 2018

Status:
On August 4, 2018, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities, as shown above, to clarify the existing reporting requirements for when the reporting entity has a negative equity valuation in an SCA investment.

---

\(^3\) Refer to the additional guidance related to discontinuance of an equity method in paragraphs 15-17 and INT 00-24: EITF 98-13: Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee and EITF 99-10: Percentage Used to Determine the Amount of Equity Method Losses.
This page intentionally left blank.
Issue: SSAP No. 48 Entities’ Loss Tracking

Check (applicable entity):

- Modification of existing SSAP: ☒
- New Issue or SSAP: ☐
- Interpretation: ☐

Description of Issue:
This agenda item has been drafted to review the accounting guidance for SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies entities, specifically when a reporting entity’s investment in a SSAP No. 48 entity is in a loss position due to the SSAP No. 48 entity’s losses that result in zero or negative equity in the entity. Agenda item 2018-09 - SCA Loss Tracking clarified the reporting guidance in SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities for SCA losses that result in zero or negative equity in an SCA, with the addition of a disclosure to track the losses. When reviewing that agenda item, it was identified that there could be uncertainty about the reporting and accounting guidance for SSAP No. 48 entities in a loss position. The intent of this agenda item is to request comments on the applicability of the loss tracking provisions and disclosure for SSAP No. 48 entities.

Existing Authoritative Literature:

SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets

Guarantees

16. A guarantee contract is a contract that contingently requires the guarantor to make payments (either in cash, financial instruments, other assets, shares of its stock, or provision of services) to the guaranteed party based on changes in the underlying that is related to an asset, a liability, or an equity security of the guaranteed party. Commercial letters of credit and loan commitments, by definition, are not considered guarantee contracts. Also excluded from the definition are indemnifications or guarantees of an entity’s own performance, subordination arrangements or a noncontingent forward contract. This definition could include contingent forward contracts if the characteristics of this paragraph are met.

19. With the exception of the provision for guarantees made to/or on behalf of a wholly-owned subsidiaries in paragraph 18.f. and “unlimited” guarantees in 18.g., this guidance does not exclude guarantees issued as intercompany transactions or between related parties from the initial liability recognition requirement. Thus, unless the guarantee is provided on behalf of a wholly-owned subsidiary or considered “unlimited,” guarantees issued between the following parties are subject to the initial recognition and disclosure requirements:

a. Guarantee issued either between parents and their subsidiaries or between corporations under common control;

b. A parent’s guarantee of its subsidiary’s debt to a third party; and

c. A subsidiary’s guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent.
20. At the inception of a guarantee, the guarantor shall recognize in its statement of financial position a liability for that guarantee. Except as indicated in paragraph 22, the objective of the initial measurement of the liability is the fair value of the guarantee at its inception.

21. The issuance of a guarantee obligates the guarantor (the issuer) in two respects: (a) the guarantor undertakes an obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur (the noncontingent aspect) and (b) the guarantor undertakes a contingent obligation to make future payments if those triggering events or conditions occur (the contingent aspect). Because the issuance of a guarantee imposes a noncontingent obligation to stand ready to perform in the event that the specified triggering event occurs, the provisions of paragraph 8 should not be interpreted as prohibiting the guarantor from initially recognizing a liability for that guarantee even though it is not probable that payments will be required under that guarantee.

22. In the event that, at the inception of the guarantee, the guarantor is required to recognize a liability under paragraph 8 for the related contingent loss, the liability to be initially recognized for that guarantee shall be the greater of (a) the amount that satisfies the fair value objective as discussed in paragraph 20 or (b) the contingent liability amount required to be recognized at inception of the guarantee by paragraph 8. For many guarantors, it would be unusual for the contingent liability under (b) to exceed the amount that satisfies the fair value objective at the inception of the guarantee.

**SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies**

6. Investments in these ventures, except for joint ventures, partnerships and limited liability companies with a minor ownership interest, shall be reported using an equity method as defined in SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities (SSAP No. 97), paragraphs 8.b.i. through 8.b.iv.

7. Investments reported using an equity method from SSAP No. 97, paragraph 8.b.ii. through 8.b.iv. may have fiscal year ends, not calendar year ends. To recognize a change to the reporting year-end of an equity method investee, including changes in, or the elimination of, previously existing differences (lag period) due to the reporting entity’s ability to obtain financial results from a reporting period that is more consistent with, or the same as, that of the reporting entity’s, the guidance included in FASB Emerging Issues Task Force No. 06-9: Reporting a Change in (or the elimination of) a Previously Existing Difference Between the Fiscal Year-End of a Parent Company and That of a Consolidated Entity or Between the Reporting Period of an Investor and That of an Equity Method Investee that defines such reporting period changes as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors shall be followed.

**Disclosures**

20. The significance of an investment to the reporting entity’s financial position and results of operations shall be considered in evaluating the extent of disclosures of the financial position and results of operations of an investee. Disclosures as follows shall be made for all investments in joint ventures, partnerships, or limited liability companies that exceed 10% of the total admitted assets of the reporting entity:

a. (1) the name of each joint venture, partnership or limited liability company and percentage of ownership, (2) the accounting policies of the reporting entity with respect to investments in joint ventures, partnerships and limited liability companies and (3) the difference, if any, between the amount at which the investment is carried and the amount of underlying equity in net assets (i.e., nonadmitted goodwill or other nonadmitted assets) and the accounting treatment of the difference;

---

1 As practical expedients, when a guarantee is issued in a standalone arm’s-length transaction, the liability recognized at the inception of the guarantee should be the premium received or receivable by the guarantor. When a guarantee is issued as part of a transaction with multiple elements, the liability recognized at the inception of the guarantee should be an estimate of the guarantee’s fair value. In that circumstance, guarantors should consider what premium would be required by the guarantor to issue the same guarantee in a standalone arm’s-length transaction.
b. For joint ventures, partnerships, and limited liability companies for which a quoted market price is available, the aggregate value of each joint venture, partnership, or limited liability company investment based on the quoted market price; and

c. Summarized information as to assets, liabilities, and results of operations for joint ventures, partnerships, and limited liability companies either individually or in groups.

21. Any commitment or contingent commitment (e.g., guarantees or commitments to provide additional capital contributions) to a joint venture, partnership, or limited liability company shall be disclosed.

SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities

13. On at least a quarterly basis, the procedures set forth below shall be followed by a reporting entity in applying an equity method of accounting (as described in paragraphs 8.b.i. through 8.b.iv.), as applicable, to investments in SCA entities:

e. For entities subject to 8.b.i., 8.b.iii. and 8.b.iv. a reporting entity’s share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by an equity method plus advances made by the investor. The reporting entity shall discontinue applying an equity method when the investment (including advances) is reduced to zero\(^2\) and shall not provide for additional losses unless the reporting entity has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee (guaranteed obligations meeting the definition of liabilities in SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets shall be recorded as liabilities). If the investee subsequently reports net income, the reporting entity shall resume applying an equity method only after its share of that net income equals the share of net losses not recognized during the period that an equity method was suspended;

Disclosures

34. All SCA investments within the scope of this statement (except paragraph 8.b.i. entities) shall include disclosure of the SCA balance sheet value (admitted and nonadmitted) as well as information received from the NAIC in response to the SCA filing (e.g., date and type of filing, NAIC valuation amount, whether resubmission of filing is required). This disclosure shall include an aggregate total of all SCAs (except paragraph 8.b.i. entities) with detail of the aggregate gross value under this statement with the admitted and nonadmitted amounts reflected on the balance sheet. (As noted in paragraph 4, joint ventures, partnerships and limited liability companies are accounted for under the guidance in SSAP No. 48. As such, those entities are not subject to this disclosure.)

a. For all periods presented, a reporting entity whose shares of losses in an SCA exceeds its investment in the SCA shall disclose its share of losses. (This is required regardless of a guarantee or commitment of future financial support to the SCA.) This disclosure shall include the following:

i. The reporting entity’s accumulated share of the SCA losses not recognized during the period that the equity method was suspended;

ii. The reporting entity’s share of the SCA’s equity, including negative equity;

iii. Whether a guaranteed obligation or commitment for financial support exists; and

iv. The SCA’s reported value.

---

\(^2\) Refer to the additional guidance related to discontinuance of an equity method in paragraphs 15-17 and INT 00-24: EITF 98-13: Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee and EITF 99-10: Percentage Used to Determine the Amount of Equity Method Losses.
This disclosure shall apply beginning in the period the SCA’s equity initially falls below zero and shall continue to be disclosed as long as the SCA investment is in a deficit position. Additionally, the reporting entity shall detail in a narrative disclosure whether losses in the SCA have impacted other investments as required by INT 00-24: EITF 98-13: Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee and EITF 99-10: Percentage Used to Determine the Amount of Equity Method Losses.

SCA Loss Tracking

<table>
<thead>
<tr>
<th>SCA Entity</th>
<th>Reporting Entity’s Share of SCA Net Income (Loss)</th>
<th>Accumulated Share of SCA Net Income (Losses)</th>
<th>Reporting Entity’s Share of SCA’s Equity, Including Negative Equity</th>
<th>Guaranteed Obligation / Commitment for Financial Support (Yes / No)</th>
<th>SCA Reported ValueFN2</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

NOTE: FN1 - This disclosure is only required for SCAs in which the reporting entity’s share of losses exceed the investment in an SCA, (the SCA investment is in a negative equity position). This disclosure shall apply beginning in the period the investment in the SCA equity initially falls below zero and shall continue to be disclosed as long as the SCA investment is in a negative equity position. The disclosure is required whenever an investment in an SCA entity is in a negative equity position, and in the first year subsequent to the negative equity position in which a positive equity position has been attained.

FN2 - For Column 6, as detailed in SSAP No. 97, (unless the entity is subject to statutory adjustments under paragraph 9), once the reporting entity’s share of losses equals or exceeds the investment in the SCA, the SCA shall be reported at zero, with discontinuation of the equity method, unless there is a guaranteed obligation or a commitment for future financial support. If there is a guaranteed obligation or a commitment for future financial support, the guarantee requirement shall be recognized pursuant to SSAP No. 5R, and the reporting entity shall report the investment in the SCA reflecting their share of losses as a contra-asset. (Disclosure of the guarantee or commitment would be captured in Note 14 and is not duplicated in this disclosure.)

SSAP No. 97, Exhibit C – Implementation Questions and Answers

8. Q - Paragraph 13.e. of SSAP No. 97, lists some situations where the equity method should be discontinued. If the equity method is discontinued, does the reporting entity cease tracking equity losses?

8.1 A - No, the reporting entity does not cease tracking losses related to the investment in the SCA if an equity method is discontinued. If the equity method is discontinued, follow the guidance in paragraphs 15-17 and INT 00-24: EITF 98-13: Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee and EITF 99-10: Percentage Used to Determine the Amount of Equity Method Losses (INT 00-24).

8.2 INT 00-24 lists situations that might require the reporting entity to write down other investments in the SCA subsidiary, such as loans, because of continuing losses in the SCA investment. Paragraphs 15-17 provides guidance to assist in determining whether prior losses are being funded if the reporting entity purchases additional stock, etc. after suspending the equity method. Paragraphs 15-17 in INT 00-24 note that even if the equity method...
is not being applied, the investment should be tracked to determine if additional losses have to be applied to other items and to determine if the investment in the SCA has a future recovery.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups):

The Statutory Accounting Principles (E) Working Group previously adopted agenda item 2018-09 – SCA Loss Tracking, which incorporated an additional disclosure to track an SCA’s losses. NAIC staff also have an agenda item for exposure to clarify the accounting guidance for SCA loss tracking.

Information or issues (included in Description of Issue) not previously contemplated by the Working Group:

None

Convergence with International Financial Reporting Standards (IFRS): N/A

Staff Recommendation:

Staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose the proposed revisions to SSAP No. 48 and SSAP No. 97 as detailed below.

Proposed Revisions:

SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies

6. Investments in these ventures, except for joint ventures, partnerships and limited liability companies with a minor ownership interest, shall be reported using an equity method as defined in SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities (SSAP No. 97), paragraphs 8.b.i. through 8.b.iv. For entities subject to 8.b.i., 8.b.iii. and 8.b.iv. a reporting entity’s share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by an equity method plus advances made by the investor. The reporting entity shall discontinue applying an equity method when the investment (including advances) is reduced to zero and shall not provide for additional losses unless the reporting entity has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee (guaranteed obligations meeting the definition of liabilities in SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets shall be recorded as liabilities). A reporting entity whose share of losses in a SSAP No. 48 entity exceeds its investment in the SSAP No. 48 entity shall track its share of losses. (This is required regardless of a guarantee or commitment of future financial support to the SSAP No. 48 entity.)

a. When the reporting entity has guaranteed obligations or committed further financial support to a SSAP No. 48 entity, in addition to the guarantee liability required under SSAP No. 5R, the book adjusted carrying value for the investment in the SSAP No. 48 entity shall reflect the reporting entity’s negative equity value (reflecting the reporting entity’s share of the SSAP No. 48 entity’s losses). (This would be reported as a contra-asset.)

b. In situations when there are no guaranteed obligations or commitment for future financial support to the SSAP No. 48 entity, if the investee subsequently reports net income, the reporting entity shall resume applying an equity method only after its share of that net income equals the share of net losses not recognized during the period that the equity method was suspended.

7. Investments reported using an equity method from SSAP No. 97, paragraph 8.b.ii. through 8.b.iv. may have fiscal year ends, not calendar year ends. To recognize a change to the reporting year-end of an equity

---

1 Refer to the additional guidance related to discontinuance of an equity method in paragraphs 15-17 and INT 00-24: EITF 98-13: Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee and EITF 99-10: Percentage Used to Determine the Amount of Equity Method Losses.
method investee, including changes in, or the elimination of, previously existing differences (lag period) due to the reporting entity’s ability to obtain financial results from a reporting period that is more consistent with, or the same as, that of the reporting entity’s, the guidance included in FASB Emerging Issues Task Force No. 06-9: Reporting a Change in (or the elimination of) a Previously Existing Difference Between the Fiscal Year-End of a Parent Company and That of a Consolidated Entity or Between the Reporting Period of an Investor and That of an Equity Method Investee that defines such reporting period changes as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors shall be followed.

Disclosures

20. The significance of an investment to the reporting entity’s financial position and results of operations shall be considered in evaluating the extent of disclosures of the financial position and results of operations of an investee. Disclosures as follows shall be made for all investments in joint ventures, partnerships, or limited liability companies that exceed 10% of the total admitted assets of the reporting entity:

a. (1) the name of each joint venture, partnership or limited liability company and percentage of ownership, (2) the accounting policies of the reporting entity with respect to investments in joint ventures, partnerships and limited liability companies and (3) the difference, if any, between the amount at which the investment is carried and the amount of underlying equity in net assets (i.e., nonadmitted goodwill or other nonadmitted assets) and the accounting treatment of the difference;

b. For joint ventures, partnerships, and limited liability companies for which a quoted market price is available, the aggregate value of each joint venture, partnership, or limited liability company investment based on the quoted market price; and

c. Summarized information as to assets, liabilities, and results of operations for joint ventures, partnerships, and limited liability companies either individually or in groups.

d. All SSAP No. 48 entities within the scope of this statement shall include disclosure of the SSAP No. 48 entity’s balance sheet value (admitted and nonadmitted). This disclosure shall include an aggregate total of all SSAP No. 48 entities with detail of the aggregate gross value under this statement with the admitted and nonadmitted amounts reflected on the balance sheet.

e. For all periods presented, a reporting entity whose shares of losses in a SSAP No. 48 entity exceeds its investment in the SSAP No. 48 entity shall disclose its share of losses. (This is required regardless of a guarantee or commitment of future financial support to the SSAP No. 48 entity.) This disclosure shall include the following:

i. The reporting entity’s accumulated share of the SCA losses not recognized during the period that the equity method was suspended;

ii. The reporting entity’s share of the SCA’s equity, including negative equity;

iii. Whether a guaranteed obligation or commitment for financial support exists; and

iv. The SSAP No. 48 entity’s reported value.

d. This disclosure shall apply beginning in the period the SSAP No. 48 entity’s equity initially falls below zero and shall continue to be disclosed as long as the SSAP No. 48 entity investment is in a deficit position. Additionally, the reporting entity shall detail in a narrative disclosure whether losses in the SSAP No. 48 entity have impacted other investments as required by INT 00-24: EITF 98-13: Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee and EITF 99-10: Percentage Used to Determine the Amount of Equity Method Losses.

21. Any commitment or contingent commitment (e.g., guarantees or commitments to provide additional capital contributions) to a joint venture, partnership, or limited liability company shall be disclosed.
22. A reporting entity that recognizes an impairment loss shall disclose the following in the financial statements that include the period of the impairment write-down:

a. A description of the impaired assets and the facts and circumstances leading to the impairment; and

b. The amount of the impairment and how fair value was determined.

23. Any change due to the requirements of paragraph 7 shall be disclosed per SSAP No. 3.

24. Refer to the Preamble for further discussion regarding disclosure requirements.

SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities

13. On at least a quarterly basis, the procedures set forth below shall be followed by a reporting entity in applying an equity method of accounting (as described in paragraphs 8.b.i. through 8.b.iv.), as applicable, to investments in SCA entities:

e. For entities subject to 8.b.i., 8.b.iii. and 8.b.iv. a reporting entity’s share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by an equity method plus advances made by the investor. The reporting entity shall discontinue applying an equity method when the investment (including advances) is reduced to zero and shall not provide for additional losses unless the reporting entity has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee (guaranteed obligations meeting the definition of liabilities in SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets shall be recorded as liabilities). If the investee subsequently reports net income, the reporting entity shall resume applying an equity method only after its share of that net income equals the share of net losses not recognized during the period that an equity method was suspended;

Disclosures

35. All SCA investments within the scope of this statement (except paragraph 8.b.i. entities) shall include disclosure of the SCA balance sheet value (admitted and nonadmitted) as well as information received from the NAIC in response to the SCA filing (e.g., date and type of filing, NAIC valuation amount, whether resubmission of filing is required). This disclosure shall include an aggregate total of all SCAs (except paragraph 8.b.i. entities) with detail of the aggregate gross value under this statement with the admitted and nonadmitted amounts reflected on the balance sheet. (As noted in paragraph 4, joint ventures, partnerships and limited liability companies are accounted for under the guidance in SSAP No. 48. As such, those entities are not subject to this disclosure.)

a. For all periods presented, a reporting entity whose shares of losses in an SCA exceeds its investment in the SCA shall disclose its share of losses. (This is required regardless of a guarantee or commitment of future financial support to the SCA.) This disclosure shall include the following:

i. The reporting entity’s accumulated share of the SCA losses not recognized during the period that the equity method was suspended;

ii. The reporting entity’s share of the SCA’s equity, including negative equity;

iii. Whether a guaranteed obligation or commitment for financial support exists; and

iv. The SCA’s reported value.

Refer to the additional guidance related to discontinuance of an equity method in paragraphs 15-17 and INT 00-24: EITF 98-13: Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee and EITF 99-10: Percentage Used to Determine the Amount of Equity Method Losses.
This disclosure shall apply beginning in the period the SCA’s equity initially falls below zero and shall continue to be disclosed as long as the SCA investment is in a deficit position. Additionally, the reporting entity shall detail in a narrative disclosure whether losses in the SCA have impacted other investments as required by INT 00-24: EITF 98-13: Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee and EITF 99-10: Percentage Used to Determine the Amount of Equity Method Losses.

SCA and SSAP No. 48 Entity Loss Tracking FN1

<table>
<thead>
<tr>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
</tr>
</thead>
<tbody>
<tr>
<td>SCA/SSAP No. 48 Entity</td>
<td>Reporting Entity’s Share of SCA/SSAP No. 48 Entity’s Net Income (Loss)</td>
<td>Accumulated Share of SCA/SSAP No. 48 Entity’s Net Income (Loss)</td>
<td>Reporting Entity’s Share of SCA/SSAP No. 48 Entity’s Equity, Including Negative Equity</td>
<td>Guaranteed Obligation / Commitment for Financial Support (Yes / No)</td>
<td>SCA/SSAP No. 48 Entity’s Value FN2</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

NOTE: FN1 - This disclosure is only required for SCAs and SSAP No. 48 entities in which the reporting entity’s share of losses exceed the investment in an SCA or SSAP No. 48 entity, (the SCA or SSAP No. 48 entity investment is in a negative equity position). This disclosure shall apply beginning in the period the investment in the SCA or SSAP No. 48 entity’s equity initially falls below zero and shall continue to be disclosed as long as the SCA or SSAP No. 48 entity investment is in a negative equity position. The disclosure is required whenever an investment in an SCA or SSAP No. 48 entity is in a negative equity position, and in the first year subsequent to the negative equity position in which a positive equity position has been attained.

FN2 - For Column 6, as detailed in SSAP No. 97, (unless the entity is subject to statutory adjustments under paragraph 9), once the reporting entity’s share of losses equals or exceeds the investment in the SCA or SSAP No. 48 entity, the SCA or SSAP No. 48 entity shall be reported at zero, with discontinuation of the equity method, unless there is a guaranteed obligation or a commitment for future financial support. If there is a guaranteed obligation or a commitment for future financial support, the guarantee requirement shall be recognized pursuant to SSAP No. 5R, and the reporting entity shall report the investment in the SCA or SSAP No. 48 entity reflecting their share of losses as a contra-asset. (Disclosure of the guarantee or commitment would be captured in Note 14 and is not duplicated in this disclosure.)

Staff Review Completed by:
Fatima Sediqzad - NAIC Staff
July 2018

Status:
On August 4, 2018, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies, as shown above, to incorporate guidance and disclosures for when a reporting entity’s share of losses in a SSAP No. 48 entity exceeds its investment in the SSAP No. 48 entity.
## TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>COMMENTER / DOCUMENT</th>
<th>PAGE REFERENCE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interested Parties – October 5, 2018</td>
<td>1</td>
</tr>
<tr>
<td>o Ref #2018-30: Hedge Effectiveness Documentation</td>
<td></td>
</tr>
<tr>
<td>o Ref #2017-28: Reinsurance Credit</td>
<td></td>
</tr>
<tr>
<td>o Ref #2017-32: Common Stock Investment Classification Project</td>
<td></td>
</tr>
<tr>
<td>o Ref #2018-17: Structured Settlements</td>
<td></td>
</tr>
<tr>
<td>o Ref #2018-18: Structured Notes</td>
<td></td>
</tr>
<tr>
<td>o Ref #2018-19: Elimination of Modified Filing Exempt (MFE)</td>
<td></td>
</tr>
<tr>
<td>o Ref #2018-20: Debt Forgiveness between Related Parties</td>
<td></td>
</tr>
<tr>
<td>o Ref #2018-21: SSAP No. 72 Distributions</td>
<td></td>
</tr>
<tr>
<td>o Ref #2018-22: Participation Agreement in a Mortgage Loan</td>
<td></td>
</tr>
<tr>
<td>o Ref #2018-23: SSAP No. 68 Mergers</td>
<td></td>
</tr>
<tr>
<td>o Ref #2018-24EP, Editorial and Maintenance Update</td>
<td></td>
</tr>
<tr>
<td>o Ref #2018-25: <em>ASU 2018-01, Leases – Land Easement Practical Expedient for transition to Topic 842</em></td>
<td></td>
</tr>
<tr>
<td>o Ref #2018-26: SCA Loss Tracking – Accounting Guidance</td>
<td></td>
</tr>
<tr>
<td>o Ref #2018-27: SSAP No. 48 Entities – Loss Tracking</td>
<td></td>
</tr>
<tr>
<td>o Ref #2018-28: Life and Annuity Liquidity</td>
<td></td>
</tr>
<tr>
<td>o Ref #2018-29: Consistency Revisions to A-820</td>
<td></td>
</tr>
<tr>
<td>American Council of Life Insurers (ACLI) – October 11, 2018</td>
<td>14</td>
</tr>
<tr>
<td>o Ref # 2016-03, Special Accounting Treatment for Limited Derivatives</td>
<td></td>
</tr>
<tr>
<td>Connecticut Department of Insurance – October 12, 2018</td>
<td>16</td>
</tr>
<tr>
<td>o Ref #2017-28: Reinsurance Credit</td>
<td></td>
</tr>
<tr>
<td>New Jersey Department of Banking and Insurance – October 26, 2018</td>
<td>17</td>
</tr>
<tr>
<td>o Ref #2017-28: Reinsurance Credit</td>
<td></td>
</tr>
</tbody>
</table>
This page intentionally left blank.
October 5, 2018

Mr. Dale Bruggeman, Chairman  
Statutory Accounting Principles Working Group  
National Association of Insurance Commissioners  
1100 Walnut Street, Suite 1500  
Kansas City, MO 64106-2197

RE: Interested Parties Comments on Items Exposed for Comment by the Statutory Accounting Principles (E) Working Group with Comments due October 5th

Dear Mr. Bruggeman:

Interested parties (IPs) appreciate the opportunity to provide comments on the items that were exposed by the Statutory Accounting Principles (E) Working Group (the “Working Group”) during the NAIC 2018 Summer National Meeting in Boston with comments due October 5th. We offer the following comments:

Ref #2018-30: Hedge Effectiveness Documentation

The Working Group, via evote, moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to incorporate revisions to reflect hedge documentation and assessment efficiencies from ASU 2017-12. This item was exposed with a shortened comment period ending Sept. 14, 2018.

Interested parties have no comment.

Ref #2017-28: Reinsurance Credit

The Working Group took the following actions:

1. Exposed substantive revisions to SSAP No. 62R—Property and Casualty Reinsurance to incorporate guidance from EITF 93-6, Accounting for Multiple-Year Retrospectively Rated
Contracts by Ceding and Assuming Enterprises and from EITF D-035, FASB Staff Views on Issue No. 93-6. The Working Group also requested, input on the effective date.

2. Exposed nonsubstantive revisions to SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance to incorporate disclosures, The proposed revisions also update the question-and-answer guidance in Appendix A-791—Life and Health Reinsurance Agreements to clarify the applicability of A-791. Note that the exposure includes a request for comments on whether the proposed disclosures adequately address the Financial Analysis (E) Working Group referral.

Comments were requested on the following items related to the exposed SSAP No. 61R disclosures:

1. The drafting group discussion determined that the prior exposure for SSAP No. 61R, paragraph 83, which was based on SSAP No. 62, paragraph 94 with modifications to be consistent with A-791 was repetitive on compliance with A-791. The subgroup reviewed existing paragraph 94 a-d in SSAP No. 62R and determined it was not useful in the context of SSAP No. 61R. Regulator and industry input is requested on any additional contract features that should be identified for disclosure.

2. Regulator input is requested regarding whether proposed disclosures would be sufficient.

Comments were requested regarding whether contracts identified for disclosure in paragraph 85 should be identified in the annual statement reinsurance schedule S with a signifier to avoid repeating details in the annual statement note, which may be in the statement schedule.

Interested parties have no comments.

Ref #2017-32: Common Stock Investment Classification Project

The Working Group exposed a revised issue paper and substantively revised SSAP No. 30R—Unaffiliated Common Stock. Key revisions are intended to improve the common stock definition and include closed-end funds and unit-investment trusts within scope. With the exposure, the Working Group directed referrals to the Valuation of Securities (E) Task Force, the Capital Adequacy (E) Task Force and the Blanks (E) Working Group to identify support for incorporating a column on Schedule D-2-2 for reporting NAIC designations for equity investments that can be reviewed and assigned a designation by the Securities Valuation Office (SVO).

Interested parties are supportive of the proposed changes to SSAP No. 30, the related Issue Paper, and a January 1, 2019 effective date.

Some in industry have noted that existing SSAP No. 30 scope language includes “shares of mutual funds” while the new exposure only specifically scopes in SEC registered mutual funds.
Foreign open-ended mutual funds that are structured similarly to SEC registered mutual funds with an NAV that is calculated and published periodically and used as the basis for purchases and redemptions should be included in SSAP No. 30. Additionally, foreign open-ended mutual funds are often registered with and regulated by competent regulatory bodies. Interested parties believe a case can be made to expand the scope of SSAP No. 30 to include such registered foreign open-end mutual funds, with similar structure and regulation, and respectfully ask the Working Group to explore this idea during 2019. Interested Parties can provide further information on such foreign open-end mutual funds upon the Working Group’s request.

Ref #2018-17: Structured Settlements

The Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 21—Other Admitted Assets, to incorporate accounting guidance for structured settlement income streams acquired by insurers as investments. Comments were requested on whether this item should be considered a substantive or nonsubstantive revision.

Interested parties support the proposed accounting and reporting guidance on structured settlements.

Ref #2018-18: Structured Notes

The Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 2—Cash, Cash Equivalents, Drafts, and Short-Term Investments, SSAP No. 26R—Bonds, SSAP No. 43R—Loan-Backed and Structured Securities and SSAP No. 86—Derivatives to revise the guidance for structured notes when the reporting entity holder assumes a risk of principal loss based on an underlying component unrelated to the credit risk of the issuer.

Interested parties agree with NAIC staff that the accounting for such structured notes, where the investor assumes risk of principal loss based on an underlying component unrelated to the credit risk of the issuer, warrants scrutiny given today’s amortized cost treatment currently afforded under SSAP No. 26R. Such scrutiny is also warranted because, unlike US GAAP, embedded derivatives are not bifurcated from the host investment under statutory accounting. Fair value measurement of such securities may be appropriate under statutory accounting.

However, interested parties believe these bonds, where the investor assumes some risk of principal loss based on an underlying component unrelated to the credit risk of the issuer, can be better addressed within SSAP No. 26R. Specifically, by requiring their measurement at fair value, through unrealized gain/loss, similar to 1) an insurer that maintains an Asset Valuation Reserve (AVR), for bonds with an NAIC designation of 6, 2) an insurer that does not maintain an AVR, for bonds with an NAIC designation of 3-6 and 3) mandatory convertible bonds, when fair value is below cost. This achieves the following three objectives:

1) Requires fair value reporting as suggested is appropriate per the exposure draft,
2) Does not require the host bond investment, with an embedded derivative, to be reported under SSAP No. 86 as a derivative, along with its embedded derivative component, and
3) Reduces the likelihood that an insurance company may inadvertently run afoul of certain state investment limitations, that may prohibit insurers from holding speculative derivative instruments. That is, by classifying a whole bond investment, as a derivative, just because the bond investment hosts an embedded derivative component.

Interested parties are supportive of the NAIC staff’s proposed definition of structured notes (i.e., the investor assumes the risk of principal loss unrelated to the credit risk of the issuer) and are supportive of NAIC’s staff’s view that all such structured notes, regardless of maturity, should be recorded at fair value. However, interested parties believe all such structured notes, including those acquired with a remaining maturity of year or less at the time of acquisition, should also be reported at fair value within SSAP No. 26R.

Lastly, interested parties are supportive of the NAIC staff’s proposed exception that would include mortgage-referenced securities within the scope of SSAP No. 43R as such securities are, in substance similar, to other SSAP No. 43R securities and where the credit risk can be assessed by existing methodologies of the NAIC Securities Valuation Office and/or the NAIC Structured Securities Group. However, interested parties would propose one small change (underlined) to the NAIC staff’s proposed changes to paragraph 33 of SSAP No. 43R to ensure consistency with other in substance similar securities:

(For mortgage-referenced securities, an OTTI is considered to have occurred when there has been a delinquency or other credit event in the reference pool of mortgages, such that the entity does not expect to recover the entire amortized cost basis of the security.)

Ref #2018-19: Elimination of Modified Filing Exempt (MFE) - Referral from the Valuation of Securities (E) Task Force

The Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed proposed revisions to eliminate the modified filing exempt (MFE) process in determining the NAIC designation in accordance with the Valuation of Securities (E) Task Force referral. The exposure specifically requested comments on the effective date and transition issues that should be considered. It was noted that this exposure was concurrent with the Valuation of Securities Task Force project and adoption by the Working Group of the exposed revisions will be contingent on the actions of the Valuation of Securities Task Force regarding MFE. With this exposure, NAIC staff was directed to send notice to the Blanks (E) Working Group to allow consideration of the impact to the Annual Statement reporting instructions.

Interested parties are supportive of the Proposal and an effective date as of March 31, 2019, with early application permitted. We understand that any company electing early application would apply this approach to all applicable securities held at December 31, 2018.

Ref #2018-20: Debt Forgiveness between Related Parties

The Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed proposed revisions to SSAP No. 15—Debt and Holding Company Obligation and SSAP No. 25—Affiliates and Other Related Parties to reference existing guidance when there has been
a forgiveness of an amount owed. With exposure, information was requested on the following questions:

- **Exposure Question 1** - Should uncollectibility of an amount loaned or advanced to a parent be considered a dividend, instead of a write-off to income? Is it clear when an amount owed from a parent has been deemed uncollectible instead of when debt has been forgiven?

- **Exposure Question 2** – Should additional guidance for the recording of related party service transactions be captured? NAIC staff is aware of instances in which intercompany service costs have been forgiven and not recorded. Generally, the intercompany transaction (and service cost expense / payable) should be recognized at the onset of the contract. Then, if the amount owed is forgiven, the offset to the payable should be to contributed capital. However, if a company does not record the initial entry, then expense recognition is not shown in the F/S.

Initial Entry for service contract:

- Debit - Service Expense / Credit - Payable

If the payable was forgiven, then the entry would be:

- Debit – Payable / Credit - Contributed Capital

This is intended to ensure both the expense entry and the impact to contributed capital were recognized.

Interested parties note that existing guidance contained within SSAP No. 25 – *Affiliates and Other Related Parties* (SSAP No. 25), and SSAP No. 5R – *Liabilities, Contingencies and Impairment of Assets* (SSAP No. 5R) should be considered in determining the proper accounting treatment for the exposed questions. In addition to the relevant accounting guidance, the exposed questions must also consider specific legal and regulatory requirements related to affiliated company transactions. The comments below are based upon the current guidance contained in SSAP No. 25 and SSAP No. 5, as well as the requirements of the Insurance Holding Company System Regulatory Act (i.e., MDL-440) and the Insurance Holding Company System Model Regulation with Reporting Forms and Instructions (i.e., MDL-450).

**Related Party Loans**

**Exposure Question 1** - Should uncollectibility of an amount loaned or advanced to a parent be considered a dividend, instead of a write-off to income? Is it clear when an amount owed from a parent has been deemed uncollectible instead of when debt has been forgiven?

Interested parties believe the relevant facts and circumstances should be evaluated to determine the appropriate accounting treatment. For example, if the reporting entity has classified this transaction as an admitted asset, the transaction would have required prior regulatory approval,
along with a consideration of the parent’s independent payment ability. The reporting entity would also be required to continuously review the asset for impairment in accordance with both SSAP No. 25 and SSAP No. 5R.

As provided in SSAP No. 25, paragraph 8: “…An affiliate’s ability to pay shall be determined after consideration of the liquid assets or revenues available from external sources (i.e., determination shall not include dividend paying ability of the subsidiary making the loan or advance) which are available to repay the balance and/or maintain the account on a current basis. Evaluation of the collectibility of loans and advances shall be made periodically. If, in accordance with SSAP No. 5R – Liabilities, Contingencies and Impairments of Assets, it is probable that the balance is uncollectible, any uncollectible balance shall be written off and charged to income in the period the determination is made.”

In most instances, the uncollectible determination will be clearly supported by the parent’s financial statements and its ability to pay based upon its liquid assets or revenues from external sources. If the preparer concludes, based upon the application of SSAP No. 5R that the asset is impaired, any uncollectible balance shall be written off and charged to income in the period the determination has been made.

There may be instances where the application of SSAP No. 5R may not be self-evident and the preparer’s determination of the parent’s ability to repay the loan may differ from the domiciliary regulator’s conclusion. These situations may be further complicated by the fact the debtor controls the reporting entity and may conclude there is an impairment rather than a forgiveness of debt. In instances where it may not be clear whether the reporting entity is forgiving the debt, rather than writing off an impaired amount, interested parties recommend that further dialogue with the domiciliary regulator occur to discuss the overall impact of the impairment to the insurance holding company system, and also to determine whether the transaction would be subject to the insurance holding company statutes and regulations. If it is concluded in these situations that the amount due is not impaired, the transaction should be considered either a dividend or a capital contribution.

**Transactions Involving Services**

**Exposure Question 2 – Should additional guidance for the recording of related party service transactions be captured?** NAIC staff is aware of instances in which intercompany service costs have been forgiven and not recorded. Generally, the intercompany transaction (and service cost expense / payable) should be recognized at the onset of the contract. Then, if the amount owed is forgiven, the offset to the payable should be to contributed capital. However, if a company does not record the initial entry, then expense recognition is not shown in the F/S.

**Initial Entry for service contract:**

*Debit - Service Expense / Credit - Payable*

*If the payable was forgiven, then the entry would be:*
This is intended to ensure both the expense entry and the impact to contributed capital were recognized.

Interested parties recommend that no additional guidance is required, as the current guidance included in SSAP No. 25, paragraph 18 explicitly provides that transactions involving services provided between related parties shall be recorded at the amount charged. This guidance does not support the fact pattern outlined in the exposed question where a company does not record the initial expense.

The failure to record the expense associated with the affiliated services is further emphasized in SSAP No. 25, where regulatory scrutiny of related party transactions which do not meet the fair and reasonable standard established by Appendix A-440 may result in (a) amounts charged being re-characterized as dividends or capital contributions, (b) transactions being reversed, (c) receivable balances being nonadmitted, or (d) other regulatory action.

As affiliated service agreements either require prior regulatory approval, or are subject to the insurance department’s oversight through financial analysis or financial examination, the insurance regulator has the regulatory authority to determine if the requirements of SSAP No. 25 and the respective service agreements are being followed. In the event that a reporting entity is not following the proper recording of expenses, the current guidance would re-characterize the amounts as a dividend or as a capital contribution.

Ref #2018-21: SSAP No. 72 Distributions

The Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed proposed revisions to SSAP No. 72—Surplus and Quasi-Reorganizations to incorporate accounting guidance for when a reporting entity provides a distribution that represents a return of capital.

The regulatory approval requirement is problematic because it conflicts with holding company laws and regulations on distributions, and it is not appropriate for the NAIC Accounting Practices and Procedures Manual to override these laws and regulations. If a company has the capacity to pay an ordinary dividend, where no regulatory approval is required, they can either pay as a dividend or return of capital. The decision of whether it’s legally a return of capital (and for tax purposes) is generally made by the board of directors when they approve the distribution. If the board approves the distribution as a return of capital and an insurer has ordinary dividend capacity, this proposed accounting requirement would require regulatory approval whereas the state laws/regulations do not.

If there are concerns or issues with the capital treatment of an ordinary dividend, we recommend that such issues be addressed through the applicable state laws and regulations. As an alternative to the proposal, SSAP No. 72 could be modified to state that the accounting treatment should follow the approach as approved by the board of directors, or if no classification was specified,
the distribution should be recorded as a dividend to the extent unassigned surplus is positive, with any remaining distribution treated as a return of capital once unassigned funds is reduced to zero. The disclosures could be modified to require identification of the accounting characterization of any distribution as a dividend or return of capital as follows:

“Reporting entities shall receive domiciliary state approval before providing a return of capital to a parent or other stockholder. Distributions that reflect a return of capital shall be charged directly to the gross paid in and contributed surplus. (A return of capital will reduce the adjusted cost basis of the parent/stockholder in the reporting entity.)”

Ref #2018-22: Participation Agreement in a Mortgage Loan

The Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed proposed revisions to SSAP No. 37—Mortgage Loans to clarify that a mortgage loan acquired through a mortgage loan participation agreement is limited to a single mortgage loan agreement with a sole borrower.

Interested parties understand from the “Description of Issue” of the Form A that the proposed revisions are intended to prohibit loans secured by “pools of mortgages” and “loan funds” from being accounted for as mortgage loans under SSAP No. 37. However, there are situations where a mortgage loan has multiple borrowers that are related parties to one another for operational ease and for additional security. There could also be instances where there is more than one borrower as in the case with “Tenant-in-Common” loans where the borrowers are jointly and severally liable as borrowers under one loan. Interested Parties do not believe that it is necessary to specify that a mortgage loan is to a “sole borrower” to preclude pools of mortgages and loan funds from being accounted for as a mortgage loan under SSAP No. 37. In fact, SSAP 37 already specifies that investments in mortgage loan funds are not within the scope of SSAP 37 per paragraph 2. Interested parties recommend that the proposed revisions strike the reference to a “sole borrower” and clarify that the mortgage loan agreement may include “one or more borrowers”. This will preserve the situation where related party borrowers on a loan agreement secured by multiple mortgaged real estate properties can appropriately be accounted for as a real estate mortgage loan as well as other situations where there is more than one borrower named in the loan agreement as could be typical for specific types of mortgage loans.

Also, after re-reading footnotes “a” and “b” in SSAP 37, interested parties would like to suggest some wording changes to both paragraphs to better clarify the distinction between co-lending agreements and participation agreements. We offer proposed edits, which we have tracked below from the SSAP No. 37 version currently in the Accounting Practices and Procedures Manual.

Proposed Wording Changes to SSAP 37

---

1 Tenancy-in-Common relates to a property’s joint ownership by two or more unrelated or related bodies in equal or unequal shares.
a. Reporting entity is a “co-lender” participant in a single mortgage loan agreement that identifies more than one lender (which includes the reporting entity) providing funds to one or more sole borrowers with the real estate collateral securing all lenders identified in the agreement. For these mortgage loan agreements, each lender is incorporated directly into the loan documents. The key differentiating characteristic of a mortgage loan provided under a group “mortgage loan participation agreement” rather than a solely-owned mortgage loan is that no one lender of the lending group may unilaterally foreclose on the mortgage. With these agreements, the lenders must foreclose on the mortgage loan as a group.

b. Reporting entity has a “participation agreement” to invest in a mortgage loan issued by another entity. The mortgage loan may have one or more borrowers. Although the reporting entity is not named on the original mortgage loan agreement, the original issuer sells a portion of the mortgage loan to an incoming participant lender ("participant") co-lender and the sale is documented by an assignment of a participation interest or participation agreement between the selling lender and the participant co-lender. With these agreements, the participant co-lender acquires an undivided participation interest in the mortgage loan and will receive direct interest in the amount of their participation in the rights related to repayment of the loan based on its pro-rata share of the loan and the collateral given to secure the loan. The financial rights and obligations of the participants lenders in these agreements shall be similar to those in a direct loan.

Ref #2018-23: SSAP No. 68 Mergers

The Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed proposed revisions to SSAP No. 68—Business Combinations and Goodwill to clarify that a scenario in which the stock ownership of an owned entity is cancelled, with the parent entity incorporating the assets and liabilities of the owned entity directly on their financial statements, is a statutory merger.

Interested parties are supportive of the changes.

Ref #2018-24EP, Editorial and Maintenance Update

The Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed editorial maintenance revisions.

Interested parties have no comments.

Ref #2018-25: ASU 2018-01, Leases – Land Easement Practical Expedient for transition to Topic 842

The Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to reject ASU 2018-01, Leases—Land Easement Practical Expedient for Transition to Topic 842 in SSAP No. 22—Leases for statutory accounting. It was noted that the
rejection of ASU 2018-01 would also be identified in the substantively revised SSAP No. 22 that is being developed in response to *ASU 2016-02, Leases*.

Interested parties support the proposed rejection of ASU 2018-01.

**Ref #2018-26: SCA Loss Tracking – Accounting Guidance**

The Working Group exposed proposed revisions to *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities* (SSAP No. 97) to clarify the accounting guidance for SCA losses that result in zero or negative equity in an SCA. Agenda item 2018-09 - SCA Loss Tracking added disclosure guidance for SCA losses that result in zero, or negative, equity in an SCA. When reviewing that agenda item, it was identified that there could be uncertainty on the existing provisions that require a negative SCA reporting amount (rather than a zero reporting value). The intent of this agenda item is to clarify the instances that require a negative SCA value and ensure the accounting guidance in SSAP No. 97 for these instances is clear.

Interested parties do not agree with the proposed revisions to SSAP No. 97 paragraph 13e. With respect to proposed subparagraph i of paragraph 13e, adjustments pursuant to SSAP No. 97 paragraph 9 (the “limited statutory adjustments”) have nothing to do with SCA operational losses that drive a negative equity value. As such, any negative equity reported as a result of the paragraph 9 limited statutory adjustments would not be responsive to the new SSAP No. 97 paragraph 34 SCA loss tracking disclosure.

With respect to the proposed subparagraph ii of paragraph 13e, the proposed revisions include similar language to the original Agenda item 2018-09 exposure. As such, interested parties have significant concerns with respect to this proposed subparagraph and we reiterate our previous comments on the same issue (from Agenda item 2018-09) that is now included in the current exposure:

Interested parties believe this proposed guidance would erroneously understate the reporting entity’s surplus by double-counting the impact of the parent insurer’s guarantee or commitment of the SCA’s obligations. For example, assume a parent insurer has a guarantee to pay a fee to a third party if the SCA’s equity drops below zero, and no other commitment related to the SCA entity. Assume at year end that the SCA’s equity is negative $100,000 thousand and the parent insurer owes the third party $20,000 under the terms of the guarantee. Under current guidance, the parent insurer would carry its SCA investment at $0 and record a liability of $20,000 under the guarantee. The $20,000 liability represents the extent of the parent insurer’s obligation and exposure to loss related to the SCA. Under the proposed guidance, the parent insurer would record the $20,000 guarantee liability as well as a liability (in the form of a contra-asset) of $100,000, the latter of which is not an obligation of the parent insurer.

**Ref #2018-27: SSAP No. 48 Entities – Loss Tracking**

The Working Group exposed proposed revisions to *SSAP No. 48—Joint Ventures, Partnerships*
and Limited Liability Companies (SSAP No. 48) to add accounting guidance and disclosures when a reporting entity’s investment in a SSAP No. 48 entity is in a loss position due to the SSAP No. 48 entity’s losses resulting in zero or negative equity in the entity. Agenda item 2018-09 - SCA Loss Tracking added disclosure guidance in SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities (SSAP No. 97) for SCA losses that result in zero or negative equity in an SCA, with the addition of a disclosure to track the losses. When reviewing that agenda item, it was identified that there could be uncertainty about the reporting and accounting guidance for SSAP No. 48 entities in a loss position. The intent of this agenda item is to request comments on the applicability of the loss tracking provisions and disclosure for SSAP No. 48 entities.

Interested parties note that the proposed changes to paragraph 6 of SSAP No. 48 only apply to investments in SSAP No. 48 entities of more than a minor ownership interest. Such SSAP No. 48 entities are subject to the equity method accounting requirements of SSAP No. 97, including the requirements of SSAP No. 97 paragraph 13e (regarding a reporting entity’s share of losses exceeding the carrying value). Therefore, the proposed additions to paragraph 6 of SSAP No. 48 are not necessary. Notwithstanding this point, interested parties also note that, with respect to the proposed subparagraph “a” of paragraph 6 of SSAP No. 48, the proposed revisions to SSAP No. 48 include similar language to the original Agenda item 2018-09 exposure. Interested parties have significant concerns with respect to this proposed subparagraph and we reiterate our previous comments on the same issue (from Agenda item 2018-09) that is now included in the current exposure:

With respect to the proposed subparagraph “a” of paragraph 6 of SSAP No. 48, interested parties believe this proposed guidance would erroneously understate the reporting entity’s surplus by double-counting the impact of the parent insurer’s guarantee or commitment of the investee’s obligations. For example, assume a reporting entity has a guarantee to pay a fee to a third party if the investee’s equity drops below zero, and no other commitment related to the reporting entity. Assume at year end that the investee’s equity is negative $100,000 thousand and the reporting entity owes the third party $20,000 under the terms of the guarantee. Under current guidance, the reporting entity would carry its investment at $0 and record a liability of $20,000 under the guarantee. The $20,000 liability represents the extent of the reporting entity’s obligation and exposure to loss related to the investee. Under the proposed guidance, the reporting entity would record the $20,000 guarantee liability as well as a liability (in the form of a contra-asset) of $100,000, the latter of which is not an obligation of the reporting entity.

Because the SSAP No. 48 entities in question are subject to the equity method accounting requirements of SSAP No. 97, interested parties do not believe the proposed disclosure additions to paragraph 20 of SSAP No. 48 are necessary, especially the new proposed disclosure paragraph “20d” of SSAP No. 48. It appears this proposed disclosure is meant to replicate the SSAP No. 97 paragraph 34 disclosure. Interested parties note that the SSAP No. 97 paragraph 34 disclosure was meant to capture information related to the limited number of SSAP No. 97 noninsurance entities, primarily in response to questions that arose regarding the completeness and timeliness of SCA filings with the SVO. Detailed information about all SSAP No. 48 entities is already
included in Schedule BA and no such SVO filings are required for SSAP No. 48 entities. These newly proposed disclosures would be excessive and duplicative.

Instead, interested parties suggest that the new paragraph 34.a of SSAP No. 97 be repurposed as a standalone paragraph (i.e., a new paragraph 35) and made applicable to all subsidiary, controlled and affiliated entities, including SSAP No. 48 entities. In addition, in order to make it clear to a reader of SSAP No. 48 that certain SSAP No. 97 disclosures may apply, interested parties recommend the following additional language to paragraph 6 of SSAP No. 48:

“Investments in these ventures, except for joint ventures, partnerships and limited liability companies with a minor ownership interest, shall be reported using an equity method as defined in SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities (SSAP No. 97), paragraphs 8.b.i. through 8.b.iv. A reporting entity whose shares of losses in such an SSAP No. 48 entity exceeds its investment in the SSAP No. 48 entity shall disclose the information required by paragraph 34a SSAP No. 97.”

Ref #2018-28: Life and Annuity Liquidity

The Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to SSAP No. 51—Life Contracts, SSAP No. 52—Deposit-Type Contracts, and SSAP No. 61R—Life, Deposit-Type and Accident and Health Reinsurance, to add life liquidity disclosures and expand the variable annuity liquidity disclosures for year-end 2019.

Interested parties are supportive of the changes.

Ref #2018-29: Consistency Revisions to A-820

The Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to Appendix A-820—Minimum Life and Annuity Reserve Standards, to remove the phrase “good and sufficient reserve” as it is not consistent with the related NAIC Standard Valuation Law Model 820. In addition, the Working Group directed that the Life Actuarial (A) Task Force be notified of the exposure.

Interested parties support the removal of the phrase “good and sufficient reserve” because it is not consistent with the NAIC Standard Valuation Law (Model 820).

* * * *

Thank you for considering interested parties’ comments. We look forward to working with you and the Working Group on this topic. If you have any questions in the interim, please do not hesitate to contact either one of us.

Sincerely,
D. Keith Bell  Rose Albrizio

cc:  Julie Gann, NAIC staff
     Robin Marcotte, NAIC staff
     Interested parties
October 11, 2018

Mr. Dale Bruggeman, Chairman
Statutory Accounting Principles Working Group
National Association of Insurance Commissioners 1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197

Re: Statutory Accounting Principles WG Ref# 2016-03, Special Accounting Treatment for Limited Derivatives

Dear Mr. Bruggeman:

The American Council of Life Insurers (“ACLI”) is writing with respect to the NAIC Statutory Accounting Principles Working Group (“SAPWG”) exposure draft Ref #2016-03, Special Accounting Treatment for Limited Derivatives (“the Exposure Draft”). The Exposure Draft includes a revised SSAP No.108 — Derivatives Hedging Variable Annuity Guarantees (“the SSAP”) detailing proposed accounting guidance for certain derivatives hedging interest rate risk of variable annuity guarantees. We have commented previously on many elements of the Exposure Draft and will therefore limit our comments to remaining open issues.

Comments on Timing and Effective Date

ACLI has stated previously that we support making the proposed guidance effective as soon as possible, because we do not believe the accounting changes need to wait until the work of the Variable Annuity Issues Working Group (VAIWG) related to reserves is complete. The framework for reserve changes was adopted by the NAIC in August and will likely be effective in 2020, with early adoption in 2019 under active consideration. Therefore, we recommend making the effective date January 1, 2020, with early adoption permitted.

Variable annuity reserves will not be fully sensitive to changes in interest rates, even after introduction of the updated framework. Timely adoption and implementation of SSAP 108 will reduce the accounting mismatch and potential negative consequences of a rising interest environment for companies that do

1 The American Council of Life Insurers (ACLI) advocates on behalf of 290 member companies dedicated to providing products and services that promote consumers’ financial and retirement security. 90 million American families depend on our members for life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, dental and vision and other supplemental benefits. ACLI represents member companies in state, federal and international forums for public policy that supports the industry marketplace and the families that rely on life insurers’ products for peace of mind. ACLI members represent 95 percent of industry assets in the United States. Learn more at www.acli.com
not have the special accounting treatment in place. It will also facilitate migration away from existing Permitted Practices.

Comments on Transition

We appreciate the efforts by regulators and NAIC staff to draft the transition language in a way that will help insurers with existing Permitted Practices transition to the new guidance. We believe the intent is that the use of a transition method approved by a domiciliary state regulator would not result in a new Permitted Practice. We suggest adding clarifying language that an approved transition method should not be considered a new Permitted Practice, as long as the insurer is fully compliant with the provisions of the SSAP for new deferrals after implementation.

Other Comments

The following additional comments reflect changes in the reserving guidance being developed by industry and regulators:

Paragraph 6b – We suggest modifying the first sentence as follows: “Actuarial certifications of VM-21 reserves, consistent with VM-21 Valuation Manual requirements”. We believe the actuarial certification requirements could end up in another section of the Valuation Manual and removing this phrase would accommodate this potential change.

Paragraph 13eii and Appendix A: We suggest clarifying with a footnote the result of this calculation (the coverage ratio) should not exceed 100% nor drop below zero.

Paragraph 14: The Standard Scenario will likely be replaced by the Standard Projection. Therefore, we suggest modifying the following statement as follows: “The amortization timeframe shall equal the Macaulay duration of the guarantee benefit cash flows based on the VM-21 Standard Scenario”. As an alternative, a technical correction could be made to the SSAP once the reserving guidance is finalized.

Appendix A: The illustration contains two references to paragraph 14 that should be updated to paragraph 13. The reference to 14.b.1 should be replaced with 13.e.i and (14b.i less 14.b.iii) should be changed to (13.e.i less 13.e.iii).

**

Thank you for considering ACLI’s comments on this exposure. We look forward to continued dialogue on this issue. Please do not hesitate to reach out to us should you have any questions on this submission.

Sincerely,

Mike Monahan
Senior Director, Accounting Policy

cc: Julie Gann, NAIC Statutory Accounting Principles WG Staff
    Robin Marcotte, NAIC Statutory Accounting Principles WG Staff
    Fatima Sediqzad, NAIC Statutory Accounting Principles WG Staff
    Jake Stultz, NAIC Statutory Accounting Principles WG Staff
October 12, 2018

Comments from Connecticut Insurance Department in response to notice sent to the Financial Analysis (E) Working Group regarding the exposure agenda item 2017-28 revisions of SSAP No. 61R—Life and Health Reinsurance

‘We have reviewed SSAP Agenda Item # 2017-28 with respect to the proposed disclosures and updates to Appendix A-791 and SSAP No. 61R. Our primary objective was to provide feedback on whether the enhanced disclosures in SSAP No. 61R would be sufficient to address FAWG’s concern with life reinsurance contracts incorporating risk-limiting features.

We have recently become aware of experience-rated YRT treaties that cede group term life risk with the primary purpose of achieving RBC relief for the cedant. The experience-refund feature is combined with “excessively high” YRT premiums, substantially mitigating and/or all but eliminating risk transfer to the assuming reinsurer.

The existence of these treaties will not be captured by the proposed disclosures to SSAP No. 61R (paragraphs 82-87). We, therefore, propose modifying the end of the second sentence of paragraph 83 to read “… a loss ratio corridor or YRT premiums in excess of amounts collected on the ceded policies.” We do not cite the experience-refund feature, as non-abusive experience refunds are common, accepted and not readily attackable. Further, it is the excessive level of reinsurance premiums that in practice limits the risk transfer and makes the net cost to the cedant (when combined with the experience-refund feature) attractive to the cedant.

We note that the blanket exclusion accorded to YRT reinsurance in Appendix A-791 remains unchanged in the proposed revision, which focuses instead on elaborating on the phrase “certain non-proportional reinsurance”. To address the concern mentioned above, three changes should be considered. Specific to Appendix A-791, we suggest expanding the second sentence of the current language to read “… does not meet the intended definition of YRT if (1) the surplus relief … from the reinsurer, or (2) the YRT premium paid to the reinsurer exceeds the equivalent amount collected by the ceding insurer.” and modifying the third line of the first paragraph to read “significant surplus relief or RBC ratio enhancement”. The third change does not impact Appendix A-791 but instead modifies paragraph 19 of SSAP No. 61R. We would add “2.e.” to the list of objectionable Appendix A-791 paragraphs cited (i.e. … paragraphs 2.b., 2.c., 2.d., 2.e., 2.h., …).”

Jim Jakielo
October 26, 2018

TO: Dale Bruggeman, Chair, Statutory Accounting Principles (E) Working Group

FROM: Steve Kern, Assistant Commissioner, NJDOBI

RE: Risk Limiting Features in Group Life YRT Reinsurance Arrangements and Reduction in RBC Charges

Dear Dale:

We understand that SAPWG is currently reviewing a referral from the Financial Analysis (E) Working Group (FAWG) regarding risk limiting features in reinsurance contracts.

The New Jersey Department of Banking and Insurance (NJDOBI) has recently become aware of a practice for Group Life YRT Reinsurance which may also require interpretive guidance and/or changes to SSAP No. 61R - Life and Health Reinsurance and Appendix A-791 - Life and Health Reinsurance Agreements. We understand there are Group Life YRT Reinsurance arrangements which significantly reduce net amount at risk subject to RRC charges for ceding insurers with limited transfer of risk of the business to the assuming reinsurers. We also understand that the companies are interpreting and treating the reinsurance arrangements as qualifying for reinsurance accounting under statutory accounting (STAT), but not under GAAP.

Features within the treaties that limit the transfer of risk of the business to assuming reinsurers include (but may not be limited to):

1. Ceding insurers may pay reinsurance premium well in excess of the proportionate direct YRT premiums.
2. Ceding insurers may be subject to annual re-pricing by the assuming reinsurers that can be multiple times (3x-4x) of the proportionate direct YRT premiums.
3. The arrangements may employ both a “Loss Carryforward Account” and an “Experience Refund.” Any amounts advanced to the ceding insurer by the reinsurers under the treaties for negative experience will be notionally tracked in an off-balance sheet loss carryforward.
account and credited with interest at rates stipulated in the treaties. Repayment of the outstanding loss carryforward balance occurs upon the generation of subsequent positive experience. Positive experience must be used first to reduce the balance included in the loss carryforward account; any excess positive experience remaining after full payment of the loss carryforward balance (and any associated risk charges owing) will be retained by the ceding insurer. The reinsurance arrangements are automatically renewable on an annual basis. If the ceding insurer cancels, the ceding insurer is obligated to pay any balance in the loss carryforward account.

The STAT analyses apparently hinge on the “transfer of proportionate share of mortality risk” under paragraph 19 of SSAP 61R (which limits the application of A-791 for YRT arrangements) and the overarching criteria of paragraph 17. The parties to the contracts believe that reinsurers do assume a theoretical, ultimate risk of loss under the treaties if everyone was to die in the same year or every group insurance policyholder were to cancel or lapse and there was an outstanding loss carryforward. Absent these events, the reinsurer has little or no risk of loss. However, this position results in a circumstance where SSAP 61R would be less stringent than its GAAP counterpart ASC 944-20. This appears contrary to the intent and approach of statutory accounting.

The impact of these transactions may be tracked within the Annual Statement. Typically, the arrangements are listed on Schedule S – Part 3 – Section 1 (life reinsurance ceded). The reinsured ceded in-force amount is reported on the Exhibit of Life Insurance, Column 9, Line 22 which reduces the total Group Life Amount of Insurance on Column 9, Line 23 (amount of insurance adjusted for reinsurance). The RBC C-2 Charges are based on the Exhibit of Life Insurance, Column 9, Line 23, resulting in the elimination of any risk-based charge for the YRT reinsurance arrangements. As the accounting issues are reviewed, the applicable statutory reporting implications would also need to follow (i.e., treaties subject to deposit accounting should not receive a reduction in RBC.)

Similar in nature to the original FAWG referral, we are concerned that reinsurance contracts with these types of risk-limiting features will continue to mask the true financial performance and position of insurers, as well as the risks they are exposed to. Therefore, we recommend the current Statutory Accounting Principles (E) Working Group work be expanded to take on the above issue.

We look forward to further discussions on this matter.

Sincerely,

Steven P. Kerner Jr.
Assistant Commissioner
New Jersey Department of Banking and Insurance

cc Robin Marcotte, Senior Manager, NAIC